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ONE Gas, Inc. (OGS)

Q2 2019 Earnings Call

CORPORATE PARTICIPANTS

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Robert S. McAnnally
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OTHER PARTICIPANTS

Christopher Paul Sighinolfi
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Aga Zmigrodzka
Analyst, UBS 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. Brandon Lohse. Please go ahead, sir.

Brandon Lohse
Director-Investor Relations, ONE Gas, Inc.

Good morning, and thank you for joining us on our second quarter 2019 Earnings Conference Call. This call is being webcast live and a replay will be made available later today. After our prepared remarks, we will 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.

Joining us on the call this morning are Caron Lawhorn, Senior Vice President and Chief Financial Officer; Curtis Dinan, Senior Vice President, Commercial; Sid McAnnally, Senior Vice President, Operations; and Pierce Norton, President and Chief Executive Officer.

And now, I'll turn the call over to Caron.

Caron A. Lawhorn

Senior Vice President & Chief Financial Officer, ONE Gas, Inc.

Thanks, Brandon. Good morning, everyone, and thank you for joining us today. Net income for second quarter 2019 was \$24.5 million or \$0.46 per diluted share, compared with \$20.4 million or \$0.39 per diluted share for the same period last year.

Our second quarter results reflect new rates and lower sales volumes, net of weather normalization in Kansas and residential customer growth in Oklahoma and Texas. Operating costs for the second quarter were \$116.1 million, compared with \$117.6 million in the same period last year, primarily due to a decrease in employee-related costs. Offsetting part of the increase is the return on employee benefit plan assets which is included below the line in other income and expense. As you will recall, in November of 2018, we refinanced \$300 million of maturing Senior Notes with \$400 million of Senior Notes at a slightly higher interest rate resulting in higher interest expense this year.

In Oklahoma and Kansas, we are returning excess accumulated deferred income taxes to our customers, which is reflected as a reduction of revenues. Income tax expense includes the amortization of the associated regulatory liability which was \$2.1 million for the second quarter. Cash provided by operating activities was approximately \$240 million through June of 2019. As we previously indicated, our 2019 cash flows continue to be impacted by tax reform.

In February, base rates in Oklahoma were lowered by \$11.3 million, and in Kansas, we refunded \$16.6 million for the over-collection of taxes. In the third quarter of this year, we expect to begin crediting customers in Oklahoma \$15.6 million over a 12-month period for the 2019 PBRC filing. With these adjustments, we will have worked through the impact of tax reform on base rates in all jurisdictions.

Earlier this month, the ONE Gas board of directors declared a dividend of \$0.50 per share, the same as the previous quarter. This dividend is consistent with the company's guidance for 2019. As we had indicated previously, we expect the average annual dividend increase to be 7% to 9% between 2018 and 2023 with a targeted dividend payout ratio of 55% to 65% of net income.

We updated our 2019 earnings per share guidance on a diluted share basis to a range of \$3.39 to \$3.57 compared with the previously announced range of \$3.27 to \$3.57, the new midpoint of \$3.48, up from \$3.42. Our updated guidance reflects positive impacts from new rate and cooler weather in the first quarter, partially offset by higher operations and maintenance expenses. Capital expenditures are expected to remain approximately \$450 million for the year.

Authorized rate base reflecting the recently completed regulatory activity in Central Texas is approximately \$3.38 billion as of June 30. Authorized rate base is defined as the rate base reflected in completed regulatory proceedings, including full rate cases and interim rate filings.

We project that for 2019, our estimated average rate base, which is defined as authorized rate base plus additional investment in our system and other changes in the components of our rate base that are not yet reflected in the approved regulatory filings, will be approximately \$3.61 billion, with 42% in Oklahoma, 29% in Kansas and 29% in Texas. ONE Gas ended the quarter with approximately \$406 million of capacity under our commercial paper program, and we still do not anticipate any equity or capital market needs in 2019.

And now, I'll turn it over to Curtis Dinan for regulatory update. Curtis?

Curtis L. Dinan

Senior Vice President-Commercial, ONE Gas, Inc.

Thanks, Caron, and good morning, everyone. Let's begin in Oklahoma. In June, a settlement was reached and a stipulation was filed in Oklahoma Natural Gas' performance-based rate change filing or PBRC. This stipulation includes a \$15.6 million PBRC credit to be returned to customers over a 12-month period. This credit represents all earnings, including amounts attributable to tax savings that were above the authorized ROE of 9.5% for 2018. The second credit is \$12.7 million associated with excess ADIT. An order from the Oklahoma Corporation Commission is expected in the third quarter. If approved, the provisions of the joint stipulation will not have a significant impact on 2019 earnings. We will have one more PBRC filing in 2020 before a full rate case is required to be filed in 2021.

