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ONE Gas, Inc. (OGS)

Q1 2016 Earnings Call

CORPORATE PARTICIPANTS

Andrew Ziola*Vice President-Investor Relations & Public Affairs***Curtis L. Dinan***Chief Financial Officer, Treasurer & Senior VP***Pierce H. Norton***President, Chief Executive Officer & Director*

OTHER PARTICIPANTS

Christopher Paul Sighinolfi*Jefferies LLC***Daniel Fidell***U.S. Capital Advisors LLC*

MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by. Good day and welcome to the ONE Gas First Quarter Earnings Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Mr. Andrew Ziola. Please go ahead, sir.

Andrew Ziola*Vice President-Investor Relations & Public Affairs*

Thank you, Paula, and good morning and thank you for joining us for ONE Gas' first quarter 2016 earnings conference call.

This call is being webcast live on the Internet, with a replay made available. After prepared remarks from our speakers, we'd be happy to take your questions. A reminder that statements made during this call that might include ONE Gas expectations or predictions should be considered forward-looking statements and are covered by the Safe Harbor provision of the Securities Acts of 1933 and 1934.

Actual results could differ materially from those projected in any forward-looking statements. For a discussion of factors that could cause actual results to differ, please refer to our SEC filings.

Our first speaker this morning is Curtis Dinan, Senior Vice President, Chief Financial Officer and Treasurer of ONE Gas. Curtis?

Curtis L. Dinan*Chief Financial Officer, Treasurer & Senior VP*

Thanks, Andrew. Good morning, everyone, and thank you for joining us today. Yesterday, the ONE Gas Board of Directors declared a dividend of \$0.35 per share, unchanged from the previous quarter when we increased it to \$0.35 from \$0.30 per share. This dividend is consistent with the company's guidance for 2016 and its expected

5% to 6% dividend payout ratio. As we indicated in our most recent guidance, we expect the average annual dividend increase to be 8% to 10% between 2015 and 2020.

Now onto first quarter results. Net income for the first quarter 2016 was \$64.7 million or \$1.22 per diluted share compared with \$60.4 million or \$1.13 per diluted share for the same period last year.

New rates in Oklahoma and Texas positively impacted results. This includes the approved rate case in Oklahoma this past January and approvals for GRIP and cost of service filings in Texas. Residential customer growth in Oklahoma and Texas also contributed to our results but were offset by lower volumes due to warmer weather in our service territories.

Weather was 18% warmer than the same period last year, with total residential gas sales volumes down 14%. Total volumes delivered were down 9%, but our high percentage of fixed charges and weather normalization mechanisms mitigated the impact, with the warmer weather having less than a 2% impact to net margins.

Operating costs for the first quarter were slightly lower compared with the same period last year. Outside services, IT expenses and fleet-related costs decreased but were mostly offset by higher employee-related costs. Capital expenditures for the first quarter were approximately \$75 million, compared with \$55 million for the same period last year. With the warmer and drier weather this first quarter, we were able to complete more system integrity and construction projects. We still expect capital expenditures to be approximately \$305 million in 2016 with more than 70% targeted towards system integrity and replacement projects.

We ended the first quarter with a total debt-to-capitalization ratio of 39%, and do not anticipate any equity needs in our five-year financial plan. ONE Gas generated operating cash flow before changes in working capital of \$121 million in the first quarter and ended the quarter with approximately \$53 million of cash and cash equivalents, and no borrowings under our \$700-million credit facility.

In the press release, we reaffirmed our net income range of \$127 million to \$137 million, or approximately \$2.40 to \$2.60 per diluted share. At March 31, 2016, our current authorized rate base defined as the rate base established in our latest regulatory proceedings, including full-rate cases and interim rate filings is approximately \$2.7 billion. Considering additional investments in our system and other changes in the components of our rate base that have occurred since those regulatory filings, we project that our rate base in 2016 will average approximately \$2.9 billion with 43% of that being our rate base in Oklahoma, 31% in Kansas, and 21% (sic) [26%] (05:22) in Texas.

And now, I'll turn it over to Pierce Norton, ONE Gas' President and Chief Executive Officer. Pierce?

Pierce H. Norton*President, Chief Executive Officer & Director*

Thanks, Curtis, and good morning, everyone. ONE Gas is solely focused on leading the industry as a safe, dependable provider of natural gas to our customers, an important component of our strategy and while we reinvest in our systems and facilities. As you may have noticed in our press releases, we have quite a bit of regulatory activity to highlight on this call.

So, let me get started with Kansas. Yesterday afternoon, Kansas Gas Service filed a request with the Kansas Corporation Commission or KCC for a total increase in base rates of \$35.4 million, reflecting system investments and operating costs necessary to maintain the safety and reliability of its natural gas system. After considering

recoveries from previous GSRS filings and other adjustments, the impact of 2017 operating income as filed will be approximately \$30 million.

