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One Gas, Inc. (OGS)

Q3 2014 Earnings Call

CORPORATE PARTICIPANTS

Andrew Ziola
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Pierce H. Norton
President, Chief Executive Officer & Director

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

OTHER PARTICIPANTS

John Michael Devir
Pacific Investment Management Co. LLC

MANAGEMENT DISCUSSION SECTION

Operator: Please stand by. Good day and welcome to the ONE Gas Third Quarter 2014 Earnings Conference Call. Today's conference is being recorded. At this time, I'd like to turn the conference over to Mr. Andrew Ziola. Please go ahead, sir.

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

Thank you, Jessica, and welcome everyone. As Jessica noted, this call is also being webcast live on the Internet, with a replay available. After our prepared remarks, we'll be happy to take 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.

Our first speaker is Pierce Norton, President and Chief Executive Officer of ONE Gas. Pierce?

Pierce H. Norton
President, Chief Executive Officer & Director

Thanks, Andrew. Good morning, everyone, and thank you for joining us for the ONE Gas third quarter 2014 earnings call. We appreciate your interest and investment in our company.

Joining me on the call today is Curtis Dinan, our Chief Financial Officer. On this morning's call, we will review the third quarter 2014 results, discuss our increased 2014 guidance, provide a regulatory update in our three states, and finally provide you an opportunity to ask questions.

We continue to focus on safety and reliability through capital investments and our systems in all three states and which we operate. Resulting in new rates, primarily in Texas and Oklahoma. We also generated incremental margin from residential customer growth. From a year-to-date perspective in addition to what I just mentioned, we earned incremental margin from CNG and commercial and industrial customers. Operating costs were higher compared with the same period last year, reflecting expenses related to the separation from ONEOK.

We increased our 2014 net income guidance range to $105 million to $110 million compared with the previously announced range of $95 million to $105 million that we announced in December 2013.

Curtis will now review the financial highlights for the quarter, discuss the moving parts that led to our increase in our 2014 guidance. Curtis?

Curtis L. Dinan

Chief Financial Officer, Treasurer & Senior VP

Thanks, Pierce, and good morning. Third quarter net income was $4.7 million or $0.09 per diluted share, compared with $0.4 million or $0.01 per diluted share for the same period last year. Last month, the ONE Gas board of directors declared our third dividend of $0.28 per share, consistent with the guidance we provided last December of $1.12 annual dividend. This dividend level is consistent with the company's expected 55% to 65% dividend payout ratio.

Pierce already discussed the factors behind the quarter-over-quarter increase in net margin. The increase in operating cost was due primarily to costs associated with the separation from ONEOK, an increase in insurance and IT expenses which is a part of the previously disclosed annual recurring increase of $11 million. These increases were partially offset by lower employee related cost that includes share-based compensation. This quarter-over-quarter variance was driven primarily by higher expenses in the third quarter of 2013 related to the increase in ONEOK share price.

The quarter-over-quarter increase in operating cost was consistent with our expectations. We substantially completed the separation of our IT systems from ONEOK this past quarter, which was earlier than originally expected.

Earlier this year we estimated the cost directly associated with the separation to total approximately $12 million. We now expect that total to be $9.2 million and have spent approximately $6 million year-to-date. We expect most, if not all of the $9.2 million, to be spent in 2014. The reduced amount was the result of lower than expected IT separation cost.

We ended the third quarter with a debt to capitalization ratio of approximately 40%, unchanged from last quarter. At September 30, we had 44 Bcf of natural gas in storage in line with our plan. And as of October 31, completed our planned injections for the 2014-2015 heating season.

Now on to guidance. As Pierce mentioned, we increased our 2014 net income guidance range to $105 million to $110 million. The increased guidance reflects higher net margin from the colder than normal weather experienced in the first quarter 2014, stronger than expected residential customer growth and lower interest expense. On a pre-tax basis, weather impacted the increase in guidance by $8 million, while residential customer growth impacted the increase in guidance by $3 million.

These positive developments were offset partially by higher operating expenses, including cost associated with the separation from ONEOK, that were not included in the original guidance provided in December of 2013. Based on our new net income midpoint of $107 million, we now expect our earned ROE for 2014 to be 7.6%, compared with our previously disclosed ROE of 7.4% for 2014.

To reiterate from our previous earnings call, we expect to be at the high-end of our capital expenditure range of $240 million to $285 million for 2014. At September 30, our current authorized rate base, defined as the rate base established in our latest regulatory proceedings, including full rate cases and interim rate filings, is approximately $2.26 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 our rate base in 2014 will average approximately $2.5 billion, with 42% of that being our rate base in Oklahoma, 33% in Kansas, and 25% in Texas.

Pierce, that concludes my remarks.

Pierce H. Norton
President, Chief Executive Officer & Director

Thanks, Curtis. Now for the regulatory updates on our three states. In Oklahoma, Oklahoma Natural Gas will file a general rate case in 2015 based on the test year consisting of 12 months ending March 31, 2015. We expect the outcome of this rate case to be reflected in our financials in early 2016. This will be the first full rate case post separation in Oklahoma.

In Kansas, we filed an annual request for interim rate relief under the Gas System Reliability Surcharge or GSRS, in August for an increase in base rates of approximately $3.5 million with new rates effective January 2015, driven by capital investments of approximately $34 million.

GSRS is a capital recovery mechanism that allows for a rate adjustment for safety-related and government-mandated capital investments made between rate cases. The Kansas Corporation Commission has a 120 days to render a decision on the request. The next Kansas general rate case is expected to be in 2016 using a 2015 as a test year with new rates effective in January 2017.