Moving on to Texas. In March, Texas Gas Service made Gas Reliability Infrastructure Program or GRIP filings for all customers in the Central Texas and the West Texas service areas. The Railroad Commission and the cities in both service areas agreed to increases of \$5.5 million and \$4.1 million, respectively. New rates in Central Texas became effective in June and new rates in West Texas became effective in July. And in Kansas, we plan to file our next Gas System Reliability Surcharge or GSRS in August for the period covering September 2018 through June 2019. As a reminder, this will be our first filing under new legislation that expands the scope of expenditures that are eligible for recovery under GSRS and increases the cap on the monthly residential surcharge.

And now, I'll turn it over to our CEO, Pierce Norton. Pierce?

Pierce H. Norton II

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

Thanks, Curtis. As Caron noted, we have updated our guidance for 2019 where we raised the midpoint of our earnings per share to \$3.48 from \$3.42. This update which includes increases in net margin and operating expenses recognizes our overall performance to-date and is reflective of our estimates for the remainder of the year. Included in this updated guidance is an increase in the annual operating expenses of \$12 million, which is primarily due to projected annual employee-related cost and to a lesser extent outside services. Employee-related cost include our employee incentive program that is based on financial and operating targets that when met benefit and align in the best interest of all stakeholders, the customer, the employee, the bondholder and the equity holder.

We take tremendous pride in delivering an energy source, natural gas, that provides reliable, affordable comfort conveniently to our 2.2 million customers year around. We remain focused on operating safely and managing our expenses as part of our efforts to maintain a competitive advantage over other energy alternatives. It takes every one of our 3,600 employees working together to accomplish our goals. These employees exemplify a culture driven by our core values as they go about their work every day, and I am thankful for their efforts.

Thank you for joining us this morning. Now, operator, we are now ready for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question will come from Chris Sighinolfi with Jefferies.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Hey. Good morning, everyone. Thanks for the time.

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

A

Good morning, Chris.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Hey, Pierce. How are you?

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

A

Good. How are you?

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

I'm doing well. Thanks. I had a couple cleanup questions if I could. I think they're both for Caron. With regard to the OCC order you're expecting here this quarter and the fact that I guess one of the provisions gets amortized in over a 12-month period, should we look at sort of the clean operating cash performance of business net of all of the Tax Cuts and Jobs Act impacts really commencing in the second half of next year then, that's where the first period where you can look at everything that would have been trued up for the impacts of that being fully recognized in?

Curtis L. Dinan
Senior Vice President-Commercial, ONE Gas, Inc.

A

Hey, Chris. This is Curtis. And I think that is the right way to look at it, because we've already – recall last year, everything became reflected in rates in Texas. Earlier this year, we had the approval from the rate case in Kansas. And then, what we're anticipating sometime in the third quarter would be the approval from the OCC for Oklahoma Natural Gas' PBRC filing, and once that starts, then 12 months later, I think we'd be into a normal cadence at that point.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. Because we've – obviously we've noticed Curtis the earnings impacts have been as predicted, but obviously cash has been lumpy because of those impacts. I also noticed some fairly significant working capital fluctuations from year to year. It seems like with gas prices low and with the heating degree days this last quarter lower than they were last year, presumably, the draws that you would normally see as we enter the winter season might be smaller all else equal coming up this fall. So we might see just some more fluctuations. I'm just trying to,

I guess, calibrate our model for what the environment looks like and then also these tax impacts. So is that the right way you would think about the environment now on maybe uses of cash going into the year end given where the commodity price environment is?

Curtis L. Dinan

Senior Vice President-Commercial, ONE Gas, Inc.

A

Yeah, Chris, let me take the piece of that coming out of the rate cases and Caron can probably speak more to the working capital pieces of it. But you're absolutely right, there were the initial refunds that were happening once we got through the rate cases or are about to happen in the case of Oklahoma's PBRC credit, that have been lumpy because those have been typically one-time type of adjustments although Oklahoma is all spread out over this 12-month period.

But then there's also the ADIT piece that we're now at a pretty consistent cadence for Kansas and Oklahoma. As we complete these filings, we still have to address the accumulated or the excess accumulated deferred income taxes in Texas, and we will be doing that as we file upcoming rate cases. Again, Caron can probably address better the other working capital components.

Caron A. Lawhorn

Senior Vice President & Chief Financial Officer, ONE Gas, Inc.

A

I think that's fair. And it's kind of interesting if you look back at our cash flow, really the anomaly was first half of last year, our cash flow was relatively consistent. And so other than all this regulatory noise that we're experiencing, I expect us to continue on that path.

Christopher Paul Sighinolfi

Analyst, Jefferies LLC

Q

Okay. Okay, great. And then there was one other item, I think this is coming from past quarters, but I haven't bothered to inquire about it, and it's just with regard to how you characterize the movement in other income. There was some mention of just some of the performance on non-qualified employee benefit plans. There's so many other utility companies [ph] that never (00:13:58) have company on life insurance policies and things of that nature that are invested in, amongst other things, the broad equity market and so fluctuate accordingly.

