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ONE Gas, Inc. (OGS)

Q2 2017 Earnings Call

CORPORATE PARTICIPANTS

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Chief Financial Officer, Treasurer & Senior VP, ONE Gas, Inc.

Pierce H. Norton II
President, Chief Executive Officer & Director, ONE Gas, Inc.

OTHER PARTICIPANTS

Spencer E. Joyce
Analyst, J.J.B. Hilliard, W.L. Lyons LLC

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Sarah Elizabeth Akers
Analyst, Wells Fargo Securities LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good day and welcome to the ONE Gas Second Quarter Earnings Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Mr. Curtis Dinan. Please go ahead, sir.

Curtis L. Dinan
Chief Financial Officer, Treasurer & Senior VP, ONE Gas, Inc.

Good morning and welcome to our second quarter 2017 earnings conference call. This call is being webcast live and a replay will be made available. After our prepared remarks, we would be happy to take your questions. A reminder that statements made during this call 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.

Net income for the second quarter 2017 was $20.6 million, or $0.39 per diluted share, compared with $20.3 million, or $0.38 per diluted share for the same period last year. New rates in Kansas and Texas positively impacted results. This includes the approved rate case in Kansas with rates going into effect this past January and our recent rate cases in the Gulf Coast, West Texas, and Central Texas jurisdictions.

Two of our recent rate cases have not only impacted our revenue requirements in each jurisdiction, but have also impacted the way we recognize revenues. In Kansas, our weather normalization adjustment or WNA is now over a 12-month period compared with the previous five month period of November through March. This new mechanism went into effect April 1 of this year, in periods of warmer weather as we've experienced in 2017, this new mechanism will result in more of our revenue requirement being recognized in April, May, and October of each year and less during the former WNA period of November through March.

In our West Texas service territory, our average fixed monthly charge has decreased, but we now have weather normalization across this entire territory. Because of this we will recognize less revenues during the non-heating months, but we will recognize a higher portion of our revenue requirement in that jurisdiction during the winter heating season due to a higher variable delivery fee coupled with weather normalization.

We expect the combination of these changes to result in more stable and predictable revenues in future periods. Operating costs for the second quarter were $115.2 million compared with $110.4 million for the same period last year, which primarily reflects an increase in employee-related expenses, pipeline maintenance activities, and IT cost.

Year-to-date operating costs were $240.3 million compared with $232.2 million for the same period last year. Capital expenditures for the second quarter were approximately $84.2 million compared with $69.5 million for the same period last year. The increase was due primarily to increased system integrity activities and extending service to new areas.

As described during our first quarter call, the mix of operations and maintenance projects and capital projects was weighted less towards capital projects in the first quarter of 2017 and that continued into the second quarter, although to a lesser extent. The net result has been higher operation and maintenance expenses in the first half of this year but we expect our project mix to shift to be more capital-focused in the second half of 2017.

We still expect full year capital expenditures to reach approximately $350 million, with more than 70% targeted towards system integrity and replacement projects. Last week, the ONE Gas Board of Directors declared a dividend of $0.42 per share, unchanged from the previous quarter. This dividend is consistent with the company's guidance for 2017.

As we have indicated previously, we expect the average annual dividend increase to be 8% to 10% between 2016 and 2021 with a targeted dividend payout ratio of 55% to 65%. Now onto our updated guidance, as announced in the press release, we updated our net income guidance range for 2017 to $155 million to $161 million compared with the previous range of $152 million to $162 million.

Earnings per diluted share is expected to be $2.94 to $3.04 compared with the previously announced range of $2.87 to $3.07. For a line item breakdown, we provided an updated guidance table on the last page in the press release.

At June 30, 2017, our current authorized rate base defined as the rate base established in our latest regulatory proceedings, including full rate cases and interim rate filings was approximately $3 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 2017 will average approximately $3.1 billion with 41% of that being our rate base in Oklahoma, 32% in Kansas, and 27% in Texas.

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

Pierce H. Norton II

President, Chief Executive Officer & Director, ONE Gas, Inc.

Thanks, Curtis, and good morning, everyone. I'll start with a brief regulatory update and then wrap up with a few comments on the updated guidance. Beginning with Texas, in June we filed a rate case requesting an increase in revenues of $4.5 million for our Rio Grande Valley service area. If approved, new rates are expected to be effective by the middle of the fourth quarter of 2017.

