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ONE Gas, Inc. (OGS)

Q3 2015 Earnings Call

CORPORATE PARTICIPANTS

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President, Chief Executive Officer & Director

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Christopher Paul Sighinolfi
Jefferies LLC

Dan M. Fidell
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MANAGEMENT DISCUSSION SECTION

Operator: Good day, and welcome to the ONE Gas Third Quarter 2015 Earnings Conference Call. Today's conference is being recorded. At this time, I'd like to turn the conference over to Mr. Andrew Ziola. Please go ahead, sir.

Andrew Ziola
Vice President-Investor Relations & Public Affairs

Thank you, and welcome to the ONE Gas third quarter 2015 earnings conference call. This call is being webcast live on the Internet, with a replay made available. After our prepared remarks, we'll 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 Pierce Norton, President and Chief Executive Officer. Pierce?

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

Thanks, Andrew. Good morning, everyone, and thank you for joining us. We appreciate your interest and investment in our company. Joining me on the call today is Curtis Dinan, our Chief Financial Officer. On this morning's call, Curtis will review our third quarter 2015 results and updated 2015 guidance. I will then provide a regulatory overview, including an update on our rate case filing in Oklahoma, and then we'll open it up for any questions that anyone has.

Our focus continues to be on maintaining the safety and reliability of our system, so that we can best serve our customers. New rates in the third quarter were a result of those focuses on system integrity and investments. Our strategy is to be 100% regulated, solely focused on leading the industry as a safe, dependable provider of natural gas to our customers. We also are committed to efficiently managing cost and we expect lower total operating expenses in 2015 than originally anticipated which contributed to us updating our 2015 net income guidance range compared with the previous range we announced back in December of 2014.

Curtis will now review the financial results for the quarter and discuss the drivers behind the updated guidance in more detail. Curtis?

Curtis L. Dinan

Chief Financial Officer, Treasurer & Senior VP

Thanks, Pierce, and good morning. First, I'd like to mention that, yesterday the ONE Gas board of directors declared a dividend of $0.30 per share. The dividend level is consistent with the company's guidance for 2015 and its expected 55% to 65% dividend payout ratio.

Now, on to third quarter results. Third quarter net income was $7.4 million, or $0.14 per diluted share, compared with $4.7 million, or $0.09 per diluted share, for the same period last year. As Pierce mentioned, we continue to invest in maintaining the safety and reliability of our systems which led to new rates in Oklahoma and Texas. Decreased operating costs in the third quarter 2015 were driven primarily by information technology expenses that occurred in 2014 associated with our separation from ONEOK. Partially offsetting these items were higher employee-related expenses.

We ended the third quarter with a total debt to capitalization ratio of 40% and do not anticipate any equity needs in our five-year financial plans. ONE Gas generated operating cash flow before changes in working capital, assets, and liabilities of $49 million in the third quarter and ended the quarter with $53 million of cash and cash equivalents and no borrowings under our $700 million credit facility.

At September 30, we had 42 BCF of natural gas in storage; and for the 2015-2016 heating season, we have leased 50 BCF of natural gas storage, a reduction of 2 BCF from last winter. Our average cost of natural gas injections, including transportation and storage costs are estimated to be approximately $3.70 per MCF in 2015, compared with approximately $4.60 per MCF in 2014. Coupled with the lower leased storage capacity, these two factors have a positive impact of approximately $55 million to $60 million on our 2015 projected cash flows.

Now, on to guidance. As Pierce mentioned, we updated our 2015 net income guidance range to $113 million to $118 million, from the previous range of $108 million to $118 million reflecting lower operating cost and lower interest cost partially offset by lower net margin. Our net margin is expected to be slightly lower, less than 1%, due primarily to warmer than normal weather experienced in Kansas in the first half of 2015.

We still expect capital expenditures to be approximately $300 million in 2015, with more than 70% targeted towards system integrity and replacement projects. Compared with last year, we've spent less capital year-to-date primarily due to rainy weather experienced this past May and June that slowed some projects down. We also have some larger growth projects scheduled with completion dates in the fourth quarter.

We expect our earned ROE for 2015 to be 7.4% compared with an ROE of 7.6% for 2014, reflecting capital expenditures of more than two times depreciation and rate case outcomes in Oklahoma and Kansas that we do not expect to be effective until 2016 and 2017, respectively.

At September 30, 2015, 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 $2.4 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 2015 will average approximately $2.7 billion with 42% of that in Oklahoma, 33% in Kansas, and 25% in Texas. And lastly, we anticipate releasing our 2016 guidance and our updated five-year guidance in January.