Since the last general rate case, Kansas Gas Service has invested \$230 million in its systems and facilities. This request would increase the average residential customers' natural gas bill by \$4.34 per month. The filing is based on a 10% return on equity and a 55% common equity ratio. For every 25 basis point change to our requested ROE, it would result in a change of approximately \$2.1 million. The filing represents a rate base of \$903 million compared with \$826 million included in the existing base rates plus previously approved GSRS eligible investments.

The company's filing also includes a proposal of a Cost of Service Adjustment or COSA mechanism that would reset rates annually based on a review of the previous year's financial results. The proposed rate mechanism is intended to reduce the need to file four rate cases, thereby saving costs associated with these traditional rate cases.

Since the KCC has 240 days to consider Kansas Gas Service's filing, new rates will be in effect in January 2017.

Now onto Texas. Texas Gas Service reached a unanimous settlement agreement for its Galveston and South Jefferson County service areas for an increase in revenues of \$2.3 million. This filing included a request to consolidate these two service areas into a new Gulf Coast service area. The final approval was received this morning, and new rates will become effective tomorrow.

On March 30, 2016, we filed a rate case requesting an increase in revenues of \$12.8 million for the El Paso, Dell City and Permian service areas. The filing also included a request to consolidate these three service areas into a new West Texas service area. If approved, new rates are expected to be effective October 2016.

We plan to file a rate case in the Central Texas jurisdiction, which includes the City of Austin, on or before June 30, 2016. This filing is also expected to include a proposal to consolidate the South Texas service area with the Central Texas service area.

In the Texas filing I just mentioned, they include the request of consolidation of certain service areas. The intent of consolidation of these service areas is to gain administrative efficiencies that will benefit our regulators, the company and our customers, who will benefit from the lower expenses involved in rate case filings.

Finally, I'd like to close by thanking our employees for what they do every day in delivering natural gas to our customers. The foundation of our company's strategy is having a high-performing workforce, and I appreciate their hard work.

Operator, we're now ready for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And we'll take our first question from Chris Sighinolfi with Jefferies.

Christopher Paul Sighinolfi
Jefferies LLC

Q

Hey. Good morning, Pierce. How are you?

Pierce H. Norton
President, Chief Executive Officer & Director

A

Good morning, Chris. We're just fine.

Christopher Paul Sighinolfi
Jefferies LLC

Q

You touch on it at the tail end of your prepared remarks, but just to clarify. So, the motivation for rebranding or consolidating the Texas jurisdictions into three areas, that's mainly costs savings as it comes to filing future regulatory action?

Pierce H. Norton
President, Chief Executive Officer & Director

A

That's correct.

Christopher Paul Sighinolfi
Jefferies LLC

Q

Okay. Operationally, there'll be no – there's no tangible savings on an operational basis, is that right?

Pierce H. Norton
President, Chief Executive Officer & Director

A

That's correct, Chris. If you remember, we have 10 jurisdictions down there right now, and the one that just got approved, that's consolidated too. So, we'd be down to nine. And so, our strategy is that as we roll through and do rate cases, we continue to look for opportunities to consolidate the different jurisdictions. So, it effectively spreads the operational expenses over a wider area as opposed to just one single jurisdiction the way we have it now. So, the plan is to take a look at our opportunities as we have rate filings.

Christopher Paul Sighinolfi
Jefferies LLC

Q

And then, with regard to the cadence of rate filings, does it change any of your expectations if – consolidating those into fewer jurisdictions, does that change the cadence of how you guys have planned to file in Texas?

Pierce H. Norton
President, Chief Executive Officer & Director

A

No, it does not. It still follows the same regulatory structure, Chris, where we have COSAs and GRIPs. And then, by the rules under those different mechanisms, you come back after a certain period of time to actually file a full-blown rate case. So, that's – the cadence is going to be just the same.

Christopher Paul Sighinolfi

Jefferies LLC

Q

Okay. Perfect. I wanted to touch real quickly just on two of the items you had or Curtis had mentioned, at least, in the release last night. With regard to some of the savings you had mentioned year-on-year, that \$2.5 million in the outside services which included fleet. I was just wondering, how much of that is just due to the fact that gasoline and fuel costs are much lower this year?

Curtis L. Dinan

Chief Financial Officer, Treasurer & Senior VP

A

Certainly, Chris. This is Curtis. Certainly, on the fleet aspect of it, it is lower fuel cost year-over-year. So, some of that – some of our fleet runs on CNG, and we've seen the decrease in gas prices for CNG as well. So, that's the primary part behind the fleet. Some of the other cost savings, candidly, while the weather was warmer, and so we didn't move as many volumes, that also have been freeze up our labor force to do other projects that we might otherwise have to outsource to third parties at different points in time. So, well, it took away some revenues and also saved us some expenses during the quarter.

Christopher Paul Sighinolfi

Jefferies LLC

Q

Okay. So, if we see commodity – Curtis, so if we see commodity prices a year from now higher and normal weather pattern to return, some of these is – it's not hard to imagine, some of this has been reversed?

Curtis L. Dinan

Chief Financial Officer, Treasurer & Senior VP

A

Yeah, we would expect that to be the case.

