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ONE Gas, Inc. (OGS)

Q3 2021 Earnings Call

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Vedula Murti
Analyst, Hudson Bay Capital Management LP

MANAGEMENT DISCUSSION SECTION

Operator: Good day and welcome to the ONE Gas Third Quarter Earnings Conference 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 third quarter 2021 earnings conference call. This call is being webcast live and a replay will be made available later today. After our prepared remarks, we'll be happy to take your questions.

A reminder that the 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 provisions of the Private Securities Litigation Reform Act of 1995, Securities Act of 1933, and the Securities and Exchange Act of 1934, each as amended. Actual results could differ materially from those projected in any forward-looking statements. For a discussion of factors that could cause the actual results to differ, please refer to our SEC filings.

Joining us on the call this morning are Sid McAnnally, President and Chief Executive Officer; Caron Lawhorn, Senior Vice President and Chief Financial Officer; and Curtis Dinan, Senior Vice President and Chief Operating Officer.

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

Caron A. Lawhorn

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

Thanks, Brandon. Good morning, everyone. Yesterday, we announced that we updated our 2021 financial guidance. Net income is now expected to be in the range of $204 million to $209 million, and earnings per diluted share is expected to be in the range of $3.80 to $3.90. Our guidance for capital expenditures and asset removal cost remains $540 million for the year.

Our actual results for the third quarter include net income of $20.3 million or $0.38 per diluted share compared with $21.1 million or $0.39 per diluted share in the same period 2020. Our third quarter results reflect an increase in net margin of $10.4 million over the same period last year, which is primarily due to $7 million from new rates and $2.1 million in sales from net residential customer growth. Operating cost for the third quarter were $6.1 million higher compared to the same period last year, driven primarily by increases in outside services, employee-related costs, and bad debt expense. It appeared in the second quarter that our bad debt expense was beginning to moderate, but our third quarter expense has ticked back up and we're currently $8.1 million of expense year-to-date compared to $8.8 million last year.

We continue to execute well on our procedures for managing past two accounts including connecting customers with payment assistance. In fact, we have currently received over $11 million or 88% more in energy assistance payments for our customers than at this time last year.

Our capital expenditures and asset removal costs were $20.6 million higher quarter-over-quarter, and we remain on track to achieve our capital plans for the year. Authorized rate base, which is rate base reflected in completed regulatory proceedings, including full rate cases and interim rate filings, is approximately $4 billion as of September 30.

We project that for 2021, our estimated average rate base, which is authorized rate base plus additional investments in our system and other changes in the components of our rate base that are not yet reflected and approved regulatory filings, will be approximately $4.34 billion with 41% in Oklahoma, 29% in Kansas, and 30% in Texas.

We ended the quarter with $336 million of commercial paper outstanding and no borrowings under our credit facility. If you'll recall, in March, we issued $2.5 billion of fixed and floating rate notes to cover costs related to winter storm Uri. Actual cost offered ended up being closer to $2.1 billion. These notes became callable in September, and we redeemed $400 million of the two-year floating rate notes in order to line up our financing with the final cost estimate.

Year-to-date, we sold $21.4 million of common stock under the $250 million at the market equity program we put in place in 2020 and we have no additional sales planned for the balance of the year.

As a result, at the significant cost incurred due to the winter storm, which will be deductible for tax purposes in 2021, we expect to generate a net operating loss carryforward, which will also reduce taxable income in future years. Our current estimate of cash taxes for 2022 is $21 million.

Yesterday, the ONE Gas board of directors declared a dividend at $0.58 per share, unchanged from the previous quarter.

Now I'll turn it over to Curtis for an update on the latest from regulatory, commercial and operations.

Curtis L. Dinan

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

Thank you, Caron, and good morning, everyone. I'll start with a brief update on securitization. The securitization process continues to progress across all three states. The Public Utility Division of the Oklahoma Corporation

Commission filed responsive testimony recommending to the OCC that all actual costs incurred be found prudent, reasonable, and recoverable, and that a financing order for securitization be approved. A hearing before the administrative law judge has been scheduled for November 22. The OCC has until January 22, 2022, to issue a financing order. Once a financing order is issued, the Oklahoma Development Finance Authority has up to 24 months to issue the securitized bonds.

In Kansas, a procedural schedule is in the process of being finalized and hearings are proposed for mid-December. Under the proposed schedule, a financing order would be issued in the first quarter of 2022, allowing the company to begin the process of issuing securitized bonds. On October 29, a unanimous joint stipulation was filed in Texas recommending that Texas Gas Services be allowed to recover its costs from Winter Storm Uri. Approximately $200 million of Winter Storm Uri costs would be included in the proposed financing order, and approximately $60 million of our cost for our West Texas service area would be recovered over three years through a separate rider for those customers.