It sounded like that disclosure would indicate you might have something similar, and I'm just curious if we can get a little bit more color on it and maybe any formal expectation you had for it in the guidance for the year. Did the performance last quarter exceed what you had expected? And is that one of the factors that led to the guidance move for the full year number?

Caron A. Lawhorn

Senior Vice President & Chief Financial Officer, ONE Gas, Inc.

A

So you're correct. And I think what we have is probably not dissimilar to what you described other utilities have in terms of how we deal with our employee benefit plans, and you are correct. So our guidance reflects really a flat market. We don't try to anticipate what the market's going to do and how the employee plans are going to fluctuate. As you know, some of that fluctuation is offset in operating expenses. The movement in those plan assets is offset in operating expenses. So we did anticipate in guidance that some of what we've achieved through the first part of the year would maintain, but then we didn't try to guess what was going to happen for the balance of the year.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. No, that's very helpful.

Caron A. Lawhorn

Senior Vice President & Chief Financial Officer, ONE Gas, Inc.

A

Yes.

Christopher Paul Sighinolfi

Analyst, Jefferies LLC

Q

That's it for me. Thanks a lot, guys. Appreciate the time. Thanks, again.

Pierce H. Norton II

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

A

Thanks, Chris.

Operator: [Operator Instructions] Moving on, we'll go to Aga Zmigrodzka with UBS.

Aga Zmigrodzka

Analyst, UBS Securities LLC

Q

Good morning. How are you?

Pierce H. Norton II

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

A

Good morning, Aga. How are you?

Aga Zmigrodzka

Analyst, UBS Securities LLC

Q

Good. Thank you. So as you discussed in the prepared remarks, O&M guidance was revised higher. Could you please discuss your expectation for O&M growth beyond 2019?

Pierce H. Norton II

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

A

I think what you asked – you broke up a little bit there Aga, but I think you asked to expand a little bit on growth I think, O&M [indiscernible] (00:16:09)...

Aga Zmigrodzka

Analyst, UBS Securities LLC

Q

O&M expenses.

Pierce H. Norton II

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

A

...is that right?

Aga Zmigrodzka

Analyst, UBS Securities LLC

Yeah.

Q

Pierce H. Norton II

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

O&M expenses. Okay. Well, I mean in general, we have guided toward a 2% to 3% increase on an annual basis in our O&M expenses kind of year-over-year. Some years, it will be a little bit more, some years it will be a little bit less. So even with the increase that we've had recently of the \$12 million in the expected guidance this year is still falls within that 3% range as to what we originally projected. So that's kind of right in line – those expenses kind of ebb and flow based on different factors, some of which were in our control and some not. So I'll ask Sid McAnnally, he is on the phone call with us, if he's got anything to expand on that.

A

Robert S. McAnnally

Senior Vice President-Operations, ONE Gas, Inc.

Hi, Aga. As Pierce said we don't expect any major variances, but we are always looking for opportunities to improve processes or efficiencies. And one of the ways we look at that is how we balance work internally and externally. So we may have opportunistic costs that come up when we've got an opportunity to look at longer term stability in the way that we execute the work. We also continue to see opportunities arising from technology increases – efficiencies and technologies.

A

An example of that would be we recently had a mandate from PHMSA to inspect farm taps with a pretty short [ph] views (00:17:42) and rather than outsourcing that work, we provided some additional training to some field techs who had additional capacity because our routing system provided that capacity. And so we were able to in-source that work which supported our internal goals and also provide additional skill sets to our employees going forward.

Aga Zmigrodzka

Analyst, UBS Securities LLC

Thank you for that color. I also have a question regarding 2Q, was ONE Gas impacted by flooding in Oklahoma? Any impact to pace of replacement work?

Q

Robert S. McAnnally

Senior Vice President-Operations, ONE Gas, Inc.

We did have significant flooding in Oklahoma as you point out. And we want to thank the first responders that we worked with. We've got a few folks that are still suffering from the flood and our thoughts go out to them. In terms of the impact on the company, Aga, we did not see any material impact either to our system or our O&M although we did incur what you would expect some additional over time a little bit of capital delay that will pick back up in the second half. So nothing that was material.

A

Aga Zmigrodzka

Analyst, UBS Securities LLC

Thank you.

Q

Operator: [Operator Instructions] And there are no further questions at this time. I'd like to turn it back to Mr. Lohse for any additional or closing comments.

Brandon Lohse

Director-Investor Relations, ONE Gas, Inc.

Thank you all again for your interest in ONE Gas. 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. Have a great rest of your day. Thank you.

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

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