The filing of this rate case in the Rio Grande Valley was the last material jurisdiction where we have not filed for a full rate case since the spinoff. In March, we made a filing under the Gas Reliability Infrastructure Program or GRIP for customers of the consolidated Central Texas service area for $4.9 million.

The request was approved by the cities and the Railroad Commission of Texas and new rates became effective in June of 2017. In the West Texas service area, we also filed a GRIP for $4.5 million. The RRC and the cities have approved an increase of $4.3 million and new rates became effective in July of 2017

Moving on to Oklahoma, we filed our first annual performance-based rate, or PBR, after the general rate case that was approved in January 2016. The filing demonstrated that we were earning within the allowed range of a 9.0% to 10.0% ROE, therefore, we did not request a change in base rates. And in Kansas, we are expecting to file a request for interim rate relief under the Gas System Reliability Surcharge rider during the third quarter with new rates effective January 2018.

Our regulatory activity during 2017 has not been as active compared with the past two years, when approximately 95% of our rate base completed full rate case reviews, and resulted in our margin increases in 2016 and 2017. We'll continue to invest in our systems and seek recovery through interim filings and full rate cases as warranted, but as we have previously described with less rate case activity in 2017, we do not anticipate a large impact from new rates over the next 18 months.

Our focus during this period will be to control cost and execute on our capital spending programs leading up to our next round of rate cases. Now I'd like to share my thoughts related to our updated 2017 guidance. I'm pleased to be able to narrow our guidance based on the stability that we continue to see in the business with seven months of the year behind us and more clarity into 2017 as a whole. The recent tariff changes in Kansas and West Texas that Curtis highlighted are expected to provide further stability and predictability to our revenues and net margin.

As always, I'd like to close by thanking our 3400 employees for what they do every day for customers. I appreciate their hard work, dedication, and commitment to delivering our product, natural gas, to more than 2.2 million customers, safely and reliably.

Operator, we are now ready for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from Spencer Joyce with Hilliard Lyons. Your line is open.

Spencer E. Joyce
Analyst, J.J.B. Hilliard, W.L. Lyons LLC

Q

Curtis, Pierce, good morning.

Pierce H. Norton II
President, Chief Executive Officer & Director, ONE Gas, Inc.

A

Hey good morning, Spencer.

Spencer E. Joyce
Analyst, J.J.B. Hilliard, W.L. Lyons LLC

Q

Hey thanks for taking the call. Listen, pretty good and clean quarter here, so just one kind of housekeeping item for me on the regulatory side. I know you all mentioned pretty diligently executing the capital plan in front of the next round of general rate cases and I know statutorily, in Oklahoma we could get kind of out 2020, maybe 2021 before we have to see a filing there, but my question is how soon might we know if we need to see something before that. How much lead time might we get before that actual filing?

Curtis L. Dinan
Chief Financial Officer, Treasurer & Senior VP, ONE Gas, Inc.

A

Well, what we'll do, Spencer, is we'll do our PBR filings every single year, so when those run out we'll do the regular filing. We typically don't signal a lot of time in front of a major rate case, we just do that intentionally. So you probably won't get a large lead time as to when our next rate case will be, but we'll run through all the PBRs which like you said on our timeline it's in those years that you're talking about there. So that's the way I'd answer that one.

Spencer E. Joyce
Analyst, J.J.B. Hilliard, W.L. Lyons LLC

Q

And I guess just kind of a follow-up. The PBRC I know is a pretty efficient mechanism. Are there any items that you're not allowed to kind of true-up or recover there that we really do have to wait till the GRC or is it really all-encompassing, just refresh me there?

Pierce H. Norton II
President, Chief Executive Officer & Director, ONE Gas, Inc.

A

It's all encompassing. The only thing that we don't do in the yearly PBR filings is we don't renegotiate the ROE or the cap structure. So everything else is included in that.

Spencer E. Joyce
Analyst, J.J.B. Hilliard, W.L. Lyons LLC

Q

Okay. Perfect. Yeah, that's what I was looking for, just a refresher there. See, almost no need to file a rate case before its absolutely necessary with so much captured by the PBRC. That's all I had. Thanks, guys.

Pierce H. Norton II
President, Chief Executive Officer & Director, ONE Gas, Inc.

A

All right. Thanks, Spencer.

Operator: Our next question comes from Chris Sighinolfi with Jefferies. Your line is open.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Hey, Good morning, Pierce.