A hearing before the administrative law judge occurred this morning. Staff made an opening statement in support of the settlement and the utility submitted their testimony and exhibit also in support of the settlement. The parties further waved a proposal for a decision. A proposed order in support of the joint stipulation will be filed tomorrow and considered by the commission at their next open meeting on November 10. The RRC has until December 27 to issue an order and an additional 90 days to issue one financing order for all participating utilities.

Turning to other regulatory matters. A joint stipulation and settlement agreement for the Oklahoma Natural Gas General Rate case was heard before an administrative law judge who recommended approval of the agreement. If the joint stipulation is approved by the OCC as filed, base rates would increase $15.3 million and go into effect later this year. The agreement also includes continuation of the performance-based rate change mechanism and ROE of 9.4% and an equity ratio of 58.55%.

Oklahoma Natural Gas would then be required to file another full rate case no later than June 2027. The agreement includes an allowance to recover up to $5 million annually for the purchase of renewable natural gas. Oklahoma Natural Gas is required to file an application requesting approval of an opt-in tariff for customers to select all or a portion of their fuel source to be RNG. The OCC has until November 28 to consider the ALJ's recommendation.

In August, Kansas Gas Service filed a gas system reliability surcharge that seeks an increase in rates of approximately $7.6 million for capital expenditures. In October, the Kansas Corporation Commission issued their report and recommendation for an increase of $7.6 million. An order from the KCC is expected in December 2021 with new rates going into effect sometime in January.

Moving on to our commercial activities. We continue to see strong economic activity across our territories and strong demand for natural gas and new construction. Continuing the positive trend from 2020, we connected approximately 5,600 new customers during the quarter and approximately 16,900 year-to-date.

In addition to the RNG update from the Oklahoma rate case I mentioned earlier, the project development momentum is picking up in several of our areas. In October, we executed four letter agreements for biogas development projects including two wastewater treatment plants, a landfill, and a food waste project for which we are in active design mode for the interconnections.

Together, the four projects are expected to produce up to 700,000 MMBtu of RNG per year or the equivalent of serving approximately 10,000 homes. We are also in active discussions for five additional biogas development projects including three dairies, a landfill, and a wastewater treatment facility.

As a response to Winter Storm Uri, we made several enhancements to our winter preparedness capabilities heading into this winter. First, we added additional storage capacity, which reduces the amount of gas we will need to purchase on the open market during the heating season. Second, we have added transportation capacity and additional interconnects to source supply from upstream providers at different delivery points to further increase system reliability.

Third, we've added to our mobile CNG trailer capacity to provide additional support to maintain system pressures in the event of supply constraints. And lastly, we've updated our forecasting models, that incorporate data from Winter Storm Uri, which helps improve our planning and preparedness for periods of extreme peak demand.

And now, I'll turn it over to Sid for closing remarks.

Robert Sid McAnnally

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

Good morning. I'll start by thanking Caron and Curtis. As you've just heard, we've seen great performance from the teams that they lead on issues related to Winter Storm Uri and securitization. And that good work is coupled with solid performance in the day to day operations across our company. So, thanks to you both and to the ONE Gas team. As you may have seen, we released our latest ESG report in October, expanding the data included and improving the transparency of our reported data.

Here are just a few of the highlights from that report. Safety is our first core value and the foundation of everything we do. Our focus on employee safety has led to substantial improvements in all of our employee safety metrics. You can find the detailed data related to those improvements in our report. In October, ONE Gas was again awarded the Safety Achievement Award for Excellence in Employee Safety by the American Gas Association. Recognizing ONE Gas for having the fewest number of lost workdays due to injury for the fourth consecutive year. We're proud of this well-deserved recognition for our employees, but we don't rest on past success. Every day requires a new commitment to employee safety and the safety of our system.

Turning to our environmental strategy. By focusing on replacement and protection of our distribution mains and service lines, we've reduced our Scope 1 CO_2 equivalent pipeline emissions by more than 26% since 2014. Using the same process, we expect to achieve a 41% reduction by 2025. We've exceeded our methane challenge goals from the EPA each year since we joined the project as a founding member, and we continue to pursue and adopt emerging technologies that support reduced emissions.

Our team is optimistic about the role that natural gas will play in a cleaner energy future for the communities that we serve. The basis for that optimism is simple, organic growth from a dynamic service territory that's demanding our product, a proven and resilient system, and supportive legislative and regulatory environment in the territories that we serve. Joining those elements with a high-performing workforce, and you can see why we're excited about the future.

