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MANAGEMENT DISCUSSION SECTION

Operator: Good day, and welcome to the ONE Gas First Quarter 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.

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

All right. Thank you for joining us on our first quarter 2020 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 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 and including amongst other statements about the length and severity of pandemics or other health crisis such as the recent outbreak of COVID-19. 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 Pierce Norton, President and Chief Executive Officer; Caron Lawhorn, Senior Vice President and Chief Financial Officer; Sid McAnnally, Senior Vice President, Operations; and Curtis Dinan, Senior Vice President, Commercial.

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

Pierce H. Norton II

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

Thanks, Brandon. Good morning everyone, and thank you for joining us on the call today. For the first time in our lifetime we're faced with an event that has impacted our economy, our businesses and our daily lives. It has impacted every person in some way. There's a good chance many of us on this call have lost a family member or friend to the COVID-19 virus, to those people the ONE Gas family extends our deepest condolences and heartfelt sympathies. We are sorry for your loss.

Because of the COVID-19 pandemic, the call today will be different. We will spend most of our time talking about how the virus and the government reactions to COVID-19 have affected our business and more importantly give you insight into our organization's thought processes of dealing with uncertainty.

Caron Lawhorn will begin with a brief update of our first quarter results, then McAnnally will cover the operational details; Curtis Dinan will update you on the commercial environment we're seeing and our regulatory activity, and then Caron will summarize how we view the financial impacts.

Our business continuity plan, which provides a framework during a crisis, is based on three principles; anticipation, awareness and agility. We support our decisions around these principles with our core values of safety, ethics, inclusion and diversity, service and value. As Sid, Curtis and Caron give you examples of our current business environment, you will have a better understanding of the culture that is ONE Gas, a culture based on collaborating around two questions, what if things are not as they seem and what else can we do to solve challenges and create opportunities. I will return later with my closing remarks.

But now, here's Caron with our first quarter results. Caron?

Caron A. Lawhorn

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

Thanks, Pierce. Good morning, everyone. As Pierce noted, COVID-19 has had a significant impact around the world, in this country, and in our service territory. Besides that, our business performed well in the first quarter and we experienced no material, financial impact in the pandemic. Net income was $91.7 million or $1.72 per diluted share, compared with $93.7 million or $1.76 per diluted share in the first quarter of 2019.

Our first quarter results reflect an increase in net margin at $6.2 million over the same period last year which included new rates in Kansas and Texas and residential customer growth. We experienced warmer weather in 2020 compared with 2019, it contributed to $5 million decrease in net margin from lower volumes net of weather normalization. Operating costs for the first quarter was $3.1 million lower than the same period last year which includes a $4.3 million decrease in the expense associated with the change in the value of liabilities for our nonqualified employee benefit plans relative to the prior year.

Other expense net increased $6.2 million in the first quarter of 2020 compared with first quarter of 2019. It includes a $6.7 million decrease in the value of investments associated with nonqualified employee benefit plans. Combined, the net impact of the nonqualified employee benefit plans was a decrease to pre-tax income of $2.4 million in the first quarter of 2020 versus 2019.

Our capital expenditures and asset removal costs increased $29 million this quarter compared with the first quarter last year. Our strong start to the year sets us up well as we continue to execute our capital plan during these challenging times. We still expect capital spending will be about $475 million for the full year. Yesterday, the ONE Gas board of directors declared a dividend of $0.54 per share, unchanged from the previous quarter. This dividend is consistent with our guidance of 2020.

And now, I'll turn it over to Sid McAnnally to begin the update on our operations related to COVID-19. Sid?

Robert S. McAnnally

Senior Vice President-Operations, ONE Gas, Inc.

Thank you, Caron, and good morning. Our business continuity plan allowed us to quickly establish a cross-functional pandemic task force representative of the entire organization and to initiate daily task force and senior leadership meetings. Collectively, we developed a multi-tier response plan that adjusts how we work based on the risk level of virus related activity in our operating areas. This framework focused on the most critical areas of the crisis; the health of our employees and customers, tracking critical data, deploying employees to work remotely where possible, adjusting field operating protocols, and monitoring our supply chain. I will provide more context around each of these five critical areas.