Pierce H. Norton II
President, Chief Executive Officer & Director, ONE Gas, Inc.

A

Good morning, Chris.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

A question for you – Curtis, I appreciate the color on the weather normalization adjustment change we saw that in the 10-Q. Just curious if we could have a little bit more maybe clarity on the shift to the shoulder season in terms of a recovery on warmer than normal conditions. Is there a sort of rough rule of thumb as to how we could think about maybe that that shift from the winter months to the shoulder months? Is that just prorated over the period? Is it done on a month-by-month basis, is there any lag in the calculation? If you could remind us of that, that would be helpful.

Pierce H. Norton II
President, Chief Executive Officer & Director, ONE Gas, Inc.

A

So Chris, it's a complicated question and a complicated answer.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay.

Pierce H. Norton II
President, Chief Executive Officer & Director, ONE Gas, Inc.

A

Broadly the way to think about it is you have so many heating degree days and those yield X amount of volumes being used. And so in the past those heating degree days were allocated to that November to March timeframe, but now they're spread out over the full 12 month period. It's not really a prorated equal amount in each of the 12 months because it still follows what a normal "normal weather pattern" would be in those territories.

So it would still be weighted more towards November through March, but we do get heating degree days especially in Kansas in that April, May, and October timeframes, they're shoulder months and they're not as big as what we see in those other five months that were part of the old WNA period but there is still some allocated to that period.

What we saw in this quarter was then while it was warmer than normal we collected additional revenues. It was warmer than normal last year but we didn't have WNA in the second quarter of 2016, so that's what led to a little bit of that uptick.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. And I guess related to this quarter one of the things that I noticed in last night's numbers, I looked at sort of the net margin like your revenues versus stripping off your cost of gas. It was a compression year-on-year in that relationship. I was just curious if there was something about the gas cost component that occurred that was acute in 2Q that we should pay attention to or if it was just maybe a misassumption on our part?

Pierce H. Norton II
President, Chief Executive Officer & Director, ONE Gas, Inc.

A

So a couple of things, one, our cost of gas on a per unit basis is higher in the second quarter of this year compared to a year ago, and by gas cost, it's not only the cost of the gas but it's transport and storage and any hedging costs related to that. So that was higher. But at the net margin line it doesn't have an impact because those costs get passed through dollar for dollar. If we're paying $4, $5 for the all-in cost of the product, what goes into the revenue line is that same $4 or $5, there's no margin or markup on that. So in a period where maybe you do see like this where the gas cost is a little bit higher, it will be a higher percentage of that revenue line.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. And then, I guess final question from me is when we think about – there was an earlier question on the capital cycle and the rate case cycle, is there anything that you guys are thinking about in terms of maybe stuff that you've contemplated or talked about. I know we've talked about replacement programs that are fairly deep and elongated in terms of their totality that would sort of cause a shift in the time profile. You guys have done a really good job in the last couple of years, as an independent company giving us a rolling five-year look. But I'm just wondering as we think about either state changes, federal changes, or any of this system integrity issues that might cause any acceleration or deceleration of that planned spend, anything [indiscernible] (17:32)?

Pierce H. Norton II
President, Chief Executive Officer & Director, ONE Gas, Inc.

A

Chris, I'll take that question. It's Pierce. We don't see anything currently there, but what could happen is if you got any sort of new rulings that came out of FEMSA or any kind of government type of action that could cause you to move some of that spending around, but right now it's focused on the replacement which we said is about 70% of the overall capital spend and based on the amount of inventory that's left then we've got in excess of 20 more years from this year to continue to spend at these levels.

So, really it's more of an internal focus on not looking at capital spend from year-to-year, but looking at that capital spend in five-year type increments so that we can better prepare and better spend and better set the organization up for what you do capital wise versus the O& M expense.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. Perfect. I guess I lied. I have one additional question, just a follow-up.

Pierce H. Norton II
President, Chief Executive Officer & Director, ONE Gas, Inc.

A

Okay.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Curtis, when we talk about weather and relative to normal I know some of the Eastern utilities have historically been using sort of 30 year NOA data sets and they're talking about condensing that to a 15-year number. And I'm just curious with regard to your service territories, if it's standardized across Kansas, Oklahoma, and Texas or if there's any similar discussion about using maybe a more recent data set. If you could remind me [indiscernible] (19:14)? And maybe what the impact might be if you did do that.

