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ONE Gas, Inc. (OGS)

Q3 2017 Earnings Call

CORPORATE PARTICIPANTS

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

Patrick Downey
Analyst, Cannon Asset Management LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to the ONE Gas Third Quarter Earnings Conference Call. Today's conference is being recorded. For opening remarks, I will now turn the call over to Mr. Curtis Dinan. Curtis, please go ahead.

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

Good morning, and thank you for joining us on our third 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 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.

Yesterday, 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 previously indicated, 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%. We also affirmed our 2017 guidance which we narrowed back in August. We expect net income to be within the range of $155 million to $161 million or $2.94 to $3.04 per diluted share. We anticipate releasing our 2018 guidance and our updated five-year forecast in January.

Now, on the third quarter results. Net income for the third quarter 2017 was $18.8 million or $0.36 per diluted share compared with $12.7 million or $0.24 per diluted share for the same period last year. New rates from investing in our systems which includes the effect of the Kansas rate case and our recent rate cases in the Gulf

Coast, West Texas, and Central Texas jurisdictions positively impacted results. Pierce will discuss more of the details of our rate cases in a few minutes.

Operating costs for the third quarter were $109.1 million compared with $112.7 million for the same period last year. As described during our second quarter call, the mix of operations and maintenance projects to capital projects was weighted more towards operations and maintenance projects in the first half of 2017, but that we expected our project mix to shift to be more capital-focused in the second half of 2017. This shift in the project mix contributed the higher capital expenditures and lower operations and maintenance expenses in the third quarter.

Capital expenditures for the third quarter increased $8 million compared with the same period last year and were approximately $18 million higher than the year-to-date quarterly average. We expect full year capital expenditures to be in the range of $350 million to $360 million with approximately 70% targeted towards system integrity and replacement projects.

At September 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.

Earlier this month, we amended and restated the $700 million ONE Gas credit agreement which now expires in October 2022. At September 30, we had $174 million in short-term borrowings issued under the agreement.

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 give you a brief regulatory update beginning with Texas. In June, Texas Gas Service filed a rate case for customers in its Rio Grande Valley service area. TGS and the cities of the Rio Grande Valley agreed to an increase of $3.6 million, and new rates became effective this month.

Now, on to Oklahoma. In August, a joint stipulation and a settlement agreement was approved by the Oklahoma Corporation Commission for our first annual performance-based rate change or PBR after the general rate case that was approved in January of 2016. The filing demonstrated that we were earning within the allowed range of 9% to 10% ROE, therefore, we did not request a change in base rates. Our next PBR filing is expected to be made in March of 2018. And in Kansas, we filed a request for interim rate relief under the Gas System Reliability Surcharge Rider in August for $2.9 million. And if approved, new rates will be effective January 2018.

Earlier this month, Kansas Gas Service, the Kansas Corporation Commission staff, and the Citizens' Utility Ratepayer Board filed a unanimous settlement agreement with the KCC regarding the KGS application filed in April, seeking approval of an accounting authority order associated with the cost incurred at and nearby its 12 former manufactured gas plant sites. If approved, the agreement will allow Kansas Gas Service to defer MGP cost for the investigation and remediation at the 12 former MGP sites incurred after January 1, 2017, up to a cap of $15 million, net of any related insurance recoveries and amortized approved cost and a future rate proceeding over a 15-year period. The unamortized amounts will not be included in the rate base or accumulate carrying charges. At the time, future investigation and remediation work, net of any related insurance recoveries, is expected to exceed $15 million. Kansas Gas Service will be required to file an application with the KCC for approval to increase the $15 million cap. The KCC is expected to issue an order no later than early January 2018.

If the agreement is approved, a regulatory asset of approximately $5.9 million will be recorded in the year the order is approved. The $5.9 million accrued at January 1, 2017 represented our estimated liability for the investigation and remediation at the 12 former NCP sites. We have not recorded any additional liabilities in 2017.

With the completion of the Rio Grande Valley rate case, 100% of our material jurisdictions have been through a rate case since the spinoff. As we have previously stated, we do not anticipate a material impact from new rates until 2019. Our focus during this period will be to continue to control costs and to execute on our capital spending programs leading up to our next round of rate cases.