First, safety continues to be our top priority which is why we established employee COVID-19 protocols. At the onset of the COVID-19 outbreak in our service territories, we began directing employees with potential exposure or flu-like symptoms to an independent medical advisor for a screening process that determined if the employee should self-quarantine, consult with a physician or could safely return to work. This screening process has made a significant impact on the ongoing health and safety of our workforce. We initially quarantine 7% of our workforce based on this process, and today that number is less than 1.5%. Approximately 20% of our workforce has used this screening service. As of April 23, we've had a total of 26 employees who have tested for the virus with 4 employees testing positive. We are pleased to report at this time, we have no hospitalizations or fatalities from COVID-19.

Second, we've been tracking critical data every day. We've provided daily reports to the organization summarizing COVID-19 related cases on the national and state levels as well as ONE Gas employee data, as we watch trends in our own operating areas. We also established a special account code to capture COVID-19 related expenses such as personal protective equipment, the cost of sanitizing high use workspaces and vehicles and medical advisory services. We're also seeing decreases in other expenses such as travel.

Third, we quickly deployed employees who could work remotely over a three day period. We currently have approximately 50% of our 3,600 employees working from home. Prior to the pandemic, we were in the process of deploying the always on virtual private network to company-owned devices as part of the cyber initiative to further protect our assets. This allows our employees to easily and securely access all of their systems and resources as if they were physically sitting in our offices. All of our systems including Internet bandwidth are operating normally. For employees who continue to work in our facilities, we have reconfigured workspaces to allow for appropriate social distancing.

Fourth, we have made operating adjustments for our field employees. We have two goals in mind; adjust to avoid customer contact where feasible and if not feasible, protect our employees and the customer. We have suspended elective work that results in planned customer outages, which would have required us to enter customer homes. Our call center personnel are screening all customer service orders to determine possible COVID-19 exposure in the premises and we perform further screening when our service technicians arrive on-site before deciding to enter the premises.

We've adopted additional personal protective equipment practices based on recommendations from the Centers for Disease Control and the Occupational Safety and Health Administration, primarily focused around the use of respirators and cloth masks. Employees are not allowed to enter a customer's home where there is a known possibility of illness or exposure to COVID-19 unless responding to an emergency or an outage. In those cases, additional personal protective protocols go into place, including a disposable full body suit and the presence of one of our safety trainers.

At all other customer appointments, our employees are practicing social distancing and wearing the appropriate PPE including respirators. We currently have an adequate supply of respirators and N95 masks and continue to monitor our PPE supply closely. We are also screening for elevated temperatures at our large service centers and we are in the process of installing automated thermal image temperature screening stations to be deployed at certain locations to allow entry only to those employees who do not have an elevated fever.

Finally, we are closely monitoring our supply chain. To-date we have not experienced procurement issues and we have adequate inventory onsite for all operations and related activities. Pricing has not been impacted to-date but certainly could be in the future. So it is one of the factors we continue to monitor. Our supply chain group has longstanding contacts with significant manufacturers in our sector and has been in close contact with them to review their operations and create redundancy were possible.

With respect to the supply of natural gas, our supply portfolio includes a diverse group of suppliers and storage providers. We have not experienced and do not anticipate issues with acquiring adequate supplies of natural gas to serve our sales customers.

And now, I'll turn over to Curtis Dinan.

Curtis L. Dinan

Senior Vice President-Commercial, ONE Gas, Inc.

Thank you, Sid, and good morning, everyone. My first comments will address the impact of COVID-19 on our commercial activities followed by a regulatory update. Across all three of our states, orders issued by the governors related to COVID-19 declared construction and essential business. Construction activity with our builders and developers has remained robust through the first four months of 2020 including single and multi-family construction as well as commercial developments.

We have anticipated a slowdown as city permitting offices were closed, but the backlog of permitted projects has allowed construction activity to continue and we're not seeing any significant impact from the pandemic. As is typical in all years, we have seen some project delays, but these have been offset by new projects that are moving forward. Accordingly, we're maintaining our expectations for growth capital project spending.

