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ONE Gas, Inc. (OGS)

Q4 2019 Earnings Call

CORPORATE PARTICIPANTS

Brandon Lohse
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Caron A. Lawhorn
Senior Vice President & Chief Financial Officer, ONE Gas, Inc.

Curtis L. Dinan
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Pierce H. Norton II
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OTHER PARTICIPANTS

Brian J. Russo
Analyst, Sidoti & Co. LLC

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good day and welcome to the ONE Gas Fourth Quarter Year-End Earnings Call. Today's conference is being recorded.

At this time, I would 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 2019 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. Our actual results could differ materially from those projected in any forward-looking statement. 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 Caron Lawhorn, Senior Vice President and Chief Financial Officer; Curtis Dinan, Senior Vice President, Commercial; Sid McAnnally, Senior Vice President, Operations; and Pierce Norton, President and Chief Executive Officer.

And now, I'll turn the call over to Caron.

Caron A. Lawhorn

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

Thanks, Brandon. Good morning, everyone, and thank you for joining us today. Net income for fourth quarter 2019 was $51.2 million or $0.96 per diluted share compared with $44.7 million or $0.84 per diluted share for the same period last year. Our fourth quarter results reflect a $16.3 million increase in net margins, including new rates in our service areas and residential customer growth primarily in Oklahoma and Texas.

Operating costs for the fourth quarter were $133.9 million compared with $123.8 million in the same period last year, contributing to the increase for employee-related expenses and bad debt expenses. While our bad debt expense was down slightly through mid-year, we ended the full year with a slight increase relative to 2018.

Net income for 2019 was $186.7 million or $3.51 per diluted share compared with $172.2 million or $3.25 per diluted share in 2018. Net margin increased $45.7 million due to new rates in our service areas, residential customer growth in Oklahoma and Texas, higher volume from transportation customers in Kansas, and higher sales volumes net of weather normalization in Texas.

Operating costs for the full year 2019 were $18.5 million higher than 2018, primarily due to employee-related costs and minor increases in general operating costs, including outside service costs, materials for pipeline maintenance activities, fleet costs, legal-related costs and the aforementioned bad debt expense.

Other expense net decreased $8.4 million from the prior year due primarily to earnings on investments associated with our non-qualified employee benefit plans, which offset the costs for these plans included in operating costs. After netting these earnings against the associated expenses, operating costs increased 2.5% from the prior year.

Interest expense was at $11.4 million relative to the prior year due to the refinancing of $300 million of senior notes in the fourth quarter of 2018, with $400 million of senior notes at a higher interest rate. Our full year 2019 income tax expense includes a credit of $12.8 million for amortization as a regulatory liability for excess accumulated deferred income taxes or ADIT, which is offset in revenues.

Capital expenditures and asset removal costs were $121.2 million for the fourth quarter, bringing our total for the year to $465.1 million. We ended the year with an average rate base of $3.62 billion, with 42% of that in Oklahoma, 49% in Kansas, and 29% in Texas. Authorized rate base, which is rate base reflected in completed regulatory proceedings, including full rate cases and interim rate filings, was approximately $3.53 billion. ONE Gas ended the fourth quarter with approximately $183.5 million of capacity under our commercial paper program. In 2019, we were a cash taxpayer for the first time, with payments of approximately $30 million.

In January, the ONE Gas board of directors declared a dividend of $0.54 per share, an increase of $0.04 or 8% compared with the previous dividend of $0.50 per share. We expect the average annual dividend increase to be 6% to 8% between 2019 and 2024, with a targeted dividend payout ratio of 55% to 65% of net income. Last month, we announced our 2020 earnings per share guidance of $3.44 to $3.68 per share.

Our 2020 capital expenditures and asset renewable costs are projected to be $475 million and we'll remain primarily focused on maintaining the safety and reliability of our system as well as extending service to new areas. We will also continue to make investments in technology to increase efficiency and improve the customer experience. Embedded in our five-year financial guidance is a forecasted average annual increase in operating costs of 2% to 3%.

