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ONE Gas, Inc. (OGS)

Q2 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

MANAGEMENT DISCUSSION SECTION

Operator: Good day and welcome to the ONE Gas Second Quarter Earnings Conference Call. Today's conference is being recorded. At this time, I'd like to turn the call 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 second quarter 2018 earnings conference call. This call is being webcast live, and a replay will be made available. We will be happy to take your questions upon completion of our prepared remarks. 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.

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 financial results, net income for the second quarter 2018 was $20.4 million or $0.39 per diluted share, compared with $20.6 million or $0.39 per diluted share for the same period last year. As in the first quarter, our second quarter results reflect increases from new rates in Texas and Kansas that were approved in 2017.

Higher sales volumes, net of weather normalization, primarily from colder weather in 2018 compared with 2017 and higher volumes from transportation customers. During the quarter, heating degree days were 29% colder than normal and 54% colder than the same period last year. Net margin increased $2.4 million or $0.05 on an earnings per share basis compared with the prior year.

Operating costs for the second quarter were $6.7 million higher compared with the same period last year due to increased employee incentive accruals and medical plan expenses. 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 $9.2 million reduction to our revenues in the second quarter 2018 or $7 million net of tax. This was partially offset by a $3.8 million reduction in our income tax expense.

This timing difference between the revenue deferral and the reduction in our income tax expense created a $0.06 negative impact to our results this quarter, partially reversing the positive $0.13 impact we experienced in the first quarter. We expect most of the remaining $0.07 to reverse in the third quarter. While the annual effective tax reform is negligible, it will continue to impact the timing and distribution of our quarterly earnings profile. Our earnings profile has some seasonality to it. So, in quarters like this second quarter, where seasonal earnings are lower, the impact of tax reform will be negative and vice versa.

Earlier this month, 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 updated our 2018 net income guidance range to $167 million to $178 million. Our updated guidance reflects the positive impacts from colder weather and stronger transportation revenues in the first half of 2018. Included in the guidance is a $5 million increase to O&M expense and a $5 million decrease to other expense. This change relates to the finalization of our pension and OPEB service and non-service cost that was completed after we originally issued guidance but does not change the total expense.

Earnings are expected to be in a range of $3.15 to $3.35 per diluted share with an achieved ROE of 7.7%. We also updated our 2018 capital expenditures guidance to a range of $375 million to $390 million. This increase relates to system expansions primarily in Oklahoma.

At June 30, 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 $3.5 billion with 42% of that being our rate base in Oklahoma, 31% 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. I'd like to give you an update on the recent regulatory activity in our service areas, and then we'll take questions after that. Beginning 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, which includes the impact of tax reform. We had a hearing before the administrative law judge on July 27, and we expect an order sometime in the third quarter.

Now, to Texas. We received approval for the filings made under the gas system reliability infrastructure program (sic) [Gas Reliability Infrastructure Program] (00:06:56) or GRIP for all customers in the West Texas service area for an increase of $3.5 million, which took effect in July. This increase is offset by $4.7 million decrease to rates due to the reduction in the Federal income tax rate. A one-time refund of $2.4 million was distributed in May for changes to the tax rate for the period between January 1, 2018 to the date when the new rates were implemented.

New rates also went into effect in July for all customers in the Central Texas service area after we received approval for the $3.3 million increase made under the GRIP filings. This increase is offset by a $4.9 million decrease to rates due to the reduction of Federal income tax. A one-time refund of $2.5 million was made in May for changes to the tax rate for the period between January 1, 2018 to the date when the new rates were implemented.

Now, on to Kansas, on June 29, Kansas Gas Service filed a request with the Kansas Corporation Commission or KCC, for a net increase in rates of $42.7 million reflecting investments in the system improvements and changes in the operating costs necessary to maintain the safety and reliability of its natural gas distribution system. The requested net increase in rates would result in an increase in the operating income of approximately $31 million.

Since the last general rate case, Kansas Gas Service has invested $179 million in its systems and facilities. This request would increase the average residential customers' natural gas bill by $5.67 per month. 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.

The filing represents a rate base of $1 billion compared with a $947 million included in our last rate case, plus previously approved GSRS-eligible investments. The KCC has 240 days to consider Kansas Gas Service's filing and new rates are expected to be effective sometime in the first quarter of 2019.

To close, I would like to turn our attention to our 3,500 outstanding employees and thank them for their focus and commitment to safely and reliably deliver natural gas to our customers.

Operator, we're now ready for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] We'll pause for just a moment to allow everyone an opportunity to signal. And we will take our first question from Sarah Akers with 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 just expand on the weather normalization mechanisms? Because it looks like the cold weather was in Kansas and Oklahoma, but I thought you had 100% weather normalization in place. So, can you just walk through that?