Continuing the trend we experienced in 2019, our customer growth rates for sales customers remained strong. The moratoriums on disconnects had a slight impact on our first quarter totals, but we have not typically had a large number of disconnects during the first quarter. With the disconnect moratoriums extending to May 15th, we will see higher customer counts in the second quarter that are not necessarily reflective of higher growth rates in our business. We have approximately 12,000 transport customers on our system that represented $114 million or 12% of our net margin in 2019.

Our 40 largest transport customers account for $28 million or 25% of our 2019 transport revenues. To-date, two of these customers, one in the automotive industry and one in the residential shingle business have temporarily suspended operations. Outside of our 40 largest transport customers, we have also had 19 other businesses that have reduced operations or temporarily or permanently suspended operations. Collectively, we anticipate a negative impact to revenues of approximately $100,000 per month from these transport customers based on their current level of business activity.

Although we have suspended disconnections for delinquent accounts until May 15, we continue to contact our customers that have past due accounts to offer flexible payment arrangements and have waived late payment fees in an effort to help our customers affected by the pandemic bring their accounts current. We have also been working with our regulators to issue accounting orders to allow for the establishment of regulatory assets for the impact of COVID-19 on our business. These orders generally allow for the deferral of pandemic related expenses, including increased costs for bad debts, personal protective equipment, facility sanitization cost, medical advisory services, costs for testing and treating employees that have potentially been exposed to COVID-19 and other necessary costs to address the impact of the pandemic as well as certain lost revenues. The Railroad Commission of Texas has issued an order and we are working with our regulators in Kansas and Oklahoma to obtain similar orders.

Moving on to our other regulatory activity. In Oklahoma, Oklahoma Natural Gas filed a performance based rate change filing in February requesting an increase in base rates of $11.8 million. If approved it would be the first 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. In Texas, Texas Gas Service filed a rate case in December 2019 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 the 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.

Texas Gas Service also made a Gas Reliability Infrastructure Program, or GRIP filing for all customers in the West Texas service area for a $4.7 million increase. We anticipate that new rates will be effective in the third quarter of 2020.

And now, I'll turn it back to Caron.

Caron A. Lawhorn

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

As you heard from Sid and Curtis, COVID-19 has not impeded our work in the fields including our capital spending on the system integrity and gross projects. To summarize what we've heard regarding how our earnings are being impacted by COVID-19, we expect a reduction in revenues from customers temporarily or permanently impacted by the pandemic. We expect higher bad debts as a result of the moratoriums on disconnects, that we expect to incur incremental expenses for other COVID-19 related costs. We also expect reductions in expenses in some areas such as expenses for travel.

With respect to our sales customers which accounted for over 86% of our net margins for the first quarter 2020, Curtis spoke to customer growth, which has continued to remain strong with over 70% of our net margin coming from fixed charges, our exposure to volumetric risk is limited. We believe the accounting orders that we have or expect to receive in these states will allow us to seek recovery and future proceedings of incremental expenses and certain loss revenues associated with COVID-19.

These accounting orders are expected to mitigate the impact of lost revenues and net increases in expenses on earnings, however, are now expected to be deferred for later regulatory recovery under the accounting orders must be probable of recovery in order to be recorded under generally accepted accounting principles.

As a result, there could be a delay in the recognition for financial reporting purposes of amounts that might ultimately be approved for recovery until the conclusion of future regulatory proceedings. Based on what we know currently, we are affirming our guidance range with net income expected to be in the range of $186 million to $198 million or $3.44 to $3.68 per diluted share. However, downside risk to 2020 earnings associated with the impact of COVID-19 exists and could result in net income and earnings per share below the midpoint of the range.

From a liquidity perspective, we expect slower cash flows resulting primarily from the effects of the moratorium on disconnect. At March 31, 2020, we've had short-term liquidity available through our commercial paper program and cash on hand totaling $235.2 million. We have a $700 million credit facility to support our commercial paper program and a $250 million at-the-market program for the issuance of equity. And earlier this month, we entered into a second revolving credit agreement which provides an additional $250 million of liquidity over the next year.