Now, I'd like to speak on the impact to our business due to Hurricane Harvey. I'd like to commend our hardworking employees who worked safely and diligently to support our operations and the communities affected by the storm. We did not experience any recordable injuries or preventable vehicle incidents during our response to the storm and this is an example of the high level of dedication and commitment that our employees exhibit every day.

We have inspected 100% of the approximately 30,000 meter settings in Port Arthur, approximately 3,200 regulators and 1,100 meters were replaced due to the damage. Approximately, 600 accounts remain off either by the customer's request or for other safety-related reasons. The capital costs which is related primarily to meters and regulators is expected to be approximately $250,000. We're tracking expenses related to the storm with preliminary estimates indicating an approximate $700,000 impact.

In closing, I'd like to thank all of our 3,400 employees for their focus and commitment to providing safe and reliable service to our more than 2.1 million customers.

Operator, we are now ready for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you, sir. [Operator Instructions] We'll take our first question today from Spencer Joyce with Hilliard Lyons.

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

Q

Pierce, Curtis, good morning. Nice quarter.

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

A

Yes. Good morning, Spencer.1040

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

Q

Hey. A quick one, just to follow up on some of the comments on Hurricane Harvey. So, appreciate the color and it sounds like you all are pulling through okay. Are you seeing construction crews or availability there impair or impact your ability to perhaps carry out your capital budget through the end of the year? I'm assuming no, but I'm just wondering if there are any kind of second level issues there.

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

A

The answer is no, Spencer. We've actually already completed 100% of our assessments. We've already replaced everything that needs to be replaced and everybody that was used to bring in from other places in the company to assist in our Port Arthur efforts. They've now gone back to their respective workplaces and it's business as usual.

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

Q

Okay. That's very helpful. And if you could, you mentioned the $700,000 figure towards the end of the prepared remarks. Can you go over that one more time? What was that specifically?

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

A

Spencer, this is Curtis. That's most of that was recognized in the third quarter and it primarily represents labor or supplies, items like that, travel costs, et cetera, as we responded to the storm.

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

Q

Okay. So, the $700,000 figure would be mostly in the third quarter, and it would represent labor supplies and then I guess some of the fixtures that would have been replaced. But I mean that's sort of your total hurricane direct impact, is that?

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

Yes, the $700,000 is the expense piece and then in addition, there's $250,000 of capital cost for regulators and meters and things like that, that had to be replaced. So, two separate amounts.

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

Okay. That's what I was looking for. Perfect. One final item here for me is, have seen lower legal costs across much of this year. Curtis, can you remind us some of the cadence there for Q4? Will we see a little bit more of that come out to close out the year. And then, what was that? I mean, have you all just perhaps internalized some of that or was there a specific item last year?

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

So, as it relates to the legal cost, Spencer?

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

Yes, yes, just specifically that [indiscernible] (13:18).

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

Yes. So, a couple of things that occurred last year. One was a larger workers' comp issue that we recognized in the quarter, and then there was another settlement that got recorded in the third quarter last year.

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

Okay. That's very helpful. That's all I had. Nice quarter.

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

Thank you.

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

Thank you, Spencer.

Operator: We'll go next to Chris Sighinolfi with Jefferies.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC
Q

Hey, good morning, guys. Happy Halloween.

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

A

Good morning, Chris.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Just a couple of questions from mine. I guess following up real quickly just on the costing cadence. I know when you guys had amended the guidance last quarter, there was a modest uptick in what you were anticipating for the full year O&M. And then obviously, a pretty significant year-on-year reduction in the cost from 3Q 2016 to 3Q 2017. So, I'm just wondering, I guess what is operating different than you expected, and might we see a continuation of that in the fourth quarter or was there anything that was more timing shifted away from 4Q perhaps in the – sorry, away from 3Q and perhaps into 4Q?

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

A

Yes. The biggest item is what I was describing in my remarks about the O&M projects that we were doing more of those in the first half of 2017, and the focus of our crews in the field shifted to be more heavily capital-focused as we were anticipating that happening in the third quarter and continuing into the fourth quarter. So, crews doing less O&M and more capital projects, so their labor then goes into those capital projects and into rate base instead of going into O&M expense.