We anticipate net financing needs over the next five years of $850 million to $900 million, with approximately one quarter of that being equity. Our forecasted five-year EPS growth rate is 5% to 7%. This compares to our previous forecast of 6% to 8%, which was the guidance we provided last year for both net income and EPS. For the first time since becoming a stand-alone company, we're planning to issue equity over the next five years and have refined our long-term growth rate to focus specifically on EPS. Our earnings outlook hasn't changed significantly. We anticipate that our net income growth rate over the next five years will average between 6% and 8%.

And now, I'll turn it over to Curtis Dinan for a regulatory update. Curtis?

Curtis L. Dinan

Senior Vice President-Commercial, ONE Gas, Inc.

Thanks, Caron, and good morning, everyone. Let's begin with Kansas. In November 2019, the Kansas Corporation Commission approved Kansas Gas Service's request for interim rate relief under the Gas System Reliability Surcharge or GSRS rider for $4.2 million. Rates became effective in December.

In Oklahoma, we anticipate making a performance-based rate change filing this month and that Oklahoma Natural Gas will request an increase in base rates. If approved, it will be the first rate increase in Oklahoma since early 2016. New rates are expected to be effective in August 2020. As required by our tariff, we will file a full rate case in 2021.

And finally in Texas, Texas Gas Service filed a rate case for all customers in the Central Texas and Gulf Coast service areas, requesting to consolidate the Gulf Coast service area with Central Texas and increase rates by $15.6 million. If approved, new rates are expected to become effective in the third quarter 2020 and our number of jurisdictions in Texas will decrease to five from six.

Our filing is based on a return on equity of 10% and a capital structure with equity of approximately 62%. We estimate that a 25-basis point change in ROE would change the revenue requirement by approximately $950,000 and a 1% change in equity by approximately $350,000.

And now, I'll turn it over to our CEO, Pierce Norton. Pierce?

Pierce H. Norton II

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

Thank you, Curtis and Caron. 2019 was another good year for ONE Gas. I'm very proud of the continued progress we made in 2019 on our safety metrics. We will continue to focus on a culture and processes that target zero harm to our employees, customers, and the public.

I want to reiterate that in 2019, we completed our five-year accelerated cast iron replacement program. That is important from a risk reduction perspective. That also was an important part of our strategy to reduce methane emissions. We will now turn our attention to other vintage pipe materials remaining in our system. With the remaining vintage materials left to replace, we still have a 20-plus year runway to deploy our capital. We will continue to monitor and adjust our pace based on the balance among risk reduction, quality construction resource availability, credit metrics, and customer impact.

With the completion of a decade, we can proudly reflect on all that we've accomplished from when we first spun out as a new company in 2014 but more importantly, look ahead to the opportunities we have in the next decade to implement solutions that continue our focus on safety, reliability, reducing emissions, and organic growth. The technology and solutions to solve the complexities of achieving zero emissions while providing reliable service and keeping energy affordable continues to evolve. In the next decade, it will be important that resiliency and costs become part of the discussion related to achieving significant emissions reductions.

We have a great conviction that natural gas and natural gas distribution assets will continue to be a significant part of the solution. It's the talented employees of this company that have and will continue to make it possible to execute our business strategy. I thank them for living out our core values and for serving our customers and communities every day. Thank you for joining us this morning and operator, we're now ready to take questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] We'll take our first question from Brian Russo with Sidoti & Company.

Brian J. Russo
Analyst, Sidoti & Co. LLC

Q

Hi, good morning.

Curtis L. Dinan
Senior Vice President-Commercial, ONE Gas, Inc.

A

Good morning, Brian.

Brian J. Russo
Analyst, Sidoti & Co. LLC

Q

Hey, thank you for the incremental information on the Texas rate case filing. Could you remind us when was the last rate case?

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

A

The last Central Texas rate case or the last rate case in Texas?

Brian J. Russo
Analyst, Sidoti & Co. LLC

Q

Whatever is more applicable to this current rate case.

Curtis L. Dinan
Senior Vice President-Commercial, ONE Gas, Inc.

A

The last one in Central Texas was approximately...

Caron A. Lawhorn
Senior Vice President & Chief Financial Officer, ONE Gas, Inc.

A

2015?

Curtis L. Dinan
Senior Vice President-Commercial, ONE Gas, Inc.

A

...yeah, 2015, I think. It was about three years or four years ago.