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

Well, probably the easiest way to explain that, Sarah, is we do have weather normalization in 100% of our territories now in all three states. But weather norm works a little bit differently as it goes throughout the year. When you have extremely cold weather or extremely warm weather in the shoulder months, the weather norm doesn't act perfectly, meaning a one-for-one swap between what the weather would've given you in either way. So, any time that you get – it works really well for us for the majority of the year. But in those shoulder months, you can get into a little bit of imperfection when you have an extremely cold weather.

Sarah Elizabeth Akers
Analyst, Wells Fargo Securities LLC
Q

Got it. Okay. And then can you talk about the drivers of the higher transportation volumes this year?

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

Well, part of it is actually due to weather.

Sarah Elizabeth Akers
Analyst, Wells Fargo Securities LLC
Q

Okay.

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

when you have the colder weather, you do have some weather sensitivity to our transportation volumes. And the other is just a slight amount of growth in the transportation volume arena.

Sarah Elizabeth Akers
Analyst, Wells Fargo Securities LLC

Q

Got it. And then, lastly, what level of customer growth did you end Q2 with?

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

A

It's about – overall, I think about 0.6%, somewhere in that area, overall three territories

Sarah Elizabeth Akers
Analyst, Wells Fargo Securities LLC

Q

Great. Thanks a lot.

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

A

Thank you, Sarah.

Operator: [Operator Instructions] And next, we will hear from Chris Sighinolfi with Jefferies.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Hey. Good morning, Pierce. How are you?

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

A

Good morning, Chris.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Just two questions for me. I think they're both for Curtis actually. One is, can you remind me? I know that there were some reclassification of some of your expense guidance with the tax changes and I think it might had to do with pension at the end of last year. And so, with regard to the update in guidance between O&M and other, can you just remind me about what those moving parts are and how to best think about them?

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

A

Yeah, Chris. So, I think you might be referring to the pension standard that we adopted on January 1 of this year. And what that does is it separates pension and OPEB costs between service costs and non-service cost. Previously, all of those expenses were in the O&M line. Beginning January 1, only the service cost stays in O&M and the non-service cost goes down into other expense.

And so, in last year's 10-K, we provided what the pro forma for [ph] 27 (00:13:40) would look like post-adoption of that standard, so that it's comparable in our actual numbers between 2017 and 2018 and going forward. What happened in our guidance is, we didn't have the final split between service and non-service costs when we issued guidance earlier this year. And in this update, we have all that. And so, it resulted in a little bit of that expense going back into O&M as opposed to being another expense.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC
Q

Okay. So, some of the guidance update did have to do with the interplay between those two items?

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

It did. No change in the total, just the geography on the income statement.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC
Q

Okay. That's super helpful. Thanks, Curtis. And then the follow-up for me is, obviously, very strong results. You mentioned the weather dynamics and obviously the timing profile for the weather norm, and the throughput obviously leading to some better transportation performance. Just curious, as a pivot to the cash flow statement, you guys had a very, very strong working capital benefit. I'm assuming it's related to that. But I guess two questions, one, am I right in interpreting the benefit that way? And two, what does that mean in terms of potential working capital needs or draws in the back half of the year?

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

So, there are a couple or several moving parts going on in those totals. Part of it is, Pierce, in his comments, talked about a refund of some of the taxes that were collected in the first half of this year. So, we'll have that continuing in the back half. One of the bigger drivers, though, is with the colder winter that we had, we pulled much more gas out of storage.

So, we haven't yet returned to our normal injection levels at this point. We're in that process now, but the difference is we're re-injecting gas at a lower cost than the gas we pulled out of the ground. So, we have roughly 50 Bcf of storage that's leased. We don't put a full 50 Bcf in, but we still have more gas to put in the ground, so that will use some working cap in the last half of the year, just not to the extent we've seen in the past few winters.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC
A

Okay. So, more to fill relative to where you might have stood in past cycles just given how cold it was, but the price point [ph] per annum (00:16:03) going back in is lower than it was in inventory, to begin with. Is that [ph] a correct (00:16:08) understanding?

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

That's correct.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC
Q

Okay.

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

Yeah. Exactly right.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC
Q

Okay. Thanks a lot, guys. It was very helpful.

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

Thanks, Chris.

Operator: [Operator Instructions] And with no further questions, I'd like to turn the call back over to Mr. Lohse for any additional or closing remarks.

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

Thank you for joining us this morning. Our quiet period for the third quarter starts when we close our books in early October and extends until we release earnings in late October. We'll provide details on the conference call at a later date. Have a great rest of your day.

Operator: And that does conclude our call for today. Thank you for your participation. You may now disconnect.