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ONE Gas, Inc. (OGS)

Q1 2018 Earnings Call

CORPORATE PARTICIPANTS

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

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

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

OTHER PARTICIPANTS

Sarah Elizabeth Akers
Analyst, Wells Fargo Securities LLC

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Timothy M. Winter
Analyst, Gabelli & Co. Investment Advisers, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to the ONE Gas First Quarter Earnings Conference Call. Today's conference is being recorded.

And at this time, I'd like to turn the conference over to Mr. Brandon Lohse. Please go ahead.

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

Good morning, and thank you for joining us on our first quarter 2018 earnings conference call. My name is Brandon Lohse and I'm pleased to have just joined the ONE Gas team as the new Director of Investor Relations. 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 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 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, Chief Financial Officer and Treasurer of ONE Gas. Curtis?

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

Thanks, Brandon, and welcome to the ONE Gas team. Good morning, everyone, and thank you for joining us. Beginning with our financial results, net income was $90.8 million or $1.72 per diluted share compared with $76.5 million or $1.44 per diluted share for the same period last year.

The strong quarterly results reflect increases from new rates in Texas and Kansas that were approved in 2017, weather normalization mechanism effects in Kansas and Oklahoma, and higher volumes from transportation customers. It's important to note that while weather in the first quarter was 1% warmer than normal, it was 31% colder than the same period last year, resulting in our net margin being positively affected by $2.5 million or $0.05 on an earnings per share basis compared with the prior year.

Due to the new accounting standard for share-based compensation that we adopted prospectively on January 1, 2017, we recorded a $2.8 million tax benefit in income tax expense, which resulted in a $0.05 per share positive impact to net income in the first quarter of 2018, slightly higher than the $0.04 per share indicated in our guidance in January, but below the $0.10 impact we recorded in the first quarter of 2017. As we previously indicated, the impact of this new accounting standard will depend on future share performance.

Operating costs for the first quarter were lower by $1.9 million compared with the same period last year and capital expenditures increased $16 million compared with the same period last year, as our mix of projects was more heavily weighted to capital spending versus operational spending.

We continue to invest in technology and infrastructure, which translates into improved efficiencies and reduced operating costs. One such example is our investment in AMR or automated meter reading. At the end of 2013, AMR penetration was around 65% of our meter assets, and as of the end of Q1, we were over 85%.

This technology reduces our labor, equipment and other operating costs, helping achieve our goal of reducing expenses to sustainable levels. This investment has been beneficial, and we will continue to make additional investments to improve efficiencies and reduce operating costs over the next several years.

Regarding tax reform, in compliance with the Accounting Authority Orders in each of our regulatory jurisdictions, we have established a regulatory liability for the difference in federal taxes included in 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 resulted in a $12.3 million reduction to our revenues in the first quarter 2018 or $9.3 million net of tax, offset by a $16.2 million reduction in our income tax expense. This timing difference between the revenue deferral and the reduction in our income tax expense created a $0.13 positive impact in our results this quarter, but the impact is expected to reverse by year-end.

While the long-term effect of tax reform is negligible, in the near term, it will impact the timing and distribution of our quarterly earnings profile. Our earnings profile has some seasonality to it. So, in quarters where seasonal earnings are higher, the impact of tax reform will be positively accentuated and vice versa.

Moving on from tax reform, yesterday the ONE Gas Board of Directors declared a dividend of $0.46 per share, the same as the previous quarter. This dividend is consistent with the company's guidance for 2018. As we have 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 also affirmed our 2018 earnings per share guidance of $2.96 to $3.20 per share. However, with the strong first quarter, we believe that the more likely scenario puts us in the upper half of that range. At March 31, 2018, 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.

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 with 42% of that being a rate base in Oklahoma, 32% (sic) [30%] (00:06:43) in Kansas and 27% (sic) [28%] (00:06:46) in Texas.

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 an update on the recent regulatory activity in our service areas. So, let's begin in Oklahoma. In March, we filed our second annual Performance-Based Rate Change application since the general rate case that was approved in January of 2016. We identified a $5.6 million credit to our base rates associated with the impact of tax reform. Our procedural schedule has not yet been approved, but we do anticipate an order in the third quarter of 2018.

