01-Nov-2016

ONE Gas, Inc. (OGS)

Q3 2016 Earnings Call

CORPORATE PARTICIPANTS

Andrew Ziola
Vice President-Investor Relations & Public Affairs, 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

Gabe Philip Moreen
Analyst, Merrill Lynch, Pierce, Fenner & Smith, Inc.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good day and welcome to the ONE Gas Third Quarter Earnings Conference Call. Today's conference is being record. And at this time, I'd like to turn the conference over to Andrew Ziola. Please go ahead.

Andrew Ziola

Vice President-Investor Relations & Public Affairs, ONE Gas, Inc.

Thank you, Evan. Good morning and thank you all for joining us for our third quarter 2016 earnings conference call. This call is being webcast live with a replay made available. After prepared remarks from our speakers, 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 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, Chief Financial Officer, and Treasurer of ONE Gas. Curtis?

Curtis L. Dinan

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

Thanks, Andrew. Good morning, everyone and thank you for joining us. Yesterday, the ONE Gas Board of Directors declared a dividend of $0.35 per share. This dividend is consistent with the company's guidance for 2016. As we have previously indicated, we expect the average annual dividend increase to be 8% to 10% between 2015 and 2020.

We also affirmed our 2016 guidance, which we updated back in August. We expect net income to be within the range of $135 million to $140 million, or $2.55 to $2.65 per diluted share. We anticipate releasing our 2017 guidance and our updated 5-year forecast in January.

Now, on to third quarter results, net income for the third quarter 2016 was $12.7 million or $0.24 per diluted share compared with $7.4 million or $0.14 per diluted share for the same period last year. New rates from investing in our systems, which includes the effect of the Oklahoma rate case that was approved earlier this year, and other various rate filings in Texas over the past year as well as residential customer growth in Oklahoma and Texas led to our positive results.

Operating costs for the third quarter were slightly higher compared with the same period last year reflecting an increase in outside service costs and fleet and materials expenses. Year-to-date, operating costs were slightly lower compared with the same period last year. This year-to-date decrease was driven primarily by lower outside service costs and lower IT expenses, offset partially by higher employee-related expenses.

Capital expenditures for the third quarter were $87 million compared with $74 million for the same period last year. We expect capital expenditures to be approximately $305 million in 2016 with more than 70% targeted towards system integrity and replacement projects.

ONE Gas ended the quarter with a total debt to capitalization ratio of 40% and $4.5 million in cash and cash equivalents. We had $42 million in short-term borrowings and letters of credit which leaves $658 million of credit available under our $700 million credit facility.

At September 30, 2016, our current authorized rate base, defined as the rate established in our latest regulatory proceedings, including full rate cases and interim rate filings, was approximately $2.7 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 2016 will average approximately $3 billion with 42% of that being our rate base in Oklahoma, 32% in Kansas and 26% in Texas.

And now, I will turn it over to Pierce Norton, ONE Gas President and Chief Executive Officer.

Pierce H. Norton II

President, Chief Executive Officer & Director, ONE Gas, Inc.

Thanks, Curtis and good morning everyone. ONE Gas is focused on being an industry leader as a safe and reliable provider of natural gas to our 2.1 million customers, a critical component of our strategy and why we reinvest in our systems and our facilities. As you may have noticed in our press release, we've had quite a bit of regulatory activity that represents the recovery of those investments. So, with that, we will continue to have a collective basket of regulatory activity across all three of our states. The various regulatory outcomes in all of our service territories determine where our results may fall within the low to high range of our 5-year plan.

Let's start with Kansas, which represents approximately 30% of our total rate base. On October 5, Kansas Gas Service reached a settlement agreement with all parties for a total base rate increase of $15.5 million, or a net increase in base rates of $8.1 million, after considering the Gas System Reliability Surcharge already being recovered.

If approved by the KCC, the impact to 2017 operating income will be approximately $9.1 million. As with our last rate case in Kansas, the agreement is a black-box settlement meaning the parties agreed to a specific revenue number, but no specific return on equity. The KCC has until December 28 to make a ruling with new rates being effective no earlier than January 1, 2017.

So, now, let's move to Texas and I'll start with the Central Texas service area which includes the City of Austin. Last month, Texas Gas Service reached a settlement agreement for its Central Texas and South Texas jurisdictions for an increase in revenues of $6.8 million, which has an operating income impact of $3.4 million.

As a result of the agreement, the parties agreed to consolidate the two service areas and establish a 9.5% return on equity and a 60.1% common equity ratio. New rates will be effective in November of this year for the incorporated cities of the former Central Texas service area. For the unincorporated areas, new rates are expected to be effective in early January upon approval from the Railroad Commission of Texas or the RRC.

Now, for our West Texas service area, in September, the RRC approved consolidation of the El Paso, Dell City and Permian service areas into a new West Texas service area. The RRC approved a base rate increase of $8.8 million, which will have a $7.6 million impact on operating income. This approved filing was based on a 9.5% return on equity and a 60.1% common equity ratio.

