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ONE Gas, Inc. (OGS)

Q3 2018 Earnings Call

CORPORATE PARTICIPANTS

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Pierce H. Norton II
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OTHER PARTICIPANTS

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Aga Zmigrodzka
Analyst, UBS Securities LLC

Dennis P. Coleman
Analyst, Bank of America Merrill Lynch

MANAGEMENT DISCUSSION SECTION

Operator: Good day and welcome to the ONE Gas Third 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. Sir, please go ahead.

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

Good morning and thank you for joining us on our third quarter 2018 earnings conference call. This call is being webcast live and a replay will be made available. 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 Act 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 and Chief Financial Officer of ONE Gas. Curtis?

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

Thanks, Brandon. Good morning, everyone, and thank you for joining us today. Beginning with our third quarter results, net income for the third quarter 2018 was $16.3 million, or $0.31 per diluted share, compared with $18.8 million, or $0.36 per diluted share, for the same period last year. The largest impact to our results was the timing of income tax deferrals and related rate adjustments, which was partially offset by increases from new rates in Texas and Kansas, and residential customer growth in Oklahoma and Texas. I will comment more as to the ongoing effects of tax reform in a minute.

Operating costs for the third quarter were $110.5 million compared with $104.8 million in the same period last year due to an increase in employee-related costs and bad debt expense. Capital expenditures for the third quarter increased $9 million to $103.5 million compared with $94.4 million for the same period last year. We are still expecting full year capital expenditures to be in the range of $375 million to $390 million, with approximately 70% targeted towards system integrity and replacement projects.

Now, for a quick update on tax reform, in compliance with the accounting authority orders in each of our jurisdictions, we have established a regulatory liability for the difference in federal taxes resulting from the recent drop in statutory income tax rates. The establishment of this regulatory liability and related rate adjustments from completed filings resulted in a $6 million reduction to our revenues in the third quarter 2018, or $4.6 million net of tax. This was partially offset by $2.6 million reduction in our income tax expense. Recall from our two previous earnings calls that this timing difference between the revenue deferral and the reduction in our income tax expense created a positive $0.13 impact on earnings in the first quarter and a negative $0.06 impact in the second quarter.

We saw another $0.04 reversal in the third quarter and expect the remaining $0.03 to reverse in the fourth quarter. The effect from the change in tax rate has now been reflected in regulatory filings across all of our jurisdictions including our pending filings in Oklahoma and Kansas. The timing and process for returning excess accumulated deferred income taxes to our customers in most of our jurisdictions is still to be determined.

Yesterday, the ONE Gas board of directors declared a dividend of $0.46 per share, unchanged from the previous quarter. This dividend is consistent with the company's guidance for 2018. As we've indicated previously, 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. We affirmed our 2018 net income guidance range of $167 million to $178 million, or $3.15 to $3.35 per diluted share.

Historically, during our earnings calls, we have provided two different rate base calculations. The first is authorized rate base, defined as the rate base reflected in our latest regulatory proceedings, including full rate cases and interim rate filings. At September 30, 2018, authorized rate base was approximately $3 billion.

The second is estimated average rate base, which is defined as authorized rate base plus additional investments in our system and other changes in the components of our rate base that are not yet reflected in approved regulatory filings. We project that for year-end 2018, our estimated average rate base will be approximately $3.36 billion with 42% in Oklahoma, 30% in Kansas, and 28% in Texas. In August, the IRS issued guidance that utility assets placed in service during the fourth quarter of 2017 are eligible for 100% bonus depreciation. We had previously assumed that these assets would not be eligible. This additional bonus deprecation had the effect of increasing deferred taxes, thereby slightly reducing estimated average rate base from our prior estimates.

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'd like to start by giving you an update on the recent regulatory activity throughout our service areas, so I'm going to begin in Oklahoma. In September, the administrative law judge issued his report regarding our performance based rate change application. The ALJ recommended the Commission approve the non-unanimous consent agreement between the staff and the company, except for the amortization period for unprotected excise accumulated deferred income taxes, for which he recommended a 10-

year amortization period. A hearing is scheduled before the Oklahoma Corporation Commission for November 28, and a final order is anticipated by the end of this year.

So on to Texas. New rates went into effect in August for the incorporated customers in the Rio Grande Valley service area after we received approval for a $1.1 million increase pursuant to the cost of service adjustment filing.

Finally, in Kansas, in August Kansas Gas Service requested an increase of approximately $2.4 million related to its gas system reliability surcharge. An order from the Kansas Corporation Commission is expected in December 2018, with new rates expected to be in effect January 1, 2019. In the pending Kansas Gas Service rate request, the procedural schedule was approved on August 2, evidentiary hearings are scheduled for December 11 through the 13, and a final order from the KCC is due February 25, 2019. New rates are expected to be effective before the end of the first quarter of 2019.