Further, our investment grade credit ratings and strong balance sheet provide us access to the financial markets for the issuance of long-term debt and equity. We believe our sources liquidity are adequate to support our current and planned level of operations.

Now, I'll turn back over to Pierce for some closing comments.

Pierce H. Norton II

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

Thank you, Caron, Curtis, and Sid. In closing today, I'd like to thank all the medical staff in our service territories for the heroic work they do especially during this pandemic. I also want to send our appreciation to the first responders on the frontline; firefighters, law enforcement, paramedics and utility workers. They too deserve recognition for the critical life services they provide every day. Thanks to the diligence of each ONE Gas employee to the pandemic protocols and our focus on our core values, we've been able to continue running our business with minimal disruptions.

I'm extremely proud of our employees and want to give a special thanks to each of them for their continued professionalism under stress, resolve when there's no clear end, poise in the face of uncertainty and moral courage to do the right thing. We are fortunate to work in an industry that strives to make every natural gas utility better through collaboration.

Once again our trade organization the American Gas Association organized calls with subject matter experts that are proving to be beneficial to navigating this process in real-time. Thank you AGA for what you do. As a natural gas utility, we have an important role in serving our communities and our customers and that includes taking the necessary precautions to protect ourselves and the people around us. We will get through this pandemic by relying on the same values we use to address any challenge we face in our business.

Thank you all again for joining us this morning. Operator, we're now ready for questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And we'll go first to Shahriar Pourreza with Guggenheim.

Constantine Lednev
Analyst, Guggenheim Securities LLC

Q

Hi, good morning. It's actually Constantine here for Shahriar. And that was a very thorough result, thank you very much and I understand the challenging times where we're all in. So one of the questions that I had was understanding that the first quarter results kind of represented a lot of weather headwinds and there is some potential slowdowns kind of related to COVID-19. How are you guys thinking about kind of on the return to normal weather scenario going forward for – on your sales forecast and kind of growth numbers in terms of customer accounts and in general kind of throughput? And does that require any kind of regulatory rethinking or regulatory outcomes to realign future earnings and how you're thinking about that?

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

A

Yeah. So, Shahriar – sorry, say who is this again. You're setting in for Shahriar, right.

Constantine Lednev
Analyst, Guggenheim Securities LLC

Q

Yeah, it's Constantine.

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

A

Right. Thanks, Con. So a couple of things, the – you know as we've been in the moratorium with the disconnects that – the normal activity that we would be starting this time of the year we haven't at this point and that's suspended until at least May 15. So even if we get to that point and those moratoriums in on that day, it would still take a period of time before we would ramp up to our normal operations and our customer service groups as well as in field operations to deal with those. So my comments earlier about seeing perhaps some elevated numbers in our customer accounts, that's really what I was trying to address with that.

Again a couple of other comments on there I believe one related to how we're thinking about weather. And as you know we have weather norm in all of our service territories and you saw that in the results that while we had much warmer weather in the first quarter and it did impact our sales volumes, that was partially offset due to the impacts of weather norm and that's really what those mechanisms are designed to achieve. So when we give guidance whether it's as we think about it for the balance of the year or we're giving it at the beginning of the year, we always assume normal weather in that guidance and then you'll see some pluses and minuses from that as we go through the year as weather does vary. Was that all the items in your question?

Constantine Lednev
Analyst, Guggenheim Securities LLC

Q

Yeah. That answers that one. And I guess just shifting a little bit more to the long-term view on kind of regulatory outcomes and kind ROEs and as we are consolidating jurisdictions and kind of filing for the rate cases, where do you see kind of ROEs trending and specifically kind of understanding that there's a – there's some systematic

ROE gap we're kind of having capital deployed and not getting the recovery [ph] as you can recall (00:23:29) is that kind of standing to improve the kind of this next round of rate cases through 2020, 2021?