Pierce, that concludes my remarks.

Pierce H. Norton II

President, Chief Executive Officer & Director

Thanks, Curtis. Now, for a regulatory update. As we mentioned in our last call, Oklahoma Natural Gas filed a request in July for an increase in base rates. Filing is based on a test year consisting of 12 months ended March 31, 2015. Our request represents an increase of $50.4 million in base rates and is based on a 10.5% return on equity, unchanged from the previous general rate case in 2009.

The common equity ratio requested is 60.5% based on ONE Gas' actual equity ratio as of March 31, 2015 with debt cost of 3.95%. Those rate increase would result in a typical residential customer paying $4.98 per month more for the utilities' natural gas delivery service. This filing also request the continuation of and to make permanent with certain modifications the performance base rate change plan, also known as PBR, that was established in 2009. The Commission has 180 days to consider our filing and we expect new rates will be in effect in early 2016. Parties of the rate case have submitted responsive testimony, which is available on the Oklahoma Corporation Commission's website.

For the established procedural schedule, there are many steps left in the process. We're reviewing the testimony and preparing our rebuttal testimony to submit on November 4. The settlement conference is scheduled for November 10 with the hearings on the merits of the request scheduled for November 18. That being said, discussions will continue with staff and other parties in the coming weeks.

In Kansas, we filed our annual request of interim rate relief under the gas system reliability surcharge, or GSRS, in August for an increase in the surcharge of approximately $2.4 million, with the increase expected to be effective by January 2016. GSRS is a capital recovery mechanism that allows for a rate adjustment for safety related and government mandated capital investments made between rate cases. The Kansas Corporation Commission has 120 days to render a decision on this request. The next Kansas general rate case filing is expected to be in 2016 using 2015 as a test year with new rates effective by January of 2017.

Now, on to Texas. As I mentioned on our last call in March, Texas Gas Service filed under the El Paso Annual Rate Review, or EPARR, requesting an increase in revenues in the City of El Paso and surrounding incorporated cities. In August 2015, the incorporated cities and the El Paso service area approved an increase in revenues of $8.55 million for the El Paso service area. In some of our other Texas jurisdictions, Texas Gas Service has received approval this year for interim rate relief under the Gas Reliability Infrastructure Program, or GRIP, and cost of service adjustments totaling approximately $4.7 million driven by capital investments and changes in the cost of service.

As always, I'd like to recognize and thank our employees. They are the ones who make our company strong and allow us to provide safe and reliable natural gas service to our customers. I'm thankful for their commitment to and passion for making our company great.

Operator, we're now ready for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] . Our first question comes from Christopher Sighinolfi with Jefferies.

Christopher Paul Sighinolfi
Jefferies LLC

Q

Hey. Good morning, guys.

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

A

Morning, Chris.

Christopher Paul Sighinolfi
Jefferies LLC

Q

Pierce, you had mentioned lower operating costs being a driver of the move in guidance within the low end. I was just wondering, I don't know if I missed in Curtis' response or prepared commentary, but what specifically on the operating front was lower and then as you think about this five-year plan or I guess in particular, 2016, are those things that you see recurring or is that more of a onetime type of benefit?

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

A

Chris, this is Curtis. I wouldn't characterize it for the full year and the guidance is being a onetime. We do continue to make progress in our efforts to run as efficiently as we can and we saw some of that coming forth so far this year. So overall, as you can tell by our guidance, we would expect that O&M in the fourth quarter to be fairly flat with what we saw last year. So, really a continuation of some of those same factors.

Christopher Paul Sighinolfi
Jefferies LLC

Q

Okay. And in terms – Curtis, in terms of the lower leased storage amount, is that driven – I think you said it was reduced by about 2 BCF year-on-year, is that due to a better assessment as to the utilities' collective need or something that you look at low gas prices [indiscernible] (13:40) storage. Could you just walk us through maybe the thought process on that?

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

A

Yeah. I'll initially answer that and Pierce may want to add some additional color, [ph] but (13:50) our gas supply group does continuously look at what our gas needs are and how the system performs overall. So, as you can imagine, those things change from year-to-year and even some of the storage that we have is not always in the same location. So, there are different changes like that that get made to the system and we're able to reassess how much storage that we need and based on where supply is coming from and pipeline capacity. All those factors are – get rolled in to determining what that plan is for each heating season.

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

A

The only color I'd add to that, Chris, is Curtis is absolutely right. It's more along the lines of the engineering assessment and load needs and how the systems are performing. It really doesn't have anything to do with the price of natural gas, because the storage is the underpinning behind what makes our systems reliable and the way all those things work with our existing systems. So, it's really more of an assessment of where we are today and the fact that we just don't think we needed that extra service to maintain the same reliability that we have in the past.