As a reminder, this filed request with the KCC is for a net increase in rates of $42.7 million, reflecting investments in the system and changes in operating costs necessary to maintain the safety and reliability of its natural gas distribution system. The requested net increase in rates would be an increase in the operating income of approximately $31 million. The filing is based on a 10% return on equity and a 62.2% common equity ratio.

For every 25 basis point change in our requested ROE, the impact on the operating income is approximately $2.2 million. For every 1% change in our requested equity ratio, the impact on the operating income is approximately $1.4 million.

On October 8, Kansas Gas Service announced it has been selected by the U.S. government to own, operate, and maintain the natural gas distribution facilities at Fort Riley under a 50-year contract. Fort Riley is a U.S. Army installation in Kansas and has more than 15,000 active military, 5,600 civilian workers, and supports over 5,000 retirees, 24,000 veterans, and more than 18,000 family members living both on and off the post. The terms of the privatization contract will be reviewed by the KCC. If approved, Kansas Gas Service will start the transition process with an intent to take over the gas system operations in April of 2020. At closing, the Fort Riley contract will add approximately $5.8 million to the rate base.

In closing, I'd like to express my gratitude to our 3,500 hardworking employees. Their focus and commitment to provide safe and reliable natural gas service every day for our more than 2.2 million customers is to be commended.

Operator, we're now ready for questions.

QUESTION AND ANSWER SECTION

Operator: Yes sir. [Operator Instructions] All right. Our first question will come from Chris Sighinolfi with Jefferies.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Pierce, just had a question on – I guess, the follow-up on your description of Fort Riley. I guess, we've talked previously about some of the municipal systems that may come available, but hadn't thought about U.S. government installations. Is that a one-off opportunity or is that an effort by the armed services to move more of, I guess, their gas infrastructure into sort of a more private professional hands?

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

A

They actually started this in motion, Chris, years ago. We actually own and operate some natural gas assets in other areas of our service territory, like Fort Bliss, and they have been moving toward this privatization type effort even prior to the President Trump administration. So this is something I think that they've had ongoing for a while. It just takes a while to go through the process.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

And, I guess, so the fact that you've done it previously, the experience in overtaking formerly federally-run assets, can you say anything about the state of those systems relative to your own systems? And any sort of associated upgrading or, I guess, if there's a standardization that's required in terms of how you guys operate or some of the hardware you used versus what's been used by the government, is there anything to be expected in that regard?

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

A

Well, it's the same thing that we do in every other place. As far as your question, Chris, it really comes down to that's part of due diligence and that's part of what takes as long as it does is, there's already been a significant amount of due diligence already done on this system. So we know who built them. We know who maintain them. It's some of the same contractors that we use on our system. So we have confidence that the systems were put in correctly. And it's routine maintenance from here on out, just like we would do on our systems.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. And the contracts could be [ph] your life (00:13:25) is what I think I heard you mentioned in your prepared remarks. That would just...

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

A

That's correct.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

...inoculate risk in case there's a base closure at some point in the future?

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

A

That's exactly right.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay.

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

A

Yeah. There are some things in there that allow us to do some different things that for some reason there was a base closure or whatever, so we can roll out of that contract.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. That was really impromptu on my part. I didn't – it was really just [indiscernible] (00:13:54) based on your prepared remarks, I appreciate the color. I was interested, Curtis, in terms of the – I guess, as I look forward into future periods and more think about next year, the maturity that you have in February, just curious your thoughts on refinancing that, and then with the capital program, if you thought you'd do it at the same size and what duration you thought would be appropriate, given what the flattening of the curve [ph] feel to you (00:14:23) at this point. Just curious thoughts on that. Thanks.

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

A

Yes. So what you're referring to is the $300 million of bond maturity that we have at the end of January next year. We haven't made final determinations as to how we'll refinance that or what that tender may look like when we do or even what the timing of it will be. The one thing I'd say is at the end of the third quarter, we had under $300 million outstanding under our $700 million revolver, so our liquidity position is really strong at this point. And so that gives us options as to how we think about what that refinancing and what the timing of that may look like.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. So something just you'll evaluate as we grind closer to it, but capacity to put down a revolver if markets aren't super attractive at that point, is that how we think about it or do you think it'll be not that way? That you'll actually term it out before it comes to maturity, but you just haven't decided on what the structure exactly looks like.

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

A

Yeah, we haven't decided exactly what that's going to look like or what that timing would be. So sort of a little bit of both of your assumptions there.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. No, that's helpful. Thanks a lot, guys. I appreciate the color.

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

A

Thanks, Chris.

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

A

Thank you, Chris.

Operator: All right. Thank you. Our next question will come from Aga with UBS.

Aga Zmigrodzka
Analyst, UBS Securities LLC

Q

Good morning.