Christopher Paul Sighinolfi

Jefferies LLC

Q

Okay. And then conversely, when I think about your employee-related expenses, I mean broadly speaking, you guys still have a policy, if I'm not mistaken, of rewarding the employees when you hit a new dollar price on the stock, is that right?

Curtis L. Dinan

Chief Financial Officer, Treasurer & Senior VP

A

That's correct.

Christopher Paul Sighinolfi

Jefferies LLC

Q

So, if I just think about the significant appreciation of stock price in the first quarter versus the year-ago quarter and just multiply out by the number of employees, I can get a sense of how much of that was embedded within this higher employee costs, or is it recorded somewhere else?

Curtis L. Dinan

Chief Financial Officer, Treasurer & Senior VP

A

You're exactly on the right track.

Christopher Paul Sighinolfi

Jefferies LLC

Q

Okay.

Curtis L. Dinan

Chief Financial Officer, Treasurer & Senior VP

A

I think we had nine new dollar highs in the quarter.

Christopher Paul Sighinolfi

Jefferies LLC

Q

That's what I counted, too. And when – just to get a – sorry for the mechanics of it, but do I – am I taking those shares at the prices at which they're closing as well, when I tally up the costs that you're accruing, i.e. last year, you were in the low \$40s. This year, you're in the upper \$50s or \$60 territory, I'm using the actual...

Curtis L. Dinan

Chief Financial Officer, Treasurer & Senior VP

A

Yeah, you're using – you should use the price on the day that it hit that new dollar high.

Christopher Paul Sighinolfi

Jefferies LLC

Q

Perfect. Okay. That's it for me. Thanks again for the added color. Appreciate it.

Curtis L. Dinan

Chief Financial Officer, Treasurer & Senior VP

A

Thanks, Chris.

Pierce H. Norton

President, Chief Executive Officer & Director

A

Thank you, Chris.

Operator: [Operator Instructions] And next we'll go to Dan Fidell with U.S. Capital Advisors.

Daniel Fidell

U.S. Capital Advisors LLC

Q

Good morning, guys.

Pierce H. Norton

President, Chief Executive Officer & Director

A

Good morning, Dan.

**Daniel Fidell**

U.S. Capital Advisors LLC

Just a couple of really quick questions, I think, for me. Just in terms of maybe if you give us an update on where you're at with your IT efforts. I think those were helping to – I guess some of the efficiencies from that work helping to keep costs down. Can you just talk about how it was for the quarter and how you see things progressing through the rest of the year?

**Pierce H. Norton**

President, Chief Executive Officer & Director

Really, there's kind of two pieces to that, Dan. The first part was, as we spun out the company, we stood up all of our IT operations. So, all of that stuff basically got done in the first year, in 2014. Then we turned the efforts of our [ph] active (15:47) resources group over to implementing field enablement-type projects where we put, what we call, top books in our trucks for our system gas, and so that's what we've maintained our assets with. So, that all got rolled out last year and that has all been on schedule. And like we said, I don't have a quantification number for you. But all of that is going toward making us a more efficient operating company, and that will continue.

**Daniel Fidell**

U.S. Capital Advisors LLC

Great. Just a final question for me on the regulatory side is, as you filed here in Kansas, I know you've got a number of positive riders already in place there. Just your thoughts in general on the COSA request. I certainly think it makes sense we see it in many jurisdictions. Can you just kind of update us in terms of where you think regulators are just in general in terms of the concept of a COSA?

**Pierce H. Norton**

President, Chief Executive Officer & Director

Well, we feel like it's time to introduce that concept in Kansas, Dan. As you know, we have the same type of mechanisms. They are called something a little bit differently in Oklahoma, and then we actually do call it a COSA in Texas. We think it's time to talk to the regulators again about the benefits of that because it gets you into systematic filings which are normally lower, [ph] and ask (17:20). So, you have less rate shock to the customers. You also get the benefits of a smaller expense around those filings. And so, we know that something has been done in other states, and some states don't have it still. But we felt like it's time to ask for it in Kansas.

**Daniel Fidell**

U.S. Capital Advisors LLC

Understood. It certainly makes sense. Thanks for the color, and we look forward to seeing you guys at AGA in a few weeks.

**Pierce H. Norton**

President, Chief Executive Officer & Director

Same here, Dan.

Operator: And that does conclude our question-and-answer session. At this time, we'll turn it back to Mr. Ziola for any additional or closing comments.

Andrew Ziola*Vice President-Investor Relations & Public Affairs*

Okay. Well, thank you, everybody, for joining us this morning. Our client period for the second quarter starts when we close our books in early July and extends until we release earnings in late July. We'll provide details on that conference call at a later date.

If you have not done so, I encourage you to visit the Investor Relations page in our website, register for e-mail alerts and view our first quarter 2016 documents. Again, looking forward to seeing many of you at the upcoming AGA financial forum. Have a great rest of your day.

Operator: And that will conclude today's conference. We'd like to thank everyone for their participation. You may now disconnect.

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