21-Feb-2019

ONE Gas, Inc. (OGS)

Q4 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.

Caron A. Lawhorn
Senior Vice President-Commercial, ONE Gas, Inc.

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

Robert S. McAnnally
Senior Vice President-Operations, ONE Gas, Inc.

OTHER PARTICIPANTS

Aga Zmigrodzka
Analyst, UBS Securities LLC

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good day and welcome to the ONE Gas Fourth Quarter and Year-End 2018 Earnings Conference Call. Today's conference is being recorded. At this time, I'd like to turn the conference over to Mr. Brandon Lohse. Please go ahead, sir.

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

Good morning and thank you for joining us on our fourth quarter and year-end 2018 earnings conference call. This call is being webcast live and a replay will be made available later today. 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 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.

Joining us on the call this morning are Curtis Dinan, Senior Vice President and Chief Financial Officer; Caron Lawhorn, Senior Vice President, Commercial; Sid McAnnally, Senior Vice President, Operations; and Pierce Norton, President and Chief Executive Officer. 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 fourth quarter 2018 results, net income was $45 million or $0.84 per diluted share compared with $47 million or $0.89 per diluted share for the same period last year. Our fourth quarter results reflect new rates in Texas and Kansas, residential customer growth in Oklahoma and Texas, and colder weather compared with 2017, offset partially by higher operating costs.

Our fourth quarter results were also impacted by revenue deferrals and related rate adjustments due to tax reform. However, the impact was offset by lower income tax expense. Operating costs for the fourth quarter were $124 million compared with $120 million in the same period last year, primarily due to the one-time deferral of previously accrued manufactured gas plant costs resulting from a December 2017 accounting authority order we received in Kansas, offset partially by a decrease in employee-related costs.

For full-year 2018, net income was $172 million or $3.25 per diluted share compared with $163 million or $3.08 per diluted share for 2017. Our full-year results included the benefit from new rates in Texas and Kansas, higher volumes from transportation customers, residential customer growth in Oklahoma and Texas, and higher sales volumes, net of weather normalization, from colder weather in 2018. Full-year results were also impacted by revenue deferrals and related rate adjustments due to tax reform that was offset by lower income tax expense.

Operating costs for the full-year were higher than 2017, primarily due to higher employee-related expenses and the previously mentioned manufactured gas plant deferral. While employee costs were higher, this was partially mitigated by lower outside service costs, as we insourced some of our previously contracted services.

And now, for an update on tax reform. In compliance with the accounting authority orders in each of our jurisdictions, recall that we established a regulatory liability for the difference in federal taxes resulting from the drop in statutory income tax rates. The establishment of this regulatory liability and related rate adjustments from completed filings resulted in a $42 million reduction to our revenues for the full-year ended 2018. This was offset by a reduction in our income tax expense.

In the first quarter of 2018, we disclosed that the timing difference between the revenue deferral and the reduction in our income tax expense had created a positive $0.13 impact on earnings that has now fully reversed over the last three quarters of the year. The effect from the change in tax rates has now been reflected in regulatory filings across all of our jurisdictions, including our recent orders in Oklahoma and Kansas and has been included in our 2019 earnings guidance.

The orders in Kansas and Oklahoma also addressed the return of excess deferred income taxes to our customers. Including those two orders and an estimate of the impacts in Texas, we expect to credit approximately $23 million to our customers in 2019, as indicated in our guidance. While this will impact cash flow, the adjustment is earnings-neutral as it affects both revenue and income tax expense. These credits will continue in future years, although the amount will vary from year-to-year.

Recall that the loss of bonus depreciation has accelerated the timing of when we start paying cash taxes. After utilizing our net operating loss carryforwards, we now forecast our cash taxes to be approximately $25 million in 2019, increasing to approximately $44 million by 2023. Last month, the ONE Gas board of directors declared a dividend of $0.50 per share, an increase of $0.04 or 8.7% compared with the previous dividend of $0.46 per share. We expect the average annual dividend increase to be 7% to 9% between 2018 and 2023 with a targeted dividend payout ratio of 55% to 65% of net income.

Also in January, we announced our 2019 earnings per share guidance of $3.27 to $3.57 per share with an expected earned ROE of 8.3%. Our 2019 capital expenditures are projected to be $450 million including asset removal costs. Please note the inclusion of asset removal costs, as this is a change from previous CapEx disclosures. Both CapEx and asset removal costs increase rate base. Going forward, our practice will be to combine the asset removal costs and CapEx as it more clearly demonstrates the significant items that increase rate base over time.

Our 2019 capital spending will remain predominantly focused on maintaining the safety and reliability of our systems and extending service to new areas. We will also continue to make investments in technology to improve efficiencies. Embedded in our five-year financial guidance is a forecasted average annual O&M increase of 2% to 3% from 2018 to 2023. Authorized rate base, reflecting the recently completed regulatory activity in Oklahoma and Kansas, is approximately $3.33 billion. Authorized rate base is defined as the rate base reflected in our latest regulatory proceedings including full rate cases and interim rate filings.