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

A

Good morning, Aga.

Aga Zmigrodzka
Analyst, UBS Securities LLC

Q

Could you please discuss the customer growth around your footprint and how do you think about the customer growth going forward? Looks like the third quarter customer growth was down to 0.4% from 0.7% in 2017. Thank you.

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

A

So, Aga, those growth numbers are net numbers. So you have customers that exit the system and customers that come on, so from – if you're looking from quarter-to-quarter, you do find some movement in that. The best time to mark that in the year is during the middle of the winter, so in the January timeframe. So when we give the annualized numbers, those are the best ones to compare year-over-year. But if you look at year-to-date numbers, it's about 0.3% in Kansas, it's about 0.5% in Oklahoma, and about 0.8% in Texas, which is very similar to what we've been experienced over the past several years.

Aga Zmigrodzka
Analyst, UBS Securities LLC

Q

Thank you. That's very helpful. I have one follow-up question. Full year O&M expense guidance implies roughly $18 million quarter-over-quarter increase. Typically O&M is higher than 4Q. But do you see any potential room for incremental efficiencies to get the full year O&M guidance below of what you provided? O&M number before the guidance below [ph] the guide (00:17:23).

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

A

Yeah. We still believe that our O&M stuff and our overall guidance numbers are right and they're definitely within our range that we've given to you guys earlier.

Aga Zmigrodzka
Analyst, UBS Securities LLC

Q

Got it. Thank you for the color.

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

A

Thank you, Aga.

Operator: All right. Thank you. Our next question comes from Dennis Coleman with Bank of America.

Dennis P. Coleman
Analyst, Bank of America Merrill Lynch

Q

Yeah, hi. Good morning, everyone. Just a couple quick ones. Pierce, can I just ask you to repeat the numbers on the Fort Riley. How many people in total is it, if I could just get a single number there? And so how many customers would it be?

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

A

Well, in total, there is about 15,000 active military on that base. Now, that can ebb and flow, because they could be deployed or whatever, and then you've got about 5,600 civilian workers. The important number that was disclosed on that is the $5.8 million of rate base, because their meters and stuff are configured sometimes differently than what you might see in the civilian market. So the thing to focus on there is the $5.8 million of rate base. And then I'd remind you that it's about $3.36 billion overall of the entire company. So it's important to us, but it's just routine business for us.

Dennis P. Coleman
Analyst, Bank of America Merrill Lynch

Q

I got you. And so does it have a different regulatory authority? Is it just the federal government or the military or does it [indiscernible] (00:19:03)...

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

A

No, it all falls under the Kansas Corporation Commission, so it's all rolled into the whole rate base of Kansas.

Dennis P. Coleman
Analyst, Bank of America Merrill Lynch

Q

Okay. And you mentioned the $3.36 billion of rate base and I should know this, but just to make sure I do understand it. So you said it was $3 billion of authorized rate base at the end of September, and estimated...

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

A

Yes.

Dennis P. Coleman
Analyst, Bank of America Merrill Lynch

Q

...average rate base of $3.36 billion, which would be at the end of 2018, and ...

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

A

Yes.

Dennis P. Coleman
Analyst, Bank of America Merrill Lynch

Q

So the difference, the $360 million, has been filed for?

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

A

No. What that represents is the capital expenditures primarily that have been made since the last rate filings. So what established the $3 billion that was our authorized rate base, so like the last Oklahoma PBR filing, the last GSRS filing in Kansas, all those different things establish that $3 billion. But we continue to spend money and so we averaged the $3.36 billion that's not yet fully reflected in those rate filings.

Dennis P. Coleman
Analyst, Bank of America Merrill Lynch

Q

Okay. So...

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

A

And, Dennis, the reason we reported that way is because we think that's the most accurate. We as the company know all the components to those rate bases in every single state. And so to be able to give you all guidance as to what those numbers are going to be, we feel like that's the most accurate reflection in real time.

Dennis P. Coleman
Analyst, Bank of America Merrill Lynch

Q

I see. But just for example, if I just make sure I understand. So the Kansas rate case, when it presumably is approved at some level next year, that will change the authorized rate base?

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

A

That's correct. Yeah, that $3 billion, the first number I gave you would increase following that.

Dennis P. Coleman
Analyst, Bank of America Merrill Lynch

Q

And so it would presumably narrow into that $3.36 million?

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

A

Yes.

Dennis P. Coleman
Analyst, Bank of America Merrill Lynch

Q

Okay. All right. That's what I thought. Okay. Thanks very much.

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

A

Thanks, Dennis.

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

A

Thanks, Dennis.

Operator: All right. Thank you. [Operator Instructions] And all right, gentlemen, we currently have no questions in queue at this time.

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

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

Operator: Thank you. Ladies and gentlemen, this concludes today's teleconference and you may now disconnect.