Corrected Transcript

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ONE Gas, Inc. (OGS)

Q4 2017 Earnings Call

CORPORATE PARTICIPANTS

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

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

MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to the ONE Gas Fourth Quarter Yearend 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 thank you for joining us on our fourth quarter and yearend 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 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.

Pierce Norton, ONE Gas President and Chief Executive Officer, has some brief opening remarks before I review the company's financial results and then turn it back over to Pierce for the regulatory update. Pierce?

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

Thanks, Curtis, and good morning everyone. The natural gas industry spends billions of dollars each year toward the integrity and safety of our systems. In the case of ONE Gas, we have invested $1.3 billion since we became a publicly traded company in 2014, and more than 70% of these capital expenditures were spent to improve our assets' safety and reliability.

We are pleased that there was an acknowledgement by the authors of the Tax Cuts and Jobs Act of 2017 that two business models exist in the U.S., one being a non-regulated model and the other being a regulated model. This recognition created a targeted solution of tax reform that allows a utility to continue investing in critical infrastructure while at the same time passing the benefit of lower cost to the customer through the reduction of federal taxes collected.

Now that the tax reform legislation is final, we look forward to working with our regulators to ensure our customers benefit from the lower tax rate and we'll continue to stay the course with our 20 plus year asset replacement plans. We realize tax reform is generating questions and Curtis will elaborate on the impact to ONE Gas in his remarks.

Curtis, I'll turn it back over to you for the review of our financials, and to discuss tax reform.

Curtis L. Dinan

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

Thanks, Pierce. Beginning with our financial results, in the fourth quarter, net income was $47.1 million or $0.89 per diluted share compared with $42.3 million or $0.80 per diluted share for the same period last year. Results were positively impacted by new rates, which includes the effect of our recent rate filings in Kansas and Texas and higher volumes from transportation customers in Kansas and Oklahoma.

Operating costs for the fourth quarter decreased $3.3 million compared with the same period last year and capital expenditures increased $30 million compared with the same period last year. For full year 2017, net income was $163 million or $3.08 per diluted share compared with $140 million or $2.65 per diluted share for 2016. Excluding the onetime items related to adoption of the share-based compensation accounting standard, accounting authority order in Kansas and tax reform that we quantified in our earnings release, our 2017 diluted earnings per share would have been $2.95 or $0.13 lower than our reported results.

Our full year results benefited from new rates in Texas and Kansas. The impact of weather normalization mechanisms which offset warmer than normal weather this year, higher volumes from transportation customers in Kansas and Oklahoma, and residential customer growth in Oklahoma and Texas.

We averaged 14,000 more customers in 2017, which is an increase of approximately 0.7% compared with 2016 and is comparable with the growth we have experienced over the past 10 years. In 2017, our capital spending remained predominantly focused on maintaining the safety and reliability of our systems and capital expenditures increased $47.4 million compared with 2016.

We also continue to spend capital to support customer growth and make investments in technology to improve efficiencies and manage cost. Last month, the ONE Gas Board of Directors declared a dividend of $0.46 per share, an increase of $0.04 or 9.5% compared with the previous dividend of $0.42 per share. We expect the average annual dividend increase to be 7% to 9% between 2017 and 2022, with a targeted dividend payout ratio of 55% to 65% of net income.

Also in January, we announced our 2018 earnings per share guidance of $2.96 to $3.20 per share, which includes a $0.04 per share contribution of the share based accounting standard we adopted in 2017, with an expected earned ROE of 7.3%

The decrease in expected ROE to 7.3% in 2018 from the 7.9% earned in 2017 primarily relates to three factors. As we have previously indicated, we expect 2018 to have less impact from new rates than we experienced in previous years, resulting in incremental regulatory lag from our capital investments.

Additionally, our rate base will increase in 2018, as we expect slightly higher capital spending and experience the effects of tax reform. Finally, tax reform actually increases regulatory lag as the net after-tax impact of investments and expenses that are not included in our cost of service is greater. We expect our ROE to improve in future years, as we normalize the impacts of tax reform through our regulatory filings.

At December 31, 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 $3.2 billion. With 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 2018 will average approximately $3.4 billion.

Considering our expectations for capital expenditures over the next five years and the impact of tax reform, we forecast that our rate base will grow 6% to 6.5% annually from 2017 to 2022.

Before turning the call back over to Pierce to provide our regulatory update, I'd like to spend a few minutes discussing the financial impact of the Tax Cuts and Jobs Act of 2017. Being a 100% regulated entity, the new Tax Act does not impact the long-term growth profile of our company. The new federal tax rate of 21% will benefit our customers as the income tax expense component of our cost of service will be lower.