We project that for 2019, our estimated average rate base, which is defined as authorized rate base plus additional investments in our system and other changes in the components of our rate base that are not yet reflected in approved regulatory filings, will be approximately $3.61 billion with 42% in Oklahoma, 29% in Kansas and 29% in Texas. ONE Gas ended 2018 with approximately $400 million of capacity in its revolving credit facility, and we do not anticipate any equity or capital market needs in 2019. From 2020 to 2023, we anticipate net financing needs of $500 million to $550 million with approximately one-third of that need being in the form of equity.

And now, I'll turn it over to Caron Lawhorn, our Senior Vice President of Commercial, to provide you with a regulatory update. Caron?

Caron A. Lawhorn

Senior Vice President-Commercial, ONE Gas, Inc.

Thanks, Curtis, and good morning, everyone. Let's start with our regulatory activity in Oklahoma. In January 2019, the Oklahoma Corporation Commission issued an order for our 2018 Performance-Based Rate Change or PBRC filing, requiring a prospective reduction in customer base rates of $11.3 million annually beginning in February 2019. This reduces base rates to the 9.5% midpoint of the company's authorized return on equity.

In addition, the order requires that any earnings in 2018 that were above the 9.5% midpoint as determined in the next PBRC filing be returned to customers. Our next filing will be made by March 15, 2019. As Curtis indicated, our 2018 earnings results and 2019 guidance reflect the impact of this final order. Following the 2019 PBRC filing, we will have one more PBRC filing in 2020 before a full rate case is required to be filed in 2021.

Moving on to Kansas, in February 2019, the Kansas Corporation Commission or KCC issued an order related to Kansas Gas Service's June 2018 general rate case filing. The order provided for a net base rate increase of $18.6 million. Kansas Gas Service is already recovering $2.9 million through the Gas System Reliability Surcharge or GSRS. Therefore, this order combined with our GSRS recovery represents a total base rate increase of $21.5 million and reflects an amortization credit for the refund of excess accumulated deferred income taxes.

In addition, the pre-tax carrying charge for future GSRS filings will be 9.1%. Still outstanding is whether Kansas Gas Service will be required to refund to customers the amount of the tax reform regulatory liability accrued pursuant to the KCC accounting order. In accordance with Kansas law, the KCC has until Monday to rule on the tax refund. Looking ahead in Kansas, we plan to file our next GSRS in August for the period covering September 2018 through June 2019.

The new GSRS legislation that was passed last year, which expanded the definition of eligible capital expenditures, will apply to all expenditures included in the filing. As previously mentioned, the recent commission orders in Oklahoma and Kansas address the regulatory liability associated with our excess accumulated deferred income taxes resulting from tax reform. In Texas, we will address this issue during 2019 through either separate filings or rate cases in each of our jurisdictions.

With that, I'll turn it over to Pierce Norton to wrap up our discussion. Pierce?

Pierce H. Norton II

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

Thank you, Caron. With the arrival of February, our company celebrated its fifth anniversary. I'd like to spend a few minutes taking a brief look back at what we accomplished and how that sets the company up for the next five years. When we first spun off as a new company, we were near the second and third quartiles for the three AGA, American Gas Association, industry standard safety metrics, those being the total recordable incident rate; days away, restricted or transferred or DART, which is the measure of severity of our injuries; and preventable vehicle incidents.

We are now in the first quartile for all three metrics and recently achieved the top DART performance for large utilities in the United States. While we're proud of those achievements, we're striving for zero incidents. We begin the next five years as focused as ever by continuing to put processes in place to give us the best chance to achieve zero. Since 2014, we've replaced 1,485 miles of vintage pipe, spent nearly $2 billion on capital expenditures to improve system integrity and reliability, helped found the Environmental Protection Agency's Challenge – Methane Challenge to reduce emissions, published our first ESG report, and added over 60,000 new customers.

[ph] While I could go on (00:13:47), we can't sit still. There's always more to do and improvements to be made. But it is important to stop every now and then and reflect on how we come and where we come from. As I look forward to the next five years, we will continue executing on our same strategy, a 100% regulated utility. Our focus remains to provide the safest, most reliable natural gas service to our customers. That is our core business. We expect to replace the last remaining cast iron pipe in our system by the end of this year. Our asset replacement program will continue to follow an advanced risk-based modeling approach to ensure prioritization of our pipeline replacement projects. We will also deploy capital to expand our customer base.

And finally, to close, I would like to acknowledge our more than 3,500 employees for their committed focus and achievements over the past year and during our first five years, as we continue to deliver safe and reliable natural gas service to our more than 2 million valued customers. Thank you all for joining us this morning, and we look forward to seeing you in the upcoming events, as we're out of the office and visiting with you in the future.

Operator, we're now ready for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] We will now take our first question from Aga Zmigrodzka from UBS. Please go ahead.

Aga Zmigrodzka
Analyst, UBS Securities LLC

Q

Good morning. My first question is about the higher earnings per share long-term growth outlook. Could you please discuss key drivers of that higher long-term growth above your expected rate base growth? Thank you.