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

Yes. So a couple of points there. The first one, as I mentioned in my prepared comments, the rate case or the PBR filing that we have in Oklahoma right now, this will be the first rate increase in Oklahoma since the beginning of 2016. So that's been a number of periods since we've had an increase there. And the intent of whether it's a GRIP filing or a GSRS [indiscernible] (00:24:04) different mechanisms that we have, what those represent are smaller filings that are meant to get more timely recovery of the capital dollars that we're spending. So we do continue to see those helping to close that gap and to get more timely recovery.

So as an example of that, again pointing to Kansas where we have the new GSRS mechanism that we filed under for the first time last year, you might remember that was only a partial period. This year will be the first year that it covers a full 12-month period and there's more capital that's eligible in that mechanism today than there used to be. And so we've talked about how much of our capital is subject to annual filings, in the past that's been about 80% but now what we're giving guidance to is that about 90% of our capital is recovered through or addressed through annual filings. And so all of those things are helping to continue to progress as we have been over the past six years.

Constantine Lednev
Analyst, Guggenheim Securities LLC
Q

Okay. Yeah. That's very hopeful. Thank you guys. I'll join back in queue.

Operator: We'll go next to Aga Zmigrodzka with UBS.

Aga Zmigrodzka
Analyst, UBS Securities LLC
Q

Good morning. Hope you're all safe and healthy. My first question is, OGS was roughly 72% of revenues from fixed charges. Could you discuss how it fluctuates throughout the year, what percent of fixed charges do you expect in 2Q versus 1Q?

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

Hey, Aga. This is Curtis. You know we never have broken out our guidance by quarter like that to separate out those pieces. I think you could probably do a top level because we do report our volumes each quarter by the different types of customers that we have as well as we provide what the fixed charges are for our sales customers. I just – on back of an envelope I don't have that data here with me. But if you're trying to get an estimate of that that probably would be the best way to do it, but just if you broadly think about it net margin as you go into those long – lower volumetric months is going to be higher. So your second quarter and third quarter your volumetric charges are going to be less, the fixed charges are going to be a higher percent of the total net margin. But if you look at our past history, whether it's quarterly or annually, you don't see a lot of fluctuation due to those volumetric differences.

Aga Zmigrodzka
Analyst, UBS Securities LLC
Q

And then, have you experience any impact from social distancing on the progress of your pending rate cases for both filing and – for both rate cases and trackers? Is there also a risk that commissions will delay decisions to avoid customer bill increases during the pandemic?

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

A

Yeah, in one instance we have Aga in our Central Texas, Gulf Coast consolidation case before – the hearing date before the ALJ was extended until May 20th and that was due to that the Texas regulatory – the RRC basically moving to a working remotely situation and a desire not to have that hearing as a virtual hearing. And so, the anticipation is – there was a new procedural schedule that was approved and that extended all of those dates by about a month. So we have seen a small impact, but that's the only one I could really point to you right now.

Aga Zmigrodzka
Analyst, UBS Securities LLC

Q

And last question is on the ATM program that you initiated in February. When does OGS plan to issue equity under the program and what is the target equity issuances in this year?

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

A

Good morning Aga, this is Caron. [indiscernible] (00:27:55) equity this year, we've not been more specific about the amount for the exact timing of that. The additional liquidity that we got to our $250 million of revolving credit agreement earlier this month, we have the luxury, if you will, of being opportunistic in how we access the market. And so, we're still evaluating [indiscernible] (00:28:17)

Aga Zmigrodzka
Analyst, UBS Securities LLC

Q

Thank you for taking my questions.

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

A

Thank you, Aga. Hope you're safe as well.

Operator: We'll go next to Chris Sighinolfi with Jefferies.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Hey, team. Good morning. Thanks very much for the update. I think detailing all the ways, you've responded and budgeted for COVID is exactly what our team was hoping to you review this morning, so I do appreciate it. I do have a couple of follow-ups, so I think probably two for Sid and two for Caron. Sid I know you historically rely on some nonemployee contract labor in the normal course of operations. I may have missed this in your prepared comments, I apologize if I did. But can you just touch on that element of the operations and if you've suspended those folks you know what the pathway you're thinking about for returning them to working for you?