Now, on to Kansas. In April, the Legislative Bill expanding the scope of the Gas System Reliability Surcharge mechanism was approved. Beginning January 1, 2019, the scope of safety-related capital investments that qualify under the GSRS statute will be expanded to include expenditures to replace, upgrade or modernize obsolete facilities, as well as projects that enhance the integrity of pipeline system components or extend the useful life of such assets. Safety-related investments will also include expenditures for physical and cyber security.

In addition, the capital or the cap on the surcharge will be increased to $0.80 per residential customer per month from $0.40. This legislation allows us to begin earning on eligible capital sooner with the expanded definition through GSRS filings instead of having to wait for the general rate case.

While the updated scope of GSRS will assist in the timing of recovery for capital spending, we are already spending at accelerated paces in Kansas to support our long-term plan. We have only 17 miles of cast iron pipe remaining in Kansas, in our own pace to have all cast iron out of our system by the end of next year.

After all the cast iron is removed, those capital dollars will be shifted to remove more bare steel pipe. We're expecting to file our next general rate case in Kansas before July 2018 based on a 2017 test year. The impacts of tax reform will be reflected through our filed cost of service.

And in Texas, we've made the filings under the Gas System Reliability Infrastructure Program (sic) [Gas Reliability Infrastructure Program] (00:09:46) for all customers in the West Texas service area, requesting an increase of $3.5 million.

This increase is offset by a $4.7 million request for a decrease to rates due to the reduction in the federal income tax rate. A one-time refund of $2.4 million is also being requested for changes to the tax rate for the period between January 1, 2018 to the date when the new rates are implemented. If approved, both filings for West Texas are expected to become effective in July of 2018.

Similar to West Texas, we've also made GRIP filings for all customers in the Central Texas service area requesting a $3.3 million increase, which is offset by $4.9 million request for decrease to rates due to the reduction in the federal income tax rate.

A one-time refund for $2.5 million is also being requested for changes to the tax rate for the period between January 1, 2018 to the date when the new rates are implemented. If approved, both filings for Central Texas are expected to become effective in July of 2018.

Filings to incorporate tax reform into rates were also made in the Rio Grande Valley service area, but are not material to earnings. ONE Gas is focused on leading the industry in a safe reliable provider of natural gas to our customers, an important component of our strategy and why we reinvest in our natural gas distribution systems and facilities.

In 2018, we expect to spend $375 million on capital expenditures, and we expect to spend approximately $2 billion through 2022, more than 70% which will be spent on system integrity and pipe replacement projects. We continue to take a risk-based approach to analyzing and upgrading our distribution systems, which creates the safest and most reliable system that our customers and regulators expect.

To close, I would like to thank all of our 3,500 employees for their engagement, dedication and commitment to safely and reliably delivering our product and for focusing on continuous improvements that benefit all of our stakeholders.

Operator, we're now ready to answer any questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And we'll go first to Sarah Akers at Wells Fargo.

Sarah Elizabeth Akers
Analyst, Wells Fargo Securities LLC
Q

Hey. Good morning.

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

Good morning, Sarah.

Sarah Elizabeth Akers
Analyst, Wells Fargo Securities LLC
Q

Can you give us a sense in Kansas, what percentage of CapEx there will now qualify for the GSRS recovery beginning next year versus the percentage that qualifies now?

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

Hey, Sarah. This is Curtis. And about 70% of our capital will qualify under that program.

Sarah Elizabeth Akers
Analyst, Wells Fargo Securities LLC
Q

Got it. Is that a pretty significant increase to the current levels?

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

Yes. Historically, we've been closer to 30% or 35%.

Sarah Elizabeth Akers
Analyst, Wells Fargo Securities LLC
Q

Got it. Great. And then, in Oklahoma, the $5.6 million proposed rate reduction, is that solely related to tax reform or is there also a base rate change embedded in there?

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

Yeah. Sarah, that's a net number, so there's a base rate change from going through the PBR mechanism and then that gets more than offset by the tax reform. So, overall, it's a net reduction in rates.