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

A

Okay. Thank you, Aga, and good morning to you as well. I'm going to let Curtis kind of walk us through what those key drivers are.

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

A

Good morning, Aga. Really, there's two primary things, the biggest being our CapEx growth, that we're a little bit higher in our CapEx and asset removal costs over this five-year period compared to our previous guidance. And then, the second item is we have better clarity on the return of the excess deferred income taxes to our customers. So, as you know, deferred income taxes are treated as a reduction in rate base. So, as you return those deferred income taxes, that also creates growth in your rate base. So, a combination of those two factors are driving the rate base growth being a little bit higher and the earnings growth being a little bit higher.

Aga Zmigrodzka
Analyst, UBS Securities LLC

Q

But could you provide more color why earnings per share growth is higher than your rate base growth?

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

A

Well, it's many of the factors we've talked about from continuing to look at investments in technology that make us more efficient, that we continue to look at process changes, both of which allow us to drive costs out of the business to what we call sustainable levels. So, as we get more efficient, it's not all just about the top line growth of revenue. It's controlling what's happening with our expenses as well. So, really a combination of all those factors.

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

A

So, Aga, this is Pierce. I want Sid to give you a tangible example of some of the – of one of those efficiency efforts. So, Sid?

Robert S. McAnnally
Senior Vice President-Operations, ONE Gas, Inc.

A

Thank you, Pierce. And Aga, there are a number of these examples. But specifically, let me give you one that looks at a system that we optimized in 2018.Last year, we focused on optimizing a system that routes our customer service technicians to customer appointments. Without additional spending or additional head count, we were able to recognize significant gains on on-time appointments, we had smoother execution of our compliance orders, and we also had significant decrease in the total miles driven by our customer service technicians, which serve to reduced cost, but also serves the safety goals that Pierce mentioned earlier. So, as Curtis mentioned, there are a number of these systems that we still think we have the opportunity to optimize without significant cost increases.

Aga Zmigrodzka
Analyst, UBS Securities LLC

Q

Thank you for that color. And one more on the Kansas rate case. Could you please provide more color on approved ROE and equity to capital structure?

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

A

Hey, Aga. I think Caron has joined us. She's the Head of our Regulatory Area and Commercial, so I'll let her answer that question.

Caron A. Lawhorn
Senior Vice President-Commercial, ONE Gas, Inc.

A

Good morning. So, in Kansas, we have a black-box settlement. So, there is no stated ROE or capital structure associated with that. However, going forward for GSRS, our approved rate is going to be 9.1% and that equates to roughly an ROE of about 9.25% and equity of about 56% in the capital structure.

Aga Zmigrodzka
Analyst, UBS Securities LLC

Q

Thanks for that additional color and thank you for taking my question.

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

A

Thank you, Aga.

Operator: [Operator Instructions] Our next question comes from Chris Sighinolfi from Jefferies. Please go ahead.

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

Curtis, I joined a little late and there was another earnings call I was joining from, and I joined at a point when you were talking about financing. I could wait and review the transcript when it comes out. [ph] But I figured since I have you (00:19:38), can you just remind me of what you had said in total in terms of the five-year outlook and the equity portion you're projecting? And I guess a related question is, can you also remind me, do you have an ATM program or how would you think about accessing equity markets?

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

A

So, Chris, good morning. Good to hear from you. A couple of points. One, no external needs in 2019. So, we had the bond offering later in 2018, which pre-refinanced our $300 million bond maturity, plus added $100 million of liquidity at that point. So, nothing needed in 2019. From 2020 through 2023, we anticipate net financing of $500 million to $550 million in total, and then about a third of that would be in the form of equity. We do not have an ATM program, but that would most likely be the approach to raising that equity. In none of those years is it that significant of a raise that we would need to do. So, that's really a pretty efficient way to go about that.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Yeah, okay. No, that's really helpful. And I guess as we think about how you'd manage it – and I appreciate that this is a bit down the road and that it's not a driver of any sort for the present year. But are there either debt levels or debt to cap levels? How do you think about where and when you might pull that in as needed?

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

A

Yeah. So, really several factors go into that. Certainly, how we approach our regulatory strategy is a piece of that and wanting to make sure our balance sheet is as efficient as it can be as we go into those filings is one. And the second one is how do we maintain our capital structure from a credit standpoint. So, the raises that we need there to help keep our balance sheet in the right order and to be able to meet the various credit metrics that we're rated on.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay, great. Thanks for the added color. And Pierce, I heard you mention about the five-year anniversary. [ph] We saved down the old models, if I go back to 2014 (00:22:04). It looks like a totally different company. So, really nice job all around.

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

A

Thank you very much, Chris.

Operator: There are no further questions currently signaled. [Operator Instructions] As there are no further questions, I will now turn the call back to your host for any additional or closing remarks.

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

Thank you all again for your interest in ONE Gas. Our quiet period for the first quarter starts when we close our books in early April and extends until we release earnings in early May. We will provide details on the conference call at a later date. Have a great rest of your day.

Operator: That will conclude today's call. Thank you for your participation, ladies and gentlemen. You may now disconnect.