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

A

Yeah. Sure, Chris. Good morning. Thank you for the question. You're right, we do rely on external contract labor, but we're able to coordinate pretty closely with our contractors as this risk emerged not only to check on their health from an execution standpoint, but also to look at their safety practices, to look at their PPE practices and we were able to execute as you heard from Caron on the capital plan year-to-date in a way that suggests that that process was a success. We don't anticipate constraints going forward to make room for that, we plan for that but right now, we don't anticipate that being an issue for us going forward.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. And I know you know everybody's talked this morning and Caron talked and Curtis talked about as you mentioned the maintenance of the capital plan for the full year, so it seems like while some projects maybe not happening other projects are available to fill that void, but you also talked about some of the operational changes to COVID-19 you know adoption of technology from working conditions. And I guess I'm just curious as you think about maybe the longer term set of OGS' operating teams and structure. What of any of the things that you've instituted here in response to the virus might be more permanent in nature? I'm imagining a world in which you're going to see some efficiency gains through being forced into you know rapid adoption of some of the stuff and I'm just curious and you know I know its early days, but have you thought about potential longer lasting impacts from that?

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

A

So there are a number of things that we've seen Chris, kind of an over the top has been increased communications, because we're working remotely in many environments the communications required to be sure that we were aligned from the management standpoint, we found to be really effective and I would anticipate that I always feel like we were an organization that communicated very efficiently and often, but we've learned that the additional communication has been even more helpful. I think we will continue that.

To speak specifically to some practices, we have begun to do some training remotely using cameras, that has been effective and efficient. I think we'll continue to do that where it's appropriate. We have learned some things about how to best utilize PPE and how to train around that. We stepped up our training considerably to be sure that our employees had the knowledge that they needed. We felt like it was adequate before, but we wanted to go above and beyond in this environment. I think we've found ways to be more effective doing that training. We've also made some improvements in our supply chain as we were trying to manage that risk.

So, we've been in touch with our suppliers. As I mentioned in the prepared remarks, but to be a bit more specific, one of the things that we've done is not only looked for redundancies, but also probed our contracting partners a bit on their own supply chains to make sure that we didn't have level two suppliers that we're feeding them with some critical element that might be a shortage that they had not thought of or they had not seen. And I want to thank our supply chain group. They have really done outstanding work not only identifying additional PPE resources and we have seen no lack of PPE. We haven't had to throttle our work due to unavailability of PPE. But they've also worked with our suppliers to keep our normal work channels flowing and we have not seen constraints nor do we anticipate any at this point.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. That's really great. Thank you, for those – for the additional comments. I guess switching gears a little bit I do have two finance related questions. Caron if you can just remind me, I've asked you this in the past and I simply forgot about it this past quarter, but the nonqualified benefit plan performance and how that affects your other income line, can you just maybe remind me what you had incorporated for that in the initial financial guidance for the year just to have a sense of maybe the magnitude of the initial quarter delta?

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

A

[indiscernible] (00:33:32) similar to how we work together in our guidance, we assume normal weather for our guidance; we also assume kind of a normal level of year performance for our nonqualified plans. To give you a little bit of perspective, if you go back to the history of time for ONE Gas if you look at I mentioned that we have the cost of the liabilities and then operating costs [indiscernible] (00:33:54) liabilities are in other income and expense.

On an annual basis that net income or expense has fluctuated from a positive or – excuse me, expense of $2 million to income of $1.3 million. So over time the fluctuations are not significant but you can see the same from quarter to quarter, for year to year what we saw in the first quarter. Obviously the markets had improved post March 31. So we expect that we will get some of that back that we basically assume a little bit more of a flattish performance from those plans.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. Okay. No, that's helpful. And when you record those I know there's some of your peers that also have flagged this because it's a more regular or larger ticket item relative to the size of your company. And when they quote it they quote it – it's the same number pre and post-tax. Is that true for you as well or is that when you quote another income impact when we think about an EPS impact that would tax effect that?

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

A

It would tax effect on recording a pre-tax number.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. Okay. And then finally you touched on some of this but – and I get the fact that the accounting rules make it – it seems like my interpretation of what you said in prepared remarks Caron is that you may not give yourself credit for some of the regulatory things you're pursuing and then upon formal recognition by the regulator it may be reversed out. And so outcomes may be improved subsequently, did I understand that correctly?