The accelerated capital expensing provisions and the limitation of interest deductibility are not applicable to us. In 2018, tax reform will reduce our cash flows as the rates we collect from our customers will begin to reflect the lower federal tax rate. Longer term, the loss of bonus depreciation will accelerate the timing of when we start paying cash taxes.

After utilizing our net operating loss carryforwards, we forecast our cash taxes to be approximately $15 million in 2019, increasing to approximately $30 million by 2022. Additionally, the reduction in the federal tax rate to 21% resulted in a revaluation of our accumulated deferred income taxes that will also benefit our customers.

We are working to determine the amounts of these regulatory liabilities that will be refunded each year, but expect to return approximately $400 million to our customers over the next 25 to 30 years. We anticipate that the reduction in operating cash flows, combined with the return of regulatory liabilities recorded in conjunction with tax reform, will increase our estimated financing needs through 2022 by approximately $150 million to $200 million.

Our balance sheet as of December 31 is well positioned with a long-term debt to equity ratio of 38% and can support this incremental financing need. While our cash flows will be lower, the reduction in deferred taxes and the return of these regulatory liabilities to customers will lead to faster rate base growth, as indicated in our five-year guidance.

We are committed to maintaining our A level credit rating and a portion of the projected financing needs may include equity. We do not have any equity needs forecast for 2018. However, we do not anticipate continuing our annual $20 million share buyback program.

And now, I'll turn it back over to Pierce.

Pierce H. Norton II

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

Thanks, Curtis. I'd like to give you a brief regulatory update, followed by summary on tax reform from a regulatory standpoint. So starting with Oklahoma, in mid-March, we plan to file the second annual performance-based rate change application, since the general rate case that was approved in January of 2016.

As with the prior annual filings, we will update our cost of service and rate base amounts. The performance based rate mechanism will also allow us to incorporate the impact of tax reform in our rates. We anticipate that process to be completed later this summer.

Now on to Kansas, in November, the Kansas Corporation Commission approved the Kansas Gas Service's request for interim rate relief under the Gas System Reliability Surcharge Rider for $2.9 million. Rates became effective in December.

Also in November, the Kansas Corporation Commission approved the settlement agreement regarding KGS' application seeking approval of an Accounting Authority Order associated with the cost incurred at its 12 former manufactured gas plant sites. We are expecting to file our next general rate case in Kansas by July 2018 based on a 2017 test year. The impacts of tax reform will be reflected through our filed cost of service.

Turning to Kansas legislation matters, on February 8, an amended version of Senate Bill 279 regarding the gas system reliability surcharge mechanism passed out of the Kansas Senate Utilities Committee and is expected to be heard by the full Senate today. The amendments to the bill were drafted by Kansas gas utilities in response to feedback from the Kansas Corporation Commission staff. In its current form, Senate Bill 279 proposes to expand the scope of safety related capital investments that qualify under the GRS statute.

In addition, the cap on the surcharge would be increased to $0.80 per residential customer per month from $0.40. Concerning tax reform, we supported our regulators' efforts to ensure our utility customers receive the benefits of changes in our rates due to the tax reform. In each of our service areas, we are currently working with our regulators to address the impact of the Tax Cuts and Jobs Act on our rates. We have received or expect to receive accounting orders requiring us to establish a separate regulatory liability for the difference in taxes, including our rates that have been calculated based on a 35% statutory income tax rate and the new 21% statutory income tax rate.

The establishment of this regulatory liability will result in a reduction to our revenues beginning in the first quarter 2018, offset by a reduction in our income tax expenses. The amount, period, and timing of the return of these amounts to our customers will be determined by our regulators in each of our jurisdictions.

As Curtis described, the results of tax reform will reduce our cash flows but this will not change our business strategy or capital investment plans. We will continue to focus on being a premier natural gas company by investing in our systems to safely deliver natural gas to our more than 2.2 million customers.

In 2018, we expect to spend $375 million on capital expenditures and we expect to spend $375 million to $415 million per year between 2018 and 2022. We've targeted more than 70% to be spent on system integrity and pipe replacement projects. We believe a risk-based approach to analyzing our distribution systems creates the safest and most reliable system that our customers and regulators expect. In 2018 and beyond, we will continue to make safety our top priority. We'll spend capital prudently and maintain our focus on controlling cost through efficiencies.

In closing, I would like to thank our more than 3,500 employees for their hard work and achievements over the past year and as they continue to deliver safe and reliable natural gas to our more than 2.2 million customers.

Operator, we are now ready for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. Ladies and gentlemen, the question-and-answer session will be conducted electronically. [Operator Instructions] And at this time, there appears to be no question. I would like to turn the call back over to management for any additional or concluding 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 first quarter starts when we close our books in early April and extends until we release earnings in early May. We'll provide details on the conference call at a later date. Have a great rest of your day.

Operator: Ladies and gentlemen, that does conclude today's presentation. We do thank everyone for your participation and you may now disconnect.