Customer satisfaction remains high with ONE Gas achieving a 93% satisfaction score on the 2020 Customer Relationship Survey, and our employee engagement scores are in the top quartile of companies that use the Gallup Employee Engagement Survey. Like safety, inclusion and diversity is one of our core values. Currently, 27% of our workforce are women and 35% identify as members of an underrepresented racial or ethnic group, performing above the latest EEOC US utility company averages. And we believe that new programs will allow us to show continued improvement.

Our seven employee resource groups continue to grow in both size and impact with one third of our employees participating in an ERG. The engagement of these groups in the life of our business is serving to develop new leaders and to help recruit new employees who align with our culture. Together, we're excited about the work that remains ahead of us.

In closing, I'd like to recognize the 3,600 employees of ONE Gas and extend my personal thanks for their dedication to service and commitment to our stakeholders. Through two years of a pandemic and one of the worst winter storms in history, our fellow employees performed at a very high level, and their focus on our customers never wavered. We're grateful for their commitment to the same core values that continue to anchor our company every day.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] We will now take our first question from Shahriar Pourreza from Guggenheim. Please go ahead. Please go ahead, caller. Your line is open. Please ensure your mute function is turned off to allow your signal to reach our equipment.

Jamieson Ward
Analyst, Guggenheim

Q

Hello. Are you guys able to hear me now?

Robert Sid McAnnally
President, Chief Executive Officer & Director, ONE Gas, Inc.

A

We can hear you, Shar. Thank you.

Jamieson Ward
Analyst, Guggenheim

Q

Yeah. Apologies about that, the headset technology. It's Jamieson on for Shar. Congrats on raising and narrowing there. We were hoping that that would be the case and obviously you've done that in the past. It's nice to see a continuation there.

The question I've got for you is actually on your ESG report filed last month. It's very clear to us from the level of detail that you provide in those disclosures that ESG is very important to you. You've obviously made it a priority in your interactions with the investment community. Looking at your target dates for carbon dioxide reduction, methane reduction, 2025 seems to be the furthest that you go out in terms of target dates, while your peers seem to be pointing more towards 2030, 2040, even 2050. And the questions that we get inbound from investors seem to be over those same 2030, 2040, 2050 timeframe. Just curious here on how you're thinking about the timeframe that you are willing to set targets for and how we might see that evolve going forward.

Robert Sid McAnnally
President, Chief Executive Officer & Director, ONE Gas, Inc.

A

You bet. First, thank you for the comment on guidance and on the ESG report. We did put a good bit of time and thought into the ESG report, and we think the report shows a renewed commitment to many of the things that the company has been doing since the company was founded in 2014.

In terms of the timelines, we've shared before that we align with our peers in the industry in terms of goals and our long-term thinking around emissions reductions and reducing the carbon intensity of the system. Where we are focused though is demonstrating clear pathways to achieve the goals that we set out. Now, we think it's important to be able to demonstrate clearly exactly what activities of the company are aligned with which goals and the pathway to get to specific targets. So, as we've set out, we've started down that path and we expect as we continue to share more information that we'll have more clarity about what that path looks like going forward and we'll be able to extend that runway.

I don't see that as a lack of commitment, just a commitment to the fact that we've always been very openhanded with our investors and with others in the community and we want to continue to be true to that history and stay on brand with the fact that what we say, we have visibility around. And when we make a commitment, we've got a clear pathway to be able to execute that. Caron is working on our ESG project as many of you know. Caron, do you have any other comment around that?

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

A

I think that was a great summary of our commitment and what we're working towards. And importantly, we believe that we are doing all the right things especially when you think about our pipeline replacement program, cathodic protection, our operational practices, advanced leak survey technology, and importantly improvement or advancements in our R&D projects as Curtis just mentioned. That's a pretty exciting development and we're really looking forward to understanding the full potential of what R&D can do to our emissions profile.

Robert Sid McAnnally
President, Chief Executive Officer & Director, ONE Gas, Inc.

A

So Jamieson, one of the things that – there are a lot of headlines this morning around methane and commitments to tightening methane systems and we sort of – we feel very validated by that. Since 2014, this company has been very focused on pipeline replacement programs that look at the condition of pipe, not necessarily budget spread across the territory evenly, but making sure that we're focused on those opportunities that present us with the greatest opportunity to tighten the system, to keep gas in the pipe and we continue on that trajectory. So, it was very affirming to us to see many people across the globe talking about something that our company has been focused on since 2014. Does that get to your issue, Jamieson?

