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ONE Gas, Inc. (OGS)

Q4 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, and welcome to the ONE Gas 2022 Fourth Quarter and Year-End Earnings Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to 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 2022 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.

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 provisions of the Private Securities Litigation Reform Act of 1995, the 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 discussion of factors that could cause 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 Sid.

Robert Sid McAnnally

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

Thanks, Brandon, and good morning, everyone. Our fourth quarter and full-year results reflect consistent performance against the guidance we communicated at the beginning of last year. Despite a range of geopolitical and monetary policy factors, which sharply altered the macroeconomic landscape during the year, our teams delivered earnings and capital execution squarely in-line with our original plans.

To put this achievement in context, in 2014, our first year as a stand-alone entity, we deployed a total of \$262 million in core capital with just \$47 million to support growth initiatives. Last year, we spent \$657 million, approximately 2.5 times our first-year total, with \$197 million dedicated to expansion initiatives, a quadrupling of our growth investment compared to that initial year.

We began 2023 and with our approach unchanged, being prudent in managing the present and remaining consistent in our commitment to the long-term execution of our core businesses and growth strategies. Leveraging lessons we learned from Winter Storm Uri and the system enhancements we made in its wake, I'm pleased to report our business performed well during Winter Storm Elliott in December and Winter Storm Mara last month.

Consistent execution during these formidable weather events underscores the value of natural gas distribution networks such as ours, particularly reliably as we look at reliable service on winter heating loads. It also underscores the logic behind the all of the above energy policies in the states we serve. On the regulatory front, the recent approval of our West-North Texas rate case represents a constructive outcome and recognition by our regulators of the need for ongoing investments to enhance system integrity, and respond to regional economic development opportunities.

As legislative sessions are underway in all three of our states, it's worth noting that each will be working with a sizeable budget surplus capable of supporting continued economic development in our service territory.

With that introduction, I'll turn it over to Caron to discuss financial details for the quarter and the full year. Caron?

Caron A. Lawhorn

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

Thanks, Sid. Good morning, everyone. Net income for the fourth quarter 2022 was \$67 million or \$1.23 per diluted share, compared with \$60.5 million or \$1.12 per diluted share in the same period 2021. Our fourth quarter results include an increase in operating income of \$16.6 million over the same period last year, which reflects \$13.6 million from new rates and \$1.6 million in sales from net residential customer growth.

Operating costs for the quarter were \$2.9 million higher compared to the same period last year. Employee costs and outside services were relatively flat compared to the prior year. For the quarter, bad debt expense was \$1.1 million higher than last year, but \$3.1 million lower for the full year.

Other income, net, increased to \$4.5 million for the quarter, which reflects a reduction of \$2.1 million in non-service costs for our pension plans due to the April re-measurement of our obligations, which we have discussed on previous calls.

Interest expense in the quarter was \$11.5 million higher than the same period in 2021. We issued \$300 million of 4.25% senior notes in August and \$336 million of securitized utility tariff bonds in November, both of which contributed to the increase. And as I mentioned last quarter, higher natural gas prices and increased natural gas storage balances as compared to the prior year contributed to an increase in our working capital needs, which we

fund with commercial paper. CP rates in the fourth quarter of 2022 were 4.3%, compared with 25 basis points in the fourth quarter of 2021.

Turning to securitization with the November completion of KGS – of the Kansas Gas Service Securitized Financing, I wanted to highlight that although there was no impact on net income during the quarter, revenues included approximately \$5.8 million related to securitization. This was directly offset by approximately \$3.5 million of amortization expense and \$2.2 million of interest expense.

We provided tables in yesterday's earnings news release that disclosed the balance sheet and income statement impacts from the Kansas securitized financing. The securitization transaction in Texas is still pending, but we now expect the bonds to be issued by April.

For the full year, net income was \$221.7 million or \$4.08 per diluted share versus \$206.4 million or \$3.85 per diluted share in 2021. Operating income was up approximately 13% or \$39.7 million, which includes \$58.7 million from new rates, and \$7 million from residential customer growth. Operating costs for the year were \$24.4 million higher than 2021, primarily as a result of increases in outside service costs and employee labor and benefits.

Our capital expenditures and asset removal costs for the fourth quarter were \$209.6 million, bringing our total for the year to \$656.5 million, compared to \$544.3 million in 2021. The increase is primarily attributable to system integrity projects and extension of service to new areas. Average rate base for the year was \$4.69 billion, with 42% of that in Oklahoma, 27% in Kansas, and 31% in Texas. Authorized rate base, which is rate based reflected in completed regulatory proceedings, including the West-North rate case that Curtis will discuss in a moment was approximately \$4.48 billion as of year-end.

Depreciation and amortization expense was \$21.2 million higher than the prior year, reflecting an increase in net property, plant and equipment as a result of a higher level of capital investment. Also contributed to the increase as amortization associated with the Kansas Gas Service Securitization transaction I previously mentioned.

Turning to our liquidity, we ended the year with \$448 million of capacity under our \$1 billion commercial paper program and no borrowings under our credit facility. During the year, we sold and issued over 400,000 shares of common stock for \$35 million under our at-the-market equity program. We also executed forward sales agreements for nearly 1.5 million shares. On December 30, we settled approximately 1.2 million of these shares generating proceeds of about \$94 million. We expect to replace our expiring registration statement and equity distribution agreement before the end of the month. In January, the ONE Gas Board of Directors declared a dividend of \$0.65 per share, an increase of \$0.03 or approximately 5% from the previous quarter.