Sarah Elizabeth Akers
Analyst, Wells Fargo Securities LLC
Q

Okay. So – but the ROE was low enough to actually trigger a requested base rate increase in Oklahoma?

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

That's correct.

Sarah Elizabeth Akers
Analyst, Wells Fargo Securities LLC
Q

Okay. Great. Thanks a lot.

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

Thank you.

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

Thank you, Sarah.

Operator: And we'll go next to Chris Sighinolfi at Jefferies.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC
Q

Hey, good morning, guys.

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

Good morning, Chris.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

I just want to follow up maybe where Sarah left off, just on the expanded definition in Kansas, the GSRS, I guess the flexibility. In terms of the capital that will now qualify, I was also curious – you had in your slide presentations in the last couple of years, Pierce, a sort of estimation on your longer term modernization efforts, both the cast iron, the bare steel, the vintage plastic. I think you have defined it in the presentation based on sort of miles of pipe and this was system wide, not just Kansas specific, but just curious, did it expand to any of the changes in the definitions for that program, expand the amount of likely work you have out there? Was that a total number to begin with?

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

A

No. That was a total number to begin with, Chris. The thing I would point out to you though is before if you look at the June 30, 2018, test year under the old program, then the capital expenditures were around 37-point something million dollars, resulting in increased revenues of about $3.6 million, which was a customer impact of about $0.37. Under the new program, the capital expenditures are in the neighborhood of $68 million, $69 million, with an additional revenue associated with that, instead of $3.6 million would be about $6.7 million.

It raises the customer impact to about $0.68. We're still under that $0.80. So, we don't expect to accelerate anything unless there's some sort of a [ph] FEMSA (00:16:30) regulation that comes out and says that we need to do some things in the past. We're already on an accelerated pace. So, it really didn't expand what's there. It just gives us quick recoveries and you don't have it under the rate case. A big picture way to look at that is everything's going to be kind of reset in this year's annual rate case filing.

So, effectively, what this does, it impacts our future earnings in that 2020 kind of timeframe. So, long term, it does have an impact on us, so...

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay.

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

A

So, does that answer your question?

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

No, it does, Pierce. That's helpful. So, greater certainty of your recovery, a faster time profile for the recovery, but in terms of the absolute opportunity set, you'd identify it [ph] as is (00:17:22)?

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

A

Right. That's correct.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

No. Okay. That's very helpful. I guess following on somewhat Curtis talked about in terms of the impact from tax reform and it making the profile of earnings a bit more pro seasonal. I'm just curious if I look at the guidance and I look at the implications, even at the top end of $3.20 for EPS, thinking about the record first quarter you all just posted and what that maybe implies year-on-year for the back half, are there other items that we should pay attention to? I'm assuming based on your comments, Curtis, there will be a disproportionately large negative tax impact in 2Q, 3Q given the low seasonality of the profits in those quarters. Are there other items we should pay attention to that might step up in the back half year that cause year-on-year earnings degradation?

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

Yeah. So, on the tax piece, you're exactly right that that $0.13 will reverse in the second and third quarters and will probably reverse even a little bit more than the $0.13 before we get into the fourth quarter, which is a little bit stronger earnings quarter for us typically. So, that's the first thing I would point to.

The second thing is that the positive impact that we're having from rates or that we had from rates in the first quarter that was from rate cases that went into effect in the last half of 2017. And so, we're getting the full annualized effects here in the first and second quarters. And there's not a lot of activity replacing that in 2018 as we've been talking about over the past year.

And the last thing I would mention is in the first quarter, a year ago, we were a little bit behind on our capital compared to this year. I think I made the comment that our mix of projects was more heavily weighted in the first half of last year to operating-type projects as opposed to capital. This year, we're a little more evenly spread, which is why our capital is up in the first quarter. So, we'll still see the same mix of capital and operations type projects. They're just spread a little bit differently between the years.

And so, it's really a combination of those three factors that are creating the situation that you're describing.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC
Q

And so, with regard to that capital deployment mix shift, [ph] we'll (00:19:47) see that show up in your O&M lines, is that where we'd most likely see it?