Christopher Paul Sighinolfi
Jefferies LLC

Q

Okay. Okay, great. I guess final question from me and, Pierce, I understand the rate cases ongoing, so there may be some limitations to how much we could really explore this. But when you talk about the effort to make permanent the PBR and some slight modification that may result, could you just talk [indiscernible] (15:25) what those changes might be or [indiscernible] (15:30) might be?

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

A

They're not really that significant, Chris, but what I would say about PBR is that we believe and you can see this on our testimony is that the PBRs, it works for everybody. It allows us to go back on a yearly basis and kind of reassess we are on expenses and also on where we are on rate base. So, if expenses go down, it benefits the ratepayers the next year; if expenses go up, then it's a fair deal for the shareholders. So, we think it works for everybody, and we think that the Commission has been supportive of it in the past.

Christopher Paul Sighinolfi
Jefferies LLC

Q

Okay. Great. Thanks for your time this morning.

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

A

Thank you.

Operator: Our next question comes from [ph] Joe Zhou (16:23) with Avon Capital Advisors.

Q

Hi. How are you?

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

A

Good morning, [ph] Joe. (16:29)

Q

Morning. My first question maybe just housekeeping. You mentioned the rate base of $2.7 billion, is that the year-end or your average rate base for the year?

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

A

[ph] Joe, (16:41) that's our projected average for all of 2015.

Q

Okay. Got it. And secondly is on your Oklahoma rate case. We see the OCC staff recommendation of $25 million with 9.75% ROE and 55% equity. Are you satisfied with that or do you – what's the likely chance you will settle with them?

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

A

So [ph] Joe (17:17) let me. I've got two comments as it relates to that and then I'll kind of discuss how you see our reactions playing out to all of your questions kind of in general. First of all, it's not over. In baseball terms, we're probably in the fifth or sixth inning, so we're not in any way over with the game. The second thing is that the process will continue to work and the reason that I mentioned this process is that's what so important about these rate cases, and that's the reason that we spend as a company so much time writing our testimony. And the testimony through this process is what builds the record and a solid, transparent, and compelling record is what allows the commission to, in the end, render a balanced and fair judgment.

So, the way that I would see our reaction playing out and you're going to be able to see this in our public comments because we will be following that rebuttal testimony on November 4, so you'll see our reactions to all the points that you just made which is the ROE, the equity, the overall settlement of $25 million. And then you also be able to follow it continuously with the settlement conference on November 10. And then finally, on November the 18, we'll have the hearing on the merits and then the commissioners will have some time after that to render their judgment. So, more to come as far as our reaction to all the things that you mentioned and you'll be able to see that in its total in our rebuttal testimony.

Q

Great. Thank you. And my third question maybe as a follow-up from Chris' question, is that I do see you have a lower operating cost and you say you'll continue to make progress and your 4Q O&M will be flat. So year-to-date, as your operating cost is actually $7 million less than year-to-date in 2014, which is really great for shareholders, one thing I want to understand is that on your Oklahoma rate case filing, I understand this $7 million is overall, but I see there is – most of decrease like the IT system and the separation from ONEOK, I assume a lot of those O&M savings are – happened in Oklahoma. And on your Oklahoma rate filings, you have O&M increase roughly $11 million, your Section A and Section H. So, can you explain to me that – how should I look at this, the difference for your O&M saving in reality and your O&M increase from your request on Oklahoma rate case?

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

A

I'll – we'll reverse this order this time, [ph] Joe, (20:24) I'll kind of add some color to that and I'll let Curtis weigh in as well. First of all, you hit on one of the components of this, which is there are certain cost that occur in 2014 that were associated with the [ph] stand up (20:44) that don't necessarily reoccur from the years after that. So, that's a part of what you're looking at.

Another effort that we've had going on in the company that we haven't talked about a tremendous amount is basically our efforts on technology and how we're rolling out new technology in the field, specifically, [ph] we had it (21:06) rolled out on the customer service side for some years now but we're doing the same thing on the operating side as it relates to the maintenance and the care of our assets. These types of technologies are going to help us a lot in maintaining a more stable cost structure in the future.

So, I'll kind of turn it over to Curtis here and let him kind of add any other color or comments that he would like to add.

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

A

[ph] Joe, (21:40) so a couple of data points even further on what Pierce wad describing. So, as you may have seen in the release on the information technology expenses that we had last year around the separation, those were almost $6 million and, of course, those are not repeating here in 2015. The other part of I think what you were comparing if I understood some of your year-on-year numbers, the rate case piece in Oklahoma is based on a test year that ended March 31, 2015. So, obviously nine months of what was included in that filing related to 2014. And so again, some of the cost that we're seeing here in the latter part of this year don't include those separation costs like we had in 2014. So, you had several questions there, have we hit on each of those or was there another one in there that I missed?

Q

Yes. That's great. Well, thank you very much, very informative. Okay. So, one more is that – forgive me if I take all your time, but the one more on the merger-acquisition side. I don't have to ask this but we have already seen that several [indiscernible] (23:00) has been – went through merger-acquisition routes. And what should I take on Oklahoma, would Oklahoma be open to a merger-acquisition?

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

A

Well, first of all, [ph] Joe (23:16) what I'd say about the two most current ones which are the AGL and Southern acquisition, Southern actually acquiring AGL; and then the second one, that one just announced, which was Duke and Piedmont. Frankly, I think both of those actually make some sense. If you look at the fact that their systems overlap. And so, there is a lot of synergies as it goes forward. I think it also speaks pretty highly to the roll that natural gas will probably play in the Clean Power Plan.

You have two extremely large electric companies there that have focused primarily on coal in the past and, in particular, clean coal. But I think they also see the opportunity for natural gas as one of their supply source, as a major supply source, of the way that they will generate electricity in the future. So, I think their strategy is looking at that and how they overlay in the fact that both of their corporate offices were both in the same hometowns, and you have opportunities to build relationships there.

So frankly, I think both of those actually make a lot of sense. And I've said this before in the past, a lot of the things that if you really start to dissect the mergers and acquisitions that have gone on in the past, the reasons or the variables that exist in those mergers and acquisitions don't necessarily always exist for us in our territories. So, as far as us going out and doing some of those things, again, we think that executing our plan is going to bring the most value to our shareholders and I think it's proven to be that so far since we've spun out the company.

Q

Great. And my initial question is would you think [ph] the State of (25:20) Oklahoma will be open to merger-acquisition if – should anything happen?

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

A

I don't think that's something that we can really even speculate on, [ph] Joe. (25:30) I know [indiscernible] (25:33) in that process. I couldn't speculate as to how they might look at that. It's not something that we've ever had any conversations with them about.

Q

Great. Thank you very much for your valuable time. Thank you.

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

A

Thank you. Thank you [ph] Joe. (25:38)

Operator: Our next question comes from Dan Fidell with U.S. Capital Advisors.

Dan M. Fidell
USCA Securities LLC

Q

Good morning.

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

A

Good morning, Dan.

Dan M. Fidell
USCA Securities LLC

Q

Most of my questions has been answered at this point, especially on the IT side. So, thanks very much for that color. Only remaining question that I had is on customer growth. Just kind a noticing it's been – had a modest tick up the last couple of quarters. Can you just kind of refresh us on kind of what your expectations are just on trend on customer growth and kind of how you see things laying out maybe not specifically, I know you're going to do your refresh on the five year plan in January, but just kind of generally how you see customer growth trending?

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

A

Actually, Dan, our customer growth has been trending right on the money of what we thought it would be. We've always said in the past that Texas has had a little bit more growth especially in the Austin area, is what's really [ph] fueling (26:46) that and also El Paso which is basically two-thirds that rate base down in Texas. And then kind of the next strongest growth area that we've had is Oklahoma, and the third is Kansas. But overall, you can kind of see basically quarter-over-quarter and year-to-date over year-to-date we've been averaging in that about 0.8% range, which is kind of right in line with what we thought it was going to be. And so, we're actually really pleased with the growth rate that we're seeing in those, mainly in Oklahoma and Texas and, basically, Kansas is holding its own.

Dan M. Fidell
USCA Securities LLC

Q

So, you think the current rate where we're at, sort of, working its way up to this 0.8%; 0.8% is kind of the sustainable level from here?

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

A

We do.

Dan M. Fidell
USCA Securities LLC

Q

Okay. Great. Thanks very much. That's all I had.

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

A

Thank you, Dan.

Operator: It appears there are no further questions at this time. I'd like to turn the conference back to Mr. Ziola for any closing or additional remarks.

Andrew Ziola
Vice President-Investor Relations & Public Affairs

Okay. Thank you, everyone, for joining us this morning. Our quiet period for the fourth quarter starts when we close our books in early January and extends until earnings are released in February of 2016. We'll provide details on the conference call at a later date. Thank you, everyone, and have a great day.

Operator: This concludes today's conference. Thank you for your participation.