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

Curtis L. Dinan

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

Thank you, Caron, and good morning, everyone. Last March, Oklahoma Natural Gas filed its Performance Based Rate Change application for \$19.7 million. Pursuant to our tariff, new rates went into effect in July. And in November, the Oklahoma Corporation Commission issued an order approving \$19.6 million in rate relief. Oklahoma Natural Gas will file its next Performance Based Rate Change application next month using 2022 as the test year.

In December, Oklahoma Natural Gas filed a request for a renewable natural gas Pilot Program and Voluntary Tariff. The proposed tariff will allow all residential, small commercial, and industrial sales customers to voluntarily

purchase RNG. If approved, the tariff will be in effect for a pilot period through 2027. An order is expected no earlier than the third quarter of 2023.

Kansas Gas Service filed a \$7.8 million Gas System Reliability Surcharge last August. And in November, an order was received authorizing a \$7.7 million increase, effective December 1. In January, the Railroad Commission of Texas approved the proposed service area consolidation and a rate increase of \$8.8 million for the West-North Texas service area, with an authorized return on equity of 9.6% and a common equity ratio of 59.74%. New rates took effect on the first of this month. And finally, Texas Gas Service made Gas Reliability Infrastructure Program filings for all customers in the Central-Gulf service area, requesting an \$11.5 million increase to be effective in June 2023.

Moving on to operations. As Sid mentioned, both Winter Storm Elliott, and more recently, Winter Storm Mara, brought extreme cold, snow, and ice to our service territories. As with Winter Storm Uri in 2021, our system, processes, and coworkers performed well with no significant service disruptions. The lessons we learned from Winter Storm Uri, and the investments we've made to our system since, including adding leased storage capacity, and further diversifying our supply portfolio, have contributed to enhanced system reliability and resiliency. While we are pleased with our performance during these extreme winter events, we continue to evaluate opportunities to further reinforce our operations.

I'll finish with a quick update on commercial activity. The work of our commercial teams continues to bear fruit, as we added over 27,000 new customer connections in 2022, up nearly 12% compared to 2021, and marking a new record for annual meter sets at ONE Gas. Equally compelling is the broad-based nature of the growth across our territories. New customer connections in Texas grew roughly 3% from 2021, Oklahoma set nearly 13,000 new meters in the year, up 17% from 2021 meter sets, and marking a new annual record, and new customer connections in Kansas jumped almost 22% compared with the prior-year increase.

We also continued to secure new business and ended the year with a record number of future meter sets in our backlog. On our first quarter call last year, I highlighted two large scale projects to illustrate the measured approach we are taking in addressing new market opportunities.

One of these was in the Oklahoma City Metro, a multi-phased \$26 million project to support the development of more than 10,000 planned building lots over the next five to seven years. I said at the time this project would meet the immediate needs of residential and commercial customers and position us to serve future waves of population growth to the area. Nine months later, we have identified the opportunity to increase the size of this project by an incremental 15% to accommodate more growth that developers have now planned in the area. This disciplined, phased approach is emblematic of our growth strategy as it allows us to prudently manage our present opportunity set, while also positioning for longer-term system expansion.

Finally, this month we opened the ONE Gas Education and Training Area. This commercial kitchen offers space for residential filming, commercial food service cooking, and equipment demonstration. Our Commercial and Energy Efficiency teams are already leveraging the space to showcase the latest in natural gas cooking technology, and innovation through hands-on demonstrations and testing. It is just another example of the creativity our teams are bringing to support the continued growth of our business.

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

Robert Sid McAnnally

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

Thank you, both. From the COVID-19 pandemic and its supply chain and labor force impacts to Winter Storm Uri and the securitization of extraordinary gas costs, to spiking inflation and the pace of monetary tightening not seen in several generations, the last three years have tested us, requiring our company to be flexible and resilient in the face of evolving challenges. We've committed to meet these challenges while maintaining our focus on three targets: a strong safety culture, excellent customer service, and building the capacity to capture organic growth in our service territory.

Our 2022 results showcase the resilience of our team and the success of our efforts as we delivered on our financial plan, despite an economic landscape which shifted significantly throughout the year. In November, we detailed our 2023 and five-year financial outlooks, open-handedly discussing how altered macroeconomic conditions would impact our business and the conditions – and the actions our company would take in response to those conditions.

While the magnitude, volatility, and direction of future changes in economic conditions are always uncertain, we remain focused on managing our business with sustainable, long-term value creation in mind. That work is made possible by the commitment of each one of our 3,800 coworkers. I'm grateful for their dedication to safety, reliability, and growth and I'm privileged to work alongside them every day.

Finally, speaking of coworkers, today marks Brandon's last earnings call as our Director of Investor Relations. He's been appointed Chief Financial Officer of the Electric Cooperatives of Arkansas and will assume that position next month. On behalf of the ONE Gas family, I want to thank Brandon for his service to the company, and wish him all the best in his new role.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question today goes to Paul Zimbardo of Bank of America. Paul, please go ahead. Your line is open.

Paul Zimbardo

Analyst, BofA Securities, Inc.

Q

Hi. Good morning. Thank you. And best of luck, Brandon. Congratulations.

Robert Sid McAnnally

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

A

Good morning, Paul.

Brandon Lohse

Director-Investor Relations, ONE Gas, Inc.

A

Thanks, Paul. Much appreciated.

Paul Zimbardo

Analyst, BofA Securities, Inc.

Q

Thanks and – of course. Of course. Best of luck. And I know you had a comprehensive guidance update, it feels like a long time ago, but just a few months ago. Just given the pretty significant decrease in natural gas prices, does that change anything that you previously contemplated around regulatory rate case strategy or just outlook for growth within the long term range?

Caron A. Lawhorn

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

Good morning, Paul. