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One Gas, Inc. (OGS)

Q1 2017 Earnings Call

CORPORATE PARTICIPANTS

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Pierce H. Norton II
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OTHER PARTICIPANTS

Brian J. Russo
Analyst, Ladenburg Thalmann & Co., Inc. (Broker)

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

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

MANAGEMENT DISCUSSION SECTION

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

At this time, I would like to turn the conference over to Mr. Andrew Ziola. Please go ahead, sir.

Andrew Ziola
Vice President-Investor Relations & Public Affairs, One Gas, Inc.

Thank you, and good morning, and welcome to our first quarter 2017 earnings conference call. This call is being webcast live and a replay will be made available on our website. After prepared remarks from our speakers, we'll 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 or 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, Chief Financial Officer and Treasurer of ONE Gas. Curtis?

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

Thanks, Andrew. Good morning, everyone, and thank you for joining us. Net income for the first quarter 2017 was $76.5 million or $1.44 per diluted share, compared with $64.7 million or $1.22 per diluted share for the same period last year. Results were driven by new rates from investments made in our systems which includes the effect of the Kansas rate case and various Texas filings approved in 2016.

Net income was also impacted by the new accounting standard for share-based compensation that we adopted prospectively on January 1, 2017. We recorded a $5.2 million tax benefit and income tax expense, which resulted in a $0.10 per diluted share positive impact in the first quarter, slightly higher than the $0.08 per share indicated in our guidance in January. The impact in future years of the new standard will be driven by the performance of our stock and our relative total shareholder return compared with our peers.

Weather was 24% warmer than normal, and we experienced 12% less heating degree days compared with the same period last year. But our higher percentage of fixed monthly service charges and weather normalization mechanisms mitigated the effect with minimal impact on our net margin from sales customers.

Operating cost for the first quarter increased compared with the same period last year, reflecting an increase in outside services, material, bad debt and IT cost, partially offset by lower legal and employee related expenses.

Capital expenditures for the first quarter were approximately $70 million compared with $75 million for the same period last year. The decrease was due primarily to the timing of projects planned in 2017. The mix of operations and maintenance projects and capital projects was weighted less to capital projects in the first quarter of 2017 compared with the first quarter of 2016. The net result slightly lower capital expenditures and slightly higher operations and maintenance expense in the first quarter of 2017. We still expect capital expenditures to be approximately $350 million in 2017, with more than 70% targeted toward system integrity and replacement projects.

Yesterday, we affirmed our 2017 earnings per share guidance of $2.87 to $3.07 per share. The ONE Gas Board of Directors also declared a dividend of $0.42 per share. As a reminder, our targeted dividend payout ratio range is 55% to 65%. At March 31, 2017, our current authorized rate base defined as the rate based established in our latest regulatory proceedings including four rate cases and interim rate filings was approximately $2.9 billion.

Considering additional investments in our system and other changes and the component 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 a rate base in Oklahoma, 32% in Kansas and 27% 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. ONE Gas is focused on leading the industry as a safe, dependable provider of natural gas to our customers, an important component of our strategy and while we reinvest in our systems and facilities. As you may have read in our press release, we have some regulatory activity to highlight on this call. So I am going to begin with Texas.

In March, we made a filing under the Gas Reliability Infrastructure Program, or GRIP, for the incorporated and environs customers of the Central Texas Service Area for $4.9 million. If approved, new rates are expected to be effective in June. In the West Texas Service Area, we also filed a GRIP for $4.5 million, and if approved, new rates are expected to take effect in July.

So now moving to Oklahoma. We filed 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 are earning within the allowed range of a 9.0% to 10.0% ROE. Therefore, we did not request a change in base rate.

And in Kansas, we are expecting to file a request for interim rate relief under the Gas System Reliability Surcharge rider during the third quarter with new rates effective January of 2018.

As always, I would like to close by thanking our 3,400 employees for what they do every day for our customers. I appreciate their hard work, dedication and commitment to delivering our product, natural gas, to more than 2.1 million customers safely and reliably.

Operator, we're now ready for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] We'll take our first question from Brian Russo with Ladenburg Thalmann.

Brian J. Russo
Analyst, Ladenburg Thalmann & Co., Inc. (Broker)

Q

Hi, good morning.

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

A

Good morning, Brian.

Brian J. Russo
Analyst, Ladenburg Thalmann & Co., Inc. (Broker)

Q

Just on the $0.10 tax benefit in the first quarter, if I heard you correctly, you had assumed roughly $0.08 in your guidance. What's kind of the effective tax rate and does this tax benefit have any kind of ongoing impact on your tax rate post 2017?

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

A

This is Curtis, Brian. A couple of different points there. The entire tax benefit related to this item was recorded in the first quarter. So the $5.2 million relates to some long-term incentive shares divested in that period. And so it's recognized all of that point in time as opposed to being spread across the entire year. So overall, our effective tax rate absent that item would be pretty consistent for the balance of the year as it has been in prior years.

Then on a go-forward basis, each first quarter is the vesting period for the long-term incentive program. So depending upon what our share price does over the vesting period as well as how our share, our total shareholder return compares to our peer group will determine what that expense ultimately is each year and what that tax benefit is that gets recorded. Does that help you?

Brian J. Russo
Analyst, Ladenburg Thalmann & Co., Inc. (Broker)

Q

Yes, it does. So I guess, if nothing changes, if your total return relative to your peers is similar to what it was when you booked this benefit and your share price doesn't move, then there's real no benefit in 2017 over 2016, is that one way to look at it, a simplistic way?

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

A

Close. The one difference would be that you look to the share price at the beginning of the three-year period. And so it's a – when the shares were granted, so the ones that were vested in 2017, they were granted in 2014, so you look at what happens to the share price over that period of time. Got a little bit deep in accounting, but that's the inside part of it.

Brian J. Russo
Analyst, Ladenburg Thalmann & Co., Inc. (Broker)

Q

No, that's helpful. And then, just curious, obviously weather was very mild, it showed up in the heating degree days as well as your first quarter 2017 volumes, but yet your weather normalized mechanisms helped mitigate basically all of it. Just can you run through real quickly how they work in each jurisdiction?

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

A

Yes, so just broadly, and there's a little bit more detail that will be in our 10-Q that we filed later today, but two of the states compare the weather in the current period to a average 10-year period, and one of the states uses an average over a 30-year period. And so it's a comparison of the actual heating degree days that you experience in the current period compared to what those averages were in that either 10 or 30 year average period that's used as the comparison point.

And then to the extent you experience more or less, you get a – you make a revenue accrual either to the customers' benefit or to help the company in the case of a warmer year like this year that effectively smoothes out the revenues that you recognized. So you don't get a dollar – big dollar impact from the weather.

Brian J. Russo
Analyst, Ladenburg Thalmann & Co., Inc. (Broker)

Q

Got it. Okay, thank you very much.

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

A

Thank you, Brian.

Operator: We'll take our next question from Spencer Joyce with Hilliard Lyons.

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

Q

Hey good morning guys. Congrats on a good quarter here. Thanks for taking the call.

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

A

Good morning Spencer.

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

Q

Curtis, hate to make you keep talking about this tax item, but just a couple of follow-ups from me. Just to be clear, there's no catch up like involved in the first quarter here. I mean this is just a clean implementation, we are not looking back any number of years and logging any kind of special catch up. Is that right?

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

A

Spencer, you're exactly right in terms of the income statement. So the $5.2 million is truly related to the tax benefit from the grants that vested in the first quarter this year. Now there was a $11 million impact that was recorded to retained earnings on January 1st when we adopted the standard and that related to some tax benefits that we have not been able to recognize in prior years. And so, that was a catch-up piece, but that did not go through the income statement, that was recorded straight to the paid-in capital.

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

Q

Okay, very helpful. Also, if we -- I look at this $0.10 and I think, given where your stock has gone that maybe at some point, we see a benefit higher than that. But I have to assume that's maybe towards the higher end of impact we'll see. And I guess, my question is, is there the same level of downside sensitivity, say if your stock were to decline by an equivalent amount or is this some sort of construct that is inherently skewed towards benefiting you all?

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

A

No, the impact can be positive or negative. So again, I'll get a little deep into the accounting perhaps. But whenever the awards are granted, you measure the compensation for book purposes on that date. And to the extent that the share price increases or decreases, that creates a tax difference, because your tax deduction is the value of the shares that are actually vest and what the price is at the vesting date. So if that price were lower and you had less tax expense that would create a negative tax impact. In this case, these were shares from 2014, I think we're trading somewhere around $33, $34 at that point in time, so you have the increase in the share price and then the actual performance of the units.

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

Q

Okay. So it really is a fair mechanism. Any sort of consistent benefit is only going to be tied to the stock price going up versus sort of systematically declining.

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

A

Yes, as well as the performance of the units. So if you had performance shares that vested at zero, that is not going to matter what the share price is. That would have a negative impact on it.

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

Q

Okay, got you. All right, I think other than that, pretty clean quarter. Congrats on the regulatory progress and we'll stay tuned.

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

A

You should be prepared to set for the CPA exam now, so look forward to talking to you.

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

Q

Maybe after one review of the transcript there, but...

Operator: We'll take our next question from Chris Sighinolfi from Jefferies.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Hey, Curtis, how are you?

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

A

Hi, Chris.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Just – I hate to do it to you, but you are an accountant and I'm not, I just have one follow-up question on this taxing issue. This is – the program that you've had in place for years around employee grants if you hit a new share price absolute dollar figure record level, as you sort of hit the high watermark on a share price for ONE Gas stock, that's not impacted by this program, is it? This is just about...

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

A

No, you're exactly right. The accounting for that is exactly the same. In the first quarter, we did have two awards that were granted that was through the $68 share. We've had a $69 share in April and the $70 share will exhaust that program. So after first quarter, there is the potential for two additional shares, one of which has already been awarded.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. But those you've just been expensing, if I'm remembering it correctly.

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

A

That's correct. They are expensed on the day that they're granted.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. Now, since that program is [ph] set expense (16:36) is there any, or should we expect that to continue, or is that a program that had a purpose, served its purpose and upon expiration we shouldn't think about it being repopulated?

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

A

Chris, this is Pierce. Right now there is no plan to continue that program.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. And then switching gears a little bit, I know natural gas costs at least as quoted at Henry Hub up significantly on a year-on-year basis. I'm just wondering, are there any purchase gas adjustments that we should think about as we move through this brand, or did you fully collect for that increase already in 1Q?

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

A

All of those ups and downs on the gas costs actually gets passed through to the PGA. The only thing that I would mention that can be affected by that is if gas costs rise, then you have more defaults on the bill, so we had about I think about 800,000 of a delta between this quarter and last quarter last year, same period last year of about 800,000.

Now that is the portion that we don't collect on that doesn't pass through to the right pair. So you pass through the gas cost, but then the service piece of that, we have to book. So because that's not separated from the bill, you can have a little bit of an impact as gas prices rise as it relates to that phenomena.

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

A

And Chris just a little bit more detail, at the end of 2016, we were under-recovered by about $20 million, and at the end of the first quarter, we're under-recovered by roughly $5 million. So we've collected some of the under-collection – under-collected position that we were at year-end.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. So, from a future cash flow statement modeling perspective, there's nothing really that remains uncollected at this point, at least for...

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

A

Yes, it is pretty close to a push. Those mechanisms adjust fairly frequently. So, it would take a pretty extreme situation to get too far out of whack.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. And I guess my final question, it's more – I guess, a bit higher level, Pierce, but there is so many mid-stream companies, upstream companies focused on sort of a resurgence of producer activity in Oklahoma and the surrounding areas. I'm just wondering if you've seen any beneficial impact on your growth rates or any of the investment plan that might get accelerated due to any of that sort of economic activities and joint activity.

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

A

The thing I'd say to that, Chris, is that Oklahoma has been pretty resilient even when gas prices were down into the $2 range. Now, granted there's a significant number of drilling rigs running all over the United States right now than was this time last year. But if you look back at Oklahoma, it was over 60% of the drilling rigs were running when the price was in the $2 range in our territories in Oklahoma and Texas.

If you look forward to today, it's around 65%. So what it tells you is the lifting cost in our territories are fairly low. So not only can they sustain the lower prices, but they sure are going to be drilled because their margins are better as the prices increase.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. And from – I guess this is from history, some areas where the opportunities have changed because of the fluctuation in drilling related jobs, that might have an effect on an ability to procure labor needs and other things like that. You're not seeing any, I guess, undue competition from that resurgence that's happening. It's pretty, I think, consistent with your plans?

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

A

Typically, yes, short answer is no, Chris. But people that are typically who want to work on the rigs are not necessarily the people that would be working inside the cities on our assets.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. Perfect. Thanks a lot for the time.

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

A

Welcome.

Operator: We have no further questions in queue at this time. I would now like to turn the conference back over to Andrew Ziola for any additional or closing remarks.

Andrew Ziola
Vice President-Investor Relations & Public Affairs, One Gas, Inc.

Okay. Well, thanks everybody for joining us this morning. Our quite period for the second quarter starts when we close our books in early July and extends until we release earnings in early August. We will provide details on the conference call at a later date. We look forward to seeing many of you at AGA Financial Forum in a few weeks in Florida. Have a great rest of your day.

Operator: And this does conclude today's conference call. Thank you all for your participation, and you may now disconnect.