Curtis L. Dinan
Chief Financial Officer, Treasurer & Senior VP, ONE Gas, Inc.

A

Just a good resource that's in our Ks and in our Qs in the back of the MD&A section but just kind of real briefly, Oklahoma is a 10-year weighted average period that gets reset with our PBR filings or with the rate cases related to the PBR filings. Kansas is on a 30-year basis and Texas is a 10-year basis, so each of those are a little bit different. I'm not aware of any discussions going on of changing those are trying to standardize anything around those mechanisms.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. That's really helpful. Thanks again for the time, guys.

Curtis L. Dinan
Chief Financial Officer, Treasurer & Senior VP, ONE Gas, Inc.

A

Thank you, Chris.

Pierce H. Norton II
President, Chief Executive Officer & Director, ONE Gas, Inc.

A

Thanks, Chris.

Operator: Our next question comes from Sarah Akers with Wells Fargo. Your line is open.

Sarah Elizabeth Akers
Analyst, Wells Fargo Securities LLC

Q

Hey, good morning.

Pierce H. Norton II
President, Chief Executive Officer & Director, ONE Gas, Inc.

A

Good morning, Sarah.

Sarah Elizabeth Akers
Analyst, Wells Fargo Securities LLC

Q

What was your customer growth rate in the quarter and then any notable trends in terms of sales growth by customer class or sector and any reason to expect any acceleration there?

Pierce H. Norton II
President, Chief Executive Officer & Director, ONE Gas, Inc.

A

Our customer growth rate, Sarah, was about 0.7%, we kind of hang in there at about that 0.6%, 0.7% range overall. We still see quite bit of growth in the Austin and the El Paso area. It's kind of leading the charge there with the secondary being in Tulsa in Oklahoma and Kansas being relatively at maybe about 0.3%.

Sarah Elizabeth Akers
Analyst, Wells Fargo Securities LLC

Q

Got it. And then, on the O&M side what level of increases are you expecting over the next few years and specifically can you keep that O&M kind of in line with customer growth or are you seeing any pressures that would push it above?

Pierce H. Norton II
President, Chief Executive Officer & Director, ONE Gas, Inc.

A

Well, it really kind of goes to what we were saying before, Sarah, which is when you take a look at your capital being five years and the level of spend that we expect to have, then the organization gets set up to run this business in that way as opposed to kind of a year-to-year type of a deal. So, we expect to set it up to have that capital focus in the year. We guided in the past to not material increases in O&M every year but we do have different pieces and parts that move around. We do give employees pay increases, those kind of things. A little bit hard to predict in this particular environment exactly where some of the healthcare stuff is going to go, so that's another thing that's a variable in the expense piece. But if that combination of O&M capital, overtime, those kind of things that go into running the business based on what your demands are from an O&M standpoint and a capital standpoint, but we do expect going forward as we've talked about in this call that there is going to be some shifting of the O&M kind of focused to the capital side.

Sarah Elizabeth Akers
Analyst, Wells Fargo Securities LLC

Q

Got it. And then lastly, just a question on Oklahoma regulation, I know there was some legislation to restructure the Commission and that didn't ultimately pass but then the Governor was pushing some measures towards kind of a more efficient commission. Can you just give us an update on any state-wide initiatives or any expected changes there?

Pierce H. Norton II
President, Chief Executive Officer & Director, ONE Gas, Inc.

A

Actually the update is what you just gave us, Sarah, which is the governor's got this kind of commission that is starting to get to be formed and we'll just have to see where that goes, frankly.

Sarah Elizabeth Akers
Analyst, Wells Fargo Securities LLC

Q

Got it. Thanks a lot.

Pierce H. Norton II
President, Chief Executive Officer & Director, ONE Gas, Inc.

A

Thank you, Sarah.

Operator: [Operator Instructions] And there are no further questions. I'll now turn the call back to Mr. Curtis Dinan for closing remarks.

Curtis L. Dinan

Chief Financial Officer, Treasurer & Senior VP, ONE Gas, Inc.

Thank you for joining us this morning. Our quiet period for the third quarter starts when we close our books in early October and extends until we release earnings in late October. We'll provide details on the conference call at a later date. If you have not done so, I encourage you to visit the Investor Relations page on our website, register for e-mail alerts, and view our second quarter 2017 documents. Have a great rest of your day.

Operator: That concludes today's conference. Thank you for your participation. You may now disconnect.