Brian J. Russo
Analyst, Sidoti & Co. LLC

Q

Okay, great. So and the approximately $15 million revenue increase request, what percentage of increase is that on average?

Curtis L. Dinan
Senior Vice President-Commercial, ONE Gas, Inc.

A

Brian, I don't have that detailed data with me right here, but we can certainly get that for you.

Brian J. Russo
Analyst, Sidoti & Co. LLC

Q

Okay. That's fine. And with the understanding that you got of that ONE Gas in Texas is regulated by the Railroad Commission versus the TUCP, could you just maybe characterize your relationship with the RRC?

Curtis L. Dinan
Senior Vice President-Commercial, ONE Gas, Inc.

A

[indiscernible] (00:12:47). Let me back up just a second, Brian. We're actually – first, we file with the city councils in the incorporated areas of those jurisdictions, and then in the unincorporated areas, we file with the Railroad Commission. So, the biggest population that's affected by those rate cases are in the incorporated cities and so again, that starts at the city council and then if it's not resolved at that level, then it can get appealed to the RRC.

So I would say broadly that we have a very constructive relationship both at the city council levels and with the RRC, but I don't think there is anything out of the norm with either of those.

Brian J. Russo
Analyst, Sidoti & Co. LLC

Q

Got it, understood. And have you reached settlements in the past with the city council and/or the RRC?

Curtis L. Dinan
Senior Vice President-Commercial, ONE Gas, Inc.

A

Typically, we have reached settlement in those cases. It has been more unusual that we don't get the settlement with the councils or the RRC and it ends up going to hearings. So your assumption is dead on.

Brian J. Russo
Analyst, Sidoti & Co. LLC

Q

Okay, great. And then also, just customer growth, it looks like Oklahoma and Texas are driving that growth of maybe 0.6%, if my math is correct. For Kansas, it's relatively flat. Could you just real quickly distinguish the customer growth profiles amongst the three states?

Curtis L. Dinan
Senior Vice President-Commercial, ONE Gas, Inc.

A

Yeah. You're picking up on exactly that trend. Our highest growth rates above that average have been in Texas, primarily in the Austin and El Paso areas. Both have been really strong for a number of years. In Oklahoma, we're right at that average, maybe a little above it and you're right that in Kansas, it's a little closer to flat to slightly up in the customer growth there.

Brian J. Russo
Analyst, Sidoti & Co. LLC

Q

Okay, great. And then I think also the 2020 guidance assumes an earned ROE of 8.2% and relative to your allowed ROEs, what initiatives do you have in place or plan to implement to further close that gap, whether it's your ongoing [indiscernible] (00:15:20) management or refinancing at lower rates and even more importantly, any regulatory initiatives to help improve the earned ROE?

Curtis L. Dinan
Senior Vice President-Commercial, ONE Gas, Inc.

A

Yeah. There's a number of things that we try to look for internally as well as externally as you describe. Let me correct one thing. The first is that the ROE expected is 8.4% for 2020 and so some of the initiatives that we take are, first, to do everything we can to be as efficient as possible in our operations so that we are doing a good job of controlling costs first.

Second, we look to be as efficient as we can be in our regulatory processes, so as we make filings whether it's a full rate case or it's the interim rate filings, looking for different ways to make sure that those are as reflective as possible as what's happening in the company. So I'll give you an example of that and where we sought external help.

The GSRS legislation that was passed in Kansas about a year ago, which increased the cap of GSRS filing from having a bill impact to the customer – a monthly bill impact to the customer of $0.40, it increased that cap to $0.80. And it also, more importantly, defined other types of capital as it relates to systems safety, physical and cyber security safety to also be included and eligible for those filings.

We had our first filing under that legislation last year. It was only a partial year filing and we ended up requesting $4.2 million and that's what was approved by the Commission through that process. So the impact on the customer was $0.43 per month and so again, that was the first one over $0.40 and that was not a full year impact. So that's a process or an external reach that we sought to provide some relief from a rate perspective that has been able to help improve those ROEs over time.

Brian J. Russo
Analyst, Sidoti & Co. LLC

Q

Okay. That's very helpful. When will your next GSRS filing be in Kansas?

Curtis L. Dinan
Senior Vice President-Commercial, ONE Gas, Inc.