Jamieson Ward
Analyst, Guggenheim

Q

Yeah. That's terrific. I really appreciate the additional color you provide there. And I think that as you further extend that timeline going forward as you alluded to doing, I think you'll find that to give you an idea of the questions we get, the inbounds are from investors that have a mandate of a company needs to be at X point now already from an ESG standpoint to be investable and then another group where they have to have a target to get to a certain point by a certain point in time.

And I think that as you continue to evolve, you're already robust ESG disclosures and you extend that timeframe you'll open up a new group of investors who will be able to look at and investing in you as well. So, good work all around, guys, and thank you for answering the question.

Robert Sid McAnnally
President, Chief Executive Officer & Director, ONE Gas, Inc.

A

Yeah. Thank you, Jamieson. And we'll continue to find that right balance between forward targets and clear pathways on how to execute on those targets. We appreciate the comments. Thank you.

Operator: [Operator Instructions] We will now take our next question from Vedula Murti from Hudson Bay Capital. Please go ahead.

Vedula Murti
Analyst, Hudson Bay Capital Management LP

Q

Good morning.

Robert Sid McAnnally
President, Chief Executive Officer & Director, ONE Gas, Inc.

A

Good morning, Vedula.

Vedula Murti
Analyst, Hudson Bay Capital Management LP

Q

I was wondering it's very positive in terms of the [indiscernible] (21:29) you've been able to reach kind of base increases as well as the work you made so far in terms of [ph] primary securitization process (21:38). Can you help us, just over the next few years here, because most of the securitization costs will – the revenues will be affected from 2022 and beyond. Can you kind of box off for us to see totality of the revenues that will be coming to [indiscernible] (22:00) securitization and how you're thinking about with your [indiscernible] (22:04) managing that with the potential base needs than more managing CapEx, such that [indiscernible] (22:13) due on your returns? And that is [indiscernible] (22:17) of headwinds to deal with going back [indiscernible] (22:21) managing the securitization [indiscernible] (22:24)

Robert Sid McAnnally
President, Chief Executive Officer & Director, ONE Gas, Inc.

A

Yeah. Sure, Vedula. Thank you for the question, and I agree with you. We're very pleased with the way that the securitization path has gone because we believe it's good for all of the stakeholders that we deal with. Let me do this just to round out the context around your question.

I'll ask Caron to speak to the mechanics of the way the securitization will work. And then Curtis can pick up and talk a little bit about both the impact, the way that it works from a regulatory standpoint and the impact on our forward CapEx planning. Caron?

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

A

Sure. So, in Oklahoma and for Texas, except for West Texas, if you saw our news release, we have a carve-out for West Texas. So, most of Texas and Oklahoma securitization is going to be completely off balance sheet.

Those bonds are going to be issued by state agency and we'll just add a charge to the bill, and we'll service those revenues, and they will go to serve – that will pay off those bonds.

In West Texas. A new twist, a positive development for the West Texas customers is there are carve out from the total securitization process in Texas, which as you know covers all participating utilities in one financing order. So, we've carved out about $60 million for West Texas that is going to be recovered over a three-year period with a special rider or surcharge that will also be part of the cost of gas. So, we'll continue to finance that have a rig asset for those costs in West Texas.

And then in Kansas, a third method, so to speak, is we will issue the securitized bonds. That debt will stay on our balance sheet. We will continue to collect that through a surcharge, pay those bonds off, but that – in that instance, that securitized debt while on balance sheet, we expect the rating agencies will look at our metrics in the absence of all of our securitized debt including the debt in Kansas that will be on the balance sheets.

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

A

And then from a – the impact as it works its way through the regulatory process and the impact that it has on the customer's bills, let me just – these aren't final, but let me give you the latest projections by the different states as to what those amounts might be. I think that'll help you put in perspective, then the anticipated impact that might have on customers. So, in Texas right now, there are ranges from 10 to 30 years as to the recovery period of those bonds. If it were a 10-year recovery period that monthly cost to a customer is about $5. And at the 30-year point, it's around $2.30 per month. So, that will give you a perspective of the recovery periods and the impact it might have there.

In Oklahoma for our low income customers, there is no surcharge related to those customers. So, no impact and no monthly billing no impact and no monthly billing. For our smaller volume customers which would be sort of between the – our low income and the larger customers, that impact is estimated to be about $5 per month. And then for our larger customers that use larger volumes of gas, it would be about $8 per month is the expectation in Oklahoma.

Then in Kansas, there's three different recovery periods that are – that were included in our testimony of 5, 7, and 10 years. At 5 years, it would be about $11 per month. And at 10 years, it would be about a $6 impact per month. So, we certainly don't want to have extra costs tacked on to customers' bills, but we think that's a very manageable way that each of the commissions have addressed the recovery of these costs. And so, it's protecting the utilities but also reducing the impact that it has on the customer.