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

A

Yes you did. For example, [indiscernible] (00:35:24) first of all, we only have an accounting order in once stay, we're still awaiting on the other two, that there could be some gray in determining what is – can be deferred under those accounting orders and I think bad debt expense is a simple example. It may be difficult to determine specifically what is COVID-19 related versus what is normal bad debt expense. So there's a little bit of gray in that.

And then as you said, for accounting purposes, you've got to be able to determine that any regulatory asset we establish is probable of a recovery. And again there may be some interpretation of those order set that ultimately we make prevail that for an account – from an accounting standpoint, we have that as a hurdle to be able to record, [ph] so we could get that mismatched (00:36:06).

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. Okay, you actually hit on something that I was more curious about which is that clearly you have service territory that overlapped with production regions, crude and natural gas and natural gas liquid production regions. And you know we're seeing a fall out there, it's certainly in activity levels and employment levels, its COVID-19 related, but it's not maybe exclusively COVID-related. And so, I'm just curious maybe how you guys think about you know the program I guess as structured and conceived by you today, I know that two other states haven't yet approved them but how that might – how that demarcation line might be treated? It's a tricky question, but I just think it would be helpful.

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

A

[indiscernible] (00:36:47) This is Pierce. Let me kind of attempt to answer your question, and I'm not sure I'm going to get to do a justice here. But as it relates to the supply and the price and those kind of things, we clearly benefit – the customers clearly benefit from a lower price environment. But it can actually get – become too low, that it's not beneficial to the E&P community and the midstream community. And it's definitely approaching some of those areas especially as it relates to crude oil.

Having us be in those areas and be a net exporters of natural gas from our states or primarily the main ones Texas and Oklahoma. You're always going to kind of take care of your needs first in the state. So I would see if there is any reduction, it's probably going to be the reductions that go to other areas of the country, not necessarily in the areas that we consume. We're also going into that time of the year for us that gas comes down, but it also goes up for the electrics during this time of the year.

So we've all been through, at least most of us, who've been in the midstream side of the business before been through these downturns. And as it gets too low, they do definitely take the rigs down, the supply then starts to get a little bit constrained and then the price then comes back, just having lived through something like this in West Texas when I was there back in 1986, I think prices all got down to $10 a barrel. So for those of us who are old enough on this call have seen this movie before. COVID-19 might complicate it a little bit, but probably it's more basic supply and demand on that side of the business. I'm not sure I answered your question, but...

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

My question was more related I guess Pierce to the bad debt side of it, you know the fact that you have customers in your service territory that have hardships because of COVID-19, because of stay at home practices and what that did to their business, non-energy business, Curtis mentioned some of your transport customers that had either temporarily or indeterminate period of time suspended operations. But you also have a lot of customers who are employed by the oil and gas industry, which is suffering its own issues right now, which are partially related to COVID-19, but partially not. And so that's I guess what I was trying to get to Caron was mentioning...

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

A

Okay.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC
Q

...if it stems to COVID-19 or it doesn't stem to COVID-19, I just some of these issues it seems like in your service territory a little bit more tricky.

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

Lets – I'll let Curtis answer that question. And in particular, let him talk a little bit about how the bad debt on the side of the gas cost flows through to our PGA. And then he can answer the other questions as well.

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

Yeah. It's really – to Pierce's point two pieces of that Chris. Anytime we have bad debts in all three of our states, the portion that's attributed to the gas cost, doesn't actually get expanse. That becomes part of our purchase gas cost adjustments. And so that then gets rebuild through the normal gas pass-through mechanism that's in place. So what we're talking about with these accounting orders is the ability to defer the non-gas cost portion of the bad debts. And so each of our rate filings in the cost of service, it will identify a level of bad debt expense that's part of that cost of service.

So what we would be looking at is during this time what's the cause of the increase or what is the increase in our bad debts compared to what is built into our cost of service. Because I think that's really the starting point to have those conversations with our regulators and as we're thinking about what that means and what can be attributed to the impacts of COVID-19, whether it's directly to one of our customers that affected or it's indirectly because of what's happening in their business being shut down due to COVID-19 or other factors.

I think that really gets to Caron's comment earlier about it's a little bit of a gray area and we'll just have to work through that with our regulators and we are visiting with them frequently both on what's happening from an operation standpoint in Sid's group as well as what we're seeing with our customers and what's happening from a customer service standpoint.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC
Q

Okay.

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

Chris it's also to...

Christopher Paul Sighinolfi
Analyst, Jefferies LLC
Q

Okay. That was very helpful. That's very helpful.

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

...Chris it's also a good chance to remind everybody that in Texas, two-thirds of our customer base and rate base is in El Paso and in Austin and those are two areas that are probably the least impacted by the downturn in oil and gas as related to loss of jobs.

Christopher Paul Sighinolfi
Analyst, Jefferies LLC

Q

Okay. Got it. Well thanks a lot for the time guys. You took a lot at this point and I appreciate all the comments.

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

A

Thank you.

Operator: We'll go next to Richard Ciciarelli with Bank of America.

Richard Ciciarelli
Analyst, BofA Securities, Inc.

Q

Hi. Good morning. Thanks for taking my question. Hope everyone is staying safe out there. Just following up on the last question on bad debt. Bad debt expense increased $20 million in 1Q versus 2019; it looks like in 2019 it is up $1.5 million altogether. Just curious how much bad debt expense you currently had in rates and what kind of parameters are you looking at for the full year for the incremental bad debt, again the COVID-19 pressures?

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

A

So this is Curtis, Richard and I'll attempt to answer that. First off, we didn't have the accounting order in Texas yet as of the end of the first quarter. So everything that happened in 2019 or in the first quarter of this year is obviously pre any impact of that accounting order. And you're really getting at the heart of the point that we'll have to work with our regulators as we look to record amounts into those deferred asset. The theoretical approach is to how we would do that. But again you can look at kind of our normal year-to-year levels of bad debt expenses to give you a sense of what would be built into our – into our cost of service. It's not always the same way quantified in every jurisdiction, so for example, it might be the bad debt expense that was in your test year in one situation and then in another cost of service that might be a three year average. So there's different ways that those get established. But – so again we'll just have to work through our regulators to come to what's the right amounts to defer as we work through that.

Richard Ciciarelli
Analyst, BofA Securities, Inc.

Q

Got it. Thank you. That's very helpful. And then just in terms of the on O&M side, even with the increase in bad debt expense you had the nonqualified pension, I guess taking some of those costs down. Just curious if there's any ability to manage our O&M profile relative to the [indiscernible] (00:44:05) inflationary increases that you're expecting that kind of offset some of these COVID-19 related pressure whether it be on the revenue or cost side?

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

A

So Richard, this is Pierce. We actually will manage through this the same way that we always do. We have our internal labor which is defined by the head count. We have outside service labor. We have a certain percentage of our internal labor and external labor that's actually [indiscernible] (00:44:35) to the capital piece and then over time. So all big picture – all four of those moving parts is really the way that we'll manage it. It's the same way we manage it you know through normal towns.

And like Sid said is you know we've intentionally went into this pandemic knowing that certain things that we do will be different operationally. And so we are targeting to come out of it having identified those things that we don't want to change because we learned enough during the pandemic that we do want to change our operations. So I do anticipate that there are some opportunities for us there. But the big picture is we manage with those four levers.

Richard Ciciarelli
Analyst, BofA Securities, Inc.

Q

All right. Got it. That's very helpful. Best of luck guys. That's all I had.

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

A

Thanks, Richard.

Operator: [Operator Instructions] And at this time, there's no response. I'll turn the call back to Brandon Lohse.

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

Thank you, all again for your interest in ONE Gas. As noted on our earnings news release, an updated investor presentation is available in the Investor Relations section of our website. Our quiet period for the second quarter starts and we close our books in early July and extends until we release earnings in late July. We'll provide details on the conference call later today. Have a great day, and stay safe. Thank you.

Operator: This does conclude today's conference. We thank you for your participation.