A

Sure. You can do one every 365 days, so our next one will come in August of this year and that will be for capital from July 1 of 2019 through June 30 of 2020.

Brian J. Russo
Analyst, Sidoti & Co. LLC

Q

Okay, great. And then just the EPS CAGR that's now at 5% to 7%, how should we kind of look at that on go forward basis? I mean is it smooth given your recovery mechanisms or is it – and the kind of levelized capital expenditures forecast over the next several years? Or will it vary year by year given a rate case or any other developments?

Caron A. Lawhorn
Senior Vice President & Chief Financial Officer, ONE Gas, Inc.

A

Hey, Brian. This is Caron. You're exactly right. Our capital spending is projected to be relatively smooth, that steady kind of uptick fluctuating a little bit with weather and whatnot, but regulatory activity can have a big impact on year-to-year swings. Oklahoma is still our largest jurisdiction and we've got an Oklahoma rate case coming up. This is a test year so we will be filing a rate case next year and the outcome of that will have a significant impact on our earnings.

Brian J. Russo
Analyst, Sidoti & Co. LLC

Q

Okay, great. Thank you very much.

Curtis L. Dinan
Senior Vice President-Commercial, ONE Gas, Inc.

A

Hey, Brian, this is Curtis again. Just to come back to your first question on the Central Texas rate case, all in, that's about a 9% increase as filed in that filing.

Brian J. Russo
Analyst, Sidoti & Co. LLC

Q

Thank you.

Curtis L. Dinan
Senior Vice President-Commercial, ONE Gas, Inc.

A

[ph] Great. (00:19:32) Thanks.

Operator: [Operator Instructions] Question's from Chris Sighinolfi, Jefferies.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Hey, everyone. How are you?

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

A

Great, Chris. How are you?

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

I'm doing well. Thanks for taking my questions as well. I think I'll be quick. I just have a couple for Caron. With regard to – I actually I think missed this last night but the fact that asset removal costs are in the operating cash line items and it looked like in working capital, as you think about the capital budget you've given, how do you think given that it includes those costs as well, I guess the question as to what you see the profile of asset removal looking like over the next couple years. Is that something – I know it trended modestly down from 2018 to 2019. Is that something you would expect to continue recurring? Could you just maybe educate me a little bit on that side of it?

Caron A. Lawhorn
Senior Vice President & Chief Financial Officer, ONE Gas, Inc.

A

So Chris, I don't expect a significant change in asset removal costs. They may come down a bit this year. Those are in part an estimate so as we fine-tune how we estimate those costs, it may come down slightly, but I don't think it will be material. And we don't really – while they get presented separately on the cash flow statement as a practical matter, we don't really think about them any differently. It's all rate days. It's all part [ph] of our – as our (00:21:09) system improvement so just want to put that in perspective.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. That was – you anticipated my second question, which was because I had missed the first part of it, I wanted to make sure that I was thinking about rate base efficient correctly. So everything you're quoting is the CapEx forecast is embedded – hopefully, it's embedded over time.

Caron A. Lawhorn
Senior Vice President & Chief Financial Officer, ONE Gas, Inc.

A

That's correct.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. All right, really I mean that was – truthfully, that was it for me so I appreciate the time.

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

A

Thank you, Chris, and have a good rest of your day.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

You too.

Operator: [Operator Instructions] A follow-up question from Brian Russo.

Brian J. Russo
Analyst, Sidoti & Co. LLC

Q

Yeah, hi. Thanks for the follow-up. Just real quick, the notes payable balance of $516 million at year-end 2019, up noticeably year-over-year, will that eventually be termed out? And is that included or excluded in the financing forecast you guys laid out back in January?

Caron A. Lawhorn
Senior Vice President & Chief Financial Officer, ONE Gas, Inc.

A

So yes to those. It will eventually be [ph] turned (00:22:25) out and it is included in our financing needs that we have provided guidance on.

Brian J. Russo
Analyst, Sidoti & Co. LLC

Q

Okay, perfect. Thanks.

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

A

Thank you, Brian.

Operator: There are no further questions at this time. Mr. Lohse, I'll turn the conference back to you 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 at the end of April. We'll provide details on the conference call at a later date. Have a great day, everybody. Thank you.

Operator: And this concludes today's call. Thank you for your participation. You may now disconnect.