In Texas, the Austin and El Paso jurisdictions represent more than 70% of our customers in Texas, and we shared the result of recent activity in those territories in our last quarter's conference call. In some of our other Texas jurisdictions, Texas Gas Service has received approval this year for add-on rate release under the Gas Reliability Infrastructure Program or GRIP, and cost of service adjustments totaling approximately $4 million driven by capital investments and changes in cost of service.

Now for an update on CNG business, since we get quite a few questions on this when we're at meetings with investors. CNG continues to gain traction in our territory. At September 30, 2013, we supplied 99 stations. At September 30, of 2014 that number has increased to 113, an increase of 14%. When you look at the amount of dekatherms that has been disbursed for all of these stations, we've increased the percentage change by 51% between those two periods. Although we started with a relatively low volumes to begin with, this data tells us that our strategy is working.

Our strategy is to deploy a minimum amount of capital to hook up these stations and allow the free market to build and operate the stations. We then pick up extra transport margins off to gas that goes through the stations.

In closing, I would like to thank our 3,200 employees for serving our customers and operating our assets in a safe, reliable and environmentally responsible manner every day.

Operator, we're now ready for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question will come from John Devir with PIMCO. Go ahead, John.

John Michael Devir
Pacific Investment Management Co. LLC

Q

Hi, Pierce and Curtis, it's John from PIMCO. Thanks so much for hosting the call. I just wanted to let you know I'm honored to be the first person to ask a question on one of your conference calls.

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

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Thank you, John.

John Michael Devir
Pacific Investment Management Co. LLC

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If you wouldn't mind, Curtis, could you just maybe give us a little more color on the expense side. And you said that the separation was a little higher. Is that because – was it just higher or were you pulling forward some expenses because of the integration has been going smoother than expected?

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

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When we originally gave our guidance for 2014 almost a year ago, at that time, we hadn't developed all the details of the plan around the separation, the biggest part of that being the IT systems. There were several different scenarios that we had considered and so we had not included any of it at that time. As we continue to work on that plan, we ended up with the process that we've gone through that had the majority of that completed by the end of this past month.

John Michael Devir
Pacific Investment Management Co. LLC

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Okay. And then do you have any thoughts on how we should be looking at expenses in 2015 and 2016? Do you start realizing any benefits from the savings or is it – how should we be looking at going forward? Was there anything one-time or is it all those were just permanent expenses going forward?

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

A

In my comments – when I talked about that we expect the separation cost to total about $9.2 million, the majority of that is here in 2014 and so that would be an item that we would not expect on a recurring basis.

John Michael Devir
Pacific Investment Management Co. LLC

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Okay. And then on the guidance [indiscernible] (12:41) you mentioned the breakout with weather and the customers. Do you view that weather as one-time and so it won't really impact your dividend strategy? And so if you look at the guidance, it sort of puts you at the low end of that $55 million to $65 million range. Is that how we should be looking at it that's more one-time and doesn't necessarily mean that you'll adjust the payout ratio?

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

A

Yeah. I wouldn't expect either in the current year or on a go-forward basis that the effects of weather are necessarily going to drive dividend decisions. When we give guidance, whether it's for the current year or what we think of a five-year outlook, we do that based off of a normal weather pattern. So we will certainly see periods where it's colder than normal.

We may pick up a little bit of a positive effect in other periods where it maybe a little bit warmer than normal and it can have a little bit of a negative impact. But keep in mind that a high percentage of our revenues are fixed fee and were less volumetrically sensitive or in the areas where we do have a little bit more volumetric sensitivity, we have weather norms during the colder periods of the year. So it helps isolate us from those.

So we don't necessarily see really big swings from those, but we can't have periods like this past year where we do see a little bit, but, again, we don't plan on that in our guidance and I wouldn't expect that to necessarily drive dividend decisions.

John Michael Devir
Pacific Investment Management Co. LLC

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Okay. And just the last question for me. Is there sort of any timetable when you expect that CNG business to be sort of more meaningful piece of your revenue stream like is it two years, five years out? Or how many stations do you think you would need to supply where it would be sort of like a meaningful generator of revenue growth?

Pierce H. Norton
President, Chief Executive Officer & Director

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John, this is Pierce. I think it's going to continue to be a steady growth piece for us. I don't think it's going to be material probably over the next, say, two years to three years. I think probably the game-changer will happen if we ever do get a home refueling station. Because an average home in the state of Oklahoma consumes around 70 dekatherms per year and actually most residential type vehicles, which is primarily like a Honda Civic, will also consume around 70 dekatherms a year. So it would be like doubling the load if you ever got a home refueling station and make it very easy for the customers to fill their vehicles up at their house.

So if that ever becomes more affordable, right now they are anywhere from $4,000 to $5,000 per unit. If that gets down into, say, the $500 range and there is a lot of R&D going on around that area right now, if that happens then that could be a real game-changer for us. But otherwise, it's probably going to be just continued steady growth for us of which we picked up to transport dollars.

John Michael Devir
Pacific Investment Management Co. LLC

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Thank you so much for your time. Have a great day, guys.

Pierce H. Norton
President, Chief Executive Officer & Director

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All right. Thank you, John.

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

A

Yeah. Thank you, John. When I get back to my desk, I'll spin the wheel of first call gift card, so we'll see what you win this month.

John Michael Devir
Pacific Investment Management Co. LLC

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I am looking forward to it.

Operator: [Operator Instructions] And I'm showing no further questions in the queue.

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

Okay. Well, thank you everyone 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 sometime in February 2015. We will provide details on that conference call at a later date. Thank you again and have a great day.

Operator: This does conclude today's conference. Thank you for your participation. You may now disconnect.