So, the quarter really came out as we were expecting it to in that regard. There's always a little bit of timing in things that shift a little bit between quarters, but that's really not the big piece or the big driver in those numbers.

Now, just on a – we don't give quarterly guidance, but if you look at our historical O&M pattern, as you would expect in the winter heating month, so the fourth quarter and then in the first quarter, our O&M expenses are higher in those periods, and they're typically lower in the second and third quarters.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Right. Okay. I guess what I was trying to figure out, Chris, is that presumably at the time of the guidance – if nothing has changed in terms of the operations versus what you guys had envisioned at the time of the guidance, the first half of this year O&M was up versus the first half of 2016, presumably because you were focused on more O&M projects and then we saw this big step down in the third quarter. So, I was just curious how I might decipher that versus the guidance. But hear you on the annual cadence into the activities of service [indiscernible] (16:14).

I guess away from that, if I could just ask about the manufactured gas plants. We've seen this around other states, New York's been dealing with this for some time. But curious if this is an initiative, this final cleanup remediation is an initiative brought on by the EPA in Kansas or the Kansas Department of Health and Environment, if it's something you guys are driving, if it's the KCC? I was just curious if you could give us some historical context as to how we are, where we are, and then in terms of the totality of the work that you guys see that remains and the time profile for completing it? Any help there...

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

A

So, really nothing has changed, Chris, other than the fact that we continue to investigate and remediate in accordance with the Kansas Department of Health and Environment consent order that we had. So, as you go through that, the only thing that changes as you continue to do investigation or whatever, then that leads to different levels of remediation. So, this is really nothing different than we've done in the past. So, it's just continuing to follow that order that's from the KDHE. And then to – basically as you start to accrue those expenses, then we have a little more clarity and that's when we wanted to put this framework in that we explained in my comments that's been agreed to by the Kansas Corporation Commission staff and the Citizens' Utility Ratepayer Board and the company. But it's not final yet until the order is actually approved by the Kansas Corporation Commission. So, nothing has really changed other than just continuing to enact the order that was put in place by the KDHE.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC
Q

Okay. And I guess, Pierce, with regard – it's 12 sites I think is what you cited in last night's release. Are there more than that or is that just – meaning, are those ones that still require remediation work or is that the totality of what was legacy to Kansas Gas Service?

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

That is the totality of the legacy of Kansas Gas Service.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC
Q

Got it. Okay. Okay. Thanks for that clarification. I appreciate the time and today's call, guys.

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

You're welcome, Chris.

Operator: We'll go next to Patrick Downey with Cannon Asset Management.

Patrick Downey
Analyst, Cannon Asset Management LLC
Q

Hey, guys. How is it going?

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

Good, Patrick.

Patrick Downey
Analyst, Cannon Asset Management LLC
Q

Hey, I wanted to ask about the Kansas asset replacement program order that they issued back in September which I believe affected all gas companies in Kansas. Does this new order replace your current GSRS rider within Kansas?

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

A

The short answer, Patrick, is no, it does not replace it. So, for years we've been replacing these obsolete materials that have been covered under the Gas System Reliability Surcharge, that's the GSRS that you just mentioned. We expect to continue that to actually initiate the ARP, which stands for the Accelerated Replacement Program.

We actually would have to file a rate case and it is in addition to the GSRS. So, the GSRS has a $0.40 per customer per month cap on it as to the level of spending so would the ARP, but that's in addition. And what we're going to do is we're going to – at the time that we file our next rate case, that's when we'll make a decision of whether or not we do or do not participate in the ARP program.

Patrick Downey
Analyst, Cannon Asset Management LLC

Q

Okay. So, but the $0.40 per month is just an annual increase cap or is that just a hard revenue cap?

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

A

No, that's an annual increase cap that's associated with those capital expenditures.

Patrick Downey
Analyst, Cannon Asset Management LLC

Q

Okay. All right.

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

A

Thanks, Pat.

Operator: [Operator Instructions] And with no other questions at this time, I'll turn the call back to Curtis Dinan for closing remarks.

Curtis L. Dinan
Senior Vice President, Chief Financial Officer & Treasurer, 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. Have a great rest of your day.

Operator: Ladies and gentlemen, thank you for your participation. This does conclude today's conference. You may now disconnect.