Last month, rates went into effect for all service areas with the exception of the incorporated cities in the former Permian service area. Texas Gas Service expects to file for these new rates this quarter also in October of 2016. Texas Gas Service and the City of El Paso filed separate motions for rehearing for various issues. The RRC has until January 2017 to make their ruling.

Our jurisdiction count in Texas will be 6 that the RRC approves the Central Texas settlement compared with 10 we started with earlier this year. This consolidation of jurisdictions benefits our stakeholders by creating administrative efficiencies and the savings are passed on to our customers. For additional details of our Texas regulatory activity, please see our third quarter 10-Q that will be filed later today.

In closing, I would like to thank all of our more than 3,400 employees for their continued focus and commitment to providing safe and reliable service to our 2.1 million customers. Operator, we're now ready for questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] We will take our first question from Gabriel Moreen, Bank of America Merrill Lynch. Please go ahead.

Gabe Philip Moreen
Analyst, Merrill Lynch, Pierce, Fenner & Smith, Inc.

Q

Hey, thanks. Good morning, everyone. Question maybe just in terms of I'm not fishing for 2017 guidance per se and I know you are not giving it on this call, but when you gave the guidance for the 5-year outlook on EPS and dividend growth at the beginning of I think this year, was that 5% to 8% basically meaning that you could or could not fall below that range for one year or is that just really looking at sort of an average over that that 5 year time horizon through 2020?

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

A

Good morning, Gabe. This is Curtis. One, the guidance I would give you is first off, yes, it was based off of 2015 as the starting point. And then within that 5-year period and that's just an average, the compounded average growth rate over that period of time. So there will be periods that it is more lumpy as it relates to if we have an above-average period of rate case activity versus a period where we may not have as many rate cases in process. So some years it may be a little higher, some years it may be a little lower, but it will still – our projection was to average out for that 5% to 8% over that 5-year period.

Gabe Philip Moreen
Analyst, Merrill Lynch, Pierce, Fenner & Smith, Inc.

Q

Understood. Thanks, Curtis. And then I guess this is a question in terms of kind of a Kansas rate case. Can you just talk about I guess the settlement amount relative to what you are asking for and I appreciate it's a black-box settlement you can't really talk ROE, but were there any major line items on expenses or things that were disputed in rate base that maybe you can sort of flag for us in terms of what's the potential outcome settlement on that case is going to be?

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

A

Well, at this time Gabe – this is Pierce. We really don't have any reason or any indication to believe that this settlement won't be approved. But I guess the way I'd answer that is it is always multiple of things that get deducted there and there is a lot of things that go into that. We do believe though that this settlement is the best thing for all the parties at this time.

And the way we would look at all of our rate activity is that the regulatory process is a marathon, it's not a sprint. So we will let the KCC make their ruling on December 29 there before. And then we'll look back and do a postmortem and see if there is anything we need to do differently in the future.

Gabe Philip Moreen
Analyst, Merrill Lynch, Pierce, Fenner & Smith, Inc.

Q

And on the postmortem, Pierce, can you just talk about is there going to be a stay-out provision here and would you envision kind of coming back to the KCC at some point in the not-too-distant future if there is not a stay-out provision?

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

A

Well, at this time, Gabe, there is no stay-out provision that's contemplated in the settlement agreement. So if for some reason the KCC decided as the commissioners to make a change, then if it's deemed a material difference from the settlement agreement, then it goes back to all the parties to kind of re-look at them. And as far as the rate activity going forward, we're going to give you a guidance into that when we come out with our guidance for the entire company in January.

Gabe Philip Moreen
Analyst, Merrill Lynch, Pierce, Fenner & Smith, Inc.

Q

Understood. Thanks, Pierce.

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

A

Thank you, Gabe.

Operator: We'll take our next question from [ph] Joe Zhou from Avon Capital Advisors (12:56). Please go ahead.

Q

Hey, good morning. Congratulations on the quarter.

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

A

Good morning, [ph] Joe (13:02). Thank you.

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

A

Thank you.

Q

Just a quick question on your O&M, I see that your nine months ending O&M is tracking almost flat year-to-date, shall I expect that to be flat going forward or how do you manage that and what's – on your 5-year plan and how shall I model that going forward? Thank you.

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

A

Hi. There is – as you know, [ph] Joe (13:27), there is a lot of moving parts to O&M. What we're concentrating on is our labor costs and our outside services costs and any sort of ancillary costs that are kind of tied to those two. And we said all along that our focus is to deploy technology so that we can maintain those expenses. Going forward, we do think that's at a little more indicative level of what we can see in the future as opposed to maybe what has been there in the past, so that's the way I'd answer that.

Q

Okay, thank you very much.

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

A

Thank you, [ph] Joe (14:04).

Operator: And we will take our next question from [ph] Steven (14:08). Please go ahead.

Stephen D'Ambrisi - Castleton

Q

Hi guys. I just had a quick question on the comment on the Kansas settlement, you said there was a net increase of $8.1 million, but the impact to operating income was $9.1 million, what's the difference between those two numbers?