So, with that thought in mind and your second part of your question, I believe, was around CapEx, keep in mind that in our three service territories, our competitive advantage to electricity is about 3.5 to 1. So, meaning if you're going to heat your home or hot water, dry your clothes, it costs less than one-third the amount, the all-in delivered cost to use gas as opposed to electricity.

And so, while we'll see some impacts that I just covered to the customers' bill, the electric companies in our service territories are facing some of those same impacts from those storms. So, we don't see that competitive advantage eroding. And so, we don't have plans to change our CapEx spending profile, as we've previously given in our five-year guidance. So, the best way to dilute the impact to customers is as we continue to grow our customer base.

Well, I'll just – I'll give you just one more data point to think about. In case you were up late on a sleepless night and read any of our testimony in the Oklahoma Natural Gas Rate case, there was a lot of testimony in there that was sponsored not only by the company, but also by interveners, recognizing that our O&M cost per customer has actually declined since the last rate case and that's due to two factors. We talk often about reducing or eliminating cost down to sustainable levels and we remain focused on that, but also growing our customer base helps spread those costs over a greater number. And so, that lessens the cost.

And it was nice to be recognized in that rate case, again, not only by our own testimony, but testimony sponsored by some of the interveners. So, hope that gives you some perspective on how we're thinking about not only the impact today, but how we proceed forward.

Vedula Murti
Analyst, Hudson Bay Capital Management LP

Q

In terms of being able to manage your expenses and [indiscernible] (28:37) CapEx and avoid the regulatory arena. I guess maybe simplistically where I'm really trying to go with this is if I thought about a $2 billion recovery across the entire system, if I was to make my math facts very simple over a 20-year period with no [ph] sharing (28:56) cost, that's $100 million a year. That's part of the customer bill that would otherwise would have been, how would I put it, until available to – for pipeline replacement and/or RNG or other types of initiatives.

That's – can you translate those percentages per – for these customers into what the actual millions of dollars will be? And kind of, when that kind of peaks out and whether that – whether your engagement with your – with the regulators and whether that – whether engagement with your – with the regulators in other parties acknowledges that's kind of separate from everything? Or is it going to ultimately somehow be commendable at least in terms of perceptions?

Robert Sid McAnnally
President, Chief Executive Officer & Director, ONE Gas, Inc.

A

Sure. So, let me just talk about the company finance aspect of that first. And as Caron covered, the $1.3 billion in Oklahoma and $200 million of the total of $2.1 million or $1.5 million of that total will be recovered through securitized bonds that are issued by the state. So, the company's finances will pick that piece up, and then the portion in Kansas, the company will directly issue those securitized bonds. And so, we'll have the cash in for that.

The only piece we're financing, and it's only over a three-year timeframe, is $60 million related to our West Texas service area. So, I think once we have those issuances behind us, very clearly, we've restored the company's balance sheet at that point.

As it relates to how we determine our capital spending programs each year, it's a balance, and it's really in equal parts. Our primary focus is what do we need to spend on the system in terms of system integrity and the maintenance that we do there. So, that's really the first thing that we look at, and we're agnostic to the impact per se that it has on anything else. That's what's needed to reinvest in the system to keep it safe and reliable.

We also look at what all the resources are that are needed to execute on that plan. So, the financial resources, our balance sheet, and then, secondly, the nonfinancial resources. So, contractors, equipment, and our internal workforce, all of those things factor in. And, finally, what is the impact that that has upon the customer bill. And we've been able to keep that in balance and we expect to continue to keep that in balance over time. Again, we invest in the system integrity based upon the system needs. And then, the growth in our service territory drives the growth capital that we spend. And as we spend that growth capital, that expands the customer base and that then gives us more customers to spread those costs over. And that's a key component of keeping our costs low to not only our existing customers, but future customers as well.

And the example that you were giving over, say, $100 million per year, we have 2.2 million customers. And so, we talk about the $5 per month impact on average that it has. I gave you the ranges for each of the states, but that's just kind of a broad number to think about to recover those.

Vedula Murti
Analyst, Hudson Bay Capital Management LP

Q

Okay. I appreciate that. Thank you very much.

Robert Sid McAnnally
President, Chief Executive Officer & Director, ONE Gas, Inc.

A

Thank you for your question, Vedula.

Operator: [Operator Instructions] It appears there are no further questions. I would like to turn the conference back to Mr. Lohse 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 fourth quarter starts when we close our books in early January and extends until we release earnings in February. We'll provide details on the conference call at a later date. Have a great day.

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