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

That's right.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC
Q

Okay.

[indiscernible] (00:19:56)

Christopher Paul Sighinolfi
Analyst, Jefferies LLC
Q

Go ahead.

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

Sorry, Chris. We use a lot of internal labor in our capital projects. So, that labor gets capitalized. When we have higher capital spending, we're therefore capitalizing more of that labor as opposed to expensing it for operating-type projects.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC
Q

Okay. I understand. I guess final question for me is on that front. You guys have done a fantastic job since – certainly since the spin-out from ONEOK back in 2014 of really holding the line on your operating costs. And I know, Pierce, you offered the commentary on the automated meter readings and the improvement you've made there. But I'm just curious what other – I guess, what work remains that you've identified that you've communicated to us that we should pay attention to in terms of incremental improvement, either on things you've already done or whole new areas of cost improvement and technological adoption that might help hold the line on a go-forward?

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

Okay. Well, the one thing that has surprised me, Chris, is the ability of our operating people to continually find ways to improve our efficiencies. And so, we continue to deploy technology to allow our people to do things much quicker on the spot as opposed to having to bring in a lot of data and do a lot of data entry in the back office.

So, we get a lot of that stuff done kind of on-site. We continue to improve the way that we deliver service and efficiency in deploying our people. It's not any one particular thing. It's just a multitude of continuous improvement in our processes and the technology that we've deployed. I do think that that's going to continue into the future. We also have – as I mentioned, going from basically this 65% to 85% AMR, we did that basically over a four-year period. So, we still have many years left to continue to improve in AMR as well.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC
Q

Okay.

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

We're also improving the stuff as it relates to safety as well. So, just the combination of everything, Chris, is really what's leading to that, but we're laser focused in that area.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC
Q

You know it's been impressive and I think – I mean, you had outlined that in your plan upon the spin or in advance of the spin and just – I guess, you admitted in the answer, Pierce, you've found ways that have surprised you and they've surprised us too. So, I'm just curious what the different avenues and channels are for that to continue? So, anyway, the color is helpful. I appreciate the time this morning, guys.

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

Thank you, Chris.

Operator: And we'll hear next from Tim Winter at Gabelli.

Timothy M. Winter
Analyst, Gabelli & Co. Investment Advisers, Inc.
Q

Good morning, guys, and congrats on another really good quarter.

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

Thank you Tim.

Timothy M. Winter
Analyst, Gabelli & Co. Investment Advisers, Inc.
Q

I wanted to ask a strategic question. I know you've been pretty clear with the simple straightforward regulated strategy and it's working very well. But I was just wondering if there's any updated thinking with all the MLP issues, whether that might lead you to find some opportunities and say like regulated like assets, storage assets, or pipeline assets or if you're seeing anything there?

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

We're not seeing anything right now, Tim. We would – if you go back all the way in most of our history in this room, a lot of these assets started off in the C-Corps and then they morphed into the MLP structure. So, that MLP structure kind of captures those earnings to be distributed through their distributions. And so, it's hard to kind of get assets out of there. We don't see anything immediately on our radar screen, but probably overall if things more back to C-Corps, there could be long term – some assets out there that might be bought and brought back into these distribution companies. But right now, I'm not seeing any of those opportunities in our territories.

Timothy M. Winter
Analyst, Gabelli & Co. Investment Advisers, Inc.
Q

Okay. Very good. Thank you.

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

Thanks, Tim.

Operator: [Operator Instructions] And it appears I have no additional questions at this time. Mr. Lohse, I'll turn the program back over to you, sir.

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

Thank you for joining us this morning. Our quiet period for the second quarter starts when we close our books in early July and extends until we release earnings in early August. We'll provide details on the conference call at a later date. We look forward to seeing many of you at the AGA Financial Forum in a few weeks, which hopefully will provide a chance for me to meet many of you in person. Have a great rest of your day.

Operator: And ladies and gentlemen, once again, that does conclude today's conference. And again, I'd like to thank, everyone, for joining us today.