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

A

Hey [ph] Steve (14:29). This is Curtis. In the – part of that revenue requirement there is some additional depreciation that gets recorded or amortization of reg assets that have been set up over the past few years. So we're recovering those costs. And then there – with that change in the amortization of those it gives you a little bit different answer than the revenue requirement. So, net-net, it's a positive impact.

Q

Okay, great. That was all I had. Thanks guys. Good afternoon.

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

A

Thank you, [ph] Steve (00:00).

Operator: [Operator Instructions] We will take our next question from Chris Sighinolfi from Jefferies. Please go ahead.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Hey Pierce, how are you?

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

A

Great. How are you, Chris?

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

I'm good. Thanks. I just had a question, you in the outcomes in Texas was just noticing some enhancement to I think what you had asked about in terms of the equity layer, obviously some not quite what you had asked about in terms of an ROE component, so just curious given the cadence of discussion that you had in your Oklahoma case as it pertains to Texas, it seems like there is more comfort around the 61% equity layer. Is there anything sort of noteworthy that the way those outcomes took shape and the discussions sort of more favoring equity component as opposed to ROE?

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

A

So, first of all, Chris, this might have been my Southern dialect that made you think that was 61%, it was actually 60.1%, well, actually – which is actually what our actual equity is at the time of the filing. So we asked for the actual and in both cases we got the actual.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay.

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

A

And then as far as the 9.5% is more indicative of what the Railroad Commission has been approving down there in other cases. So, there is some consistency that we saw across basically different jurisdictions and different companies in the State of Texas.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. Yes, that was my misinterpretation of the equity layer I was hearing 61%, so thanks for the clarification.

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

A

Well, again that was my dialect, I think.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Well, I have been working hard to get rid of my Maine accent, so no problem.

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

A

You can hang around me and I can pick that for you.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

You're right. Also I was thinking there has been a lot of recapitalization that's happened with the E&P community, we're seeing rigs go back to work, Pierce, the West Texas is an area that's really picked up from the bottom and

I'm just curious as it pertains to your service territory there, but also in parts of Oklahoma, how that if at all shapes what you guys are thinking might be in store in the intermediate term in terms of customer growth rates and then also capital spend if there is an ability to sort of flex forward maybe within the 5-year plan some of the spending to accommodate enhanced customer growth or if it was just spare capacity that you think is going to get taken back up as people move back to those areas?

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

A

OK, So there is a lot packed into that question, Chris. I think I heard three things that I will try to answer. The first one is as far as the E&P community as it applies to Oklahoma and Texas, the best word I could describe it is resiliency. Because even there in the downturn when the prices were low and rigs were laid down across the entire United States, 60% of the active drilling rigs in the U.S. continued to run in the states of Texas and Oklahoma. So yes, it's – we have had a little bit of uptick lightly, but we're still in the – somewhere around that 60% number facts as far as the drilling rigs in the United States.

When it comes to flexing capital spending that's something that we will analyze and give clarity to when we do our updated guidance for 2017 and our 5-year plan. I would characterize that as we seem to be steady as far as customer growth goes, it's along the same numbers that we've always reported. And it shifts around just a little bit from time-to-time based on the seasonality and things that happened in the year. But we expect that to continue. But the main spend will continue to be on system integrity. So that will kind of dwarf the spending that we'll have even if the customer growth picks up. But at the end of the day, it all goes into rate base.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay, perfect. And I think a final question from me, Pierce, I mean, obviously there has been more of an emphasis in the last couple of years on the regulatory filings in Oklahoma and in Kansas particularly and then on the costing side of the equation moving off the separation and then some of the achievements you guys have made on efficiencies. But curious, CNG guys remain as really small part of the program, but something we've talked about in the past. Has there been anything from a materiality standpoint that's taken shape within your ambitions in that realm or from a technology perspective anything to be aware of?

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

A

Yes, the short answer, Chris, is no, but we do continue to see growth in that area. We continue to add more and more stations – our station count right now that we serve is around 140. I think the last time we talked it may have been in the 115 to 118 kind of range. So, we have continued to see growth in that area and it is really focused on the larger vehicles, fleets, such as FedEx, UPS, those kind of folks and we do continue to see growth there. But in materiality, I would say, we're not there yet and we don't see at least anything currently that's going to be a breakthrough as far as a game changer yet in the technology.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay, great. Thanks so much for the time this morning.

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

A

Thank you, Chris.

Operator: And there appear to be no more questions at this time. So, I would like to turn the call back over to Andrew for closing remarks.

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

Well, thank you everyone for joining us. Our quiet period for the fourth quarter starts when we close our books in early January and extends until we release earnings in February of 2017. We will certainly provide details on the conference call at a later date. If you have not done so, I encourage you to visit the IR page on our website, register for e-mail alerts and view our third quarter documents. Have a great rest of your day.

Operator: And that does conclude today's presentation. Thank you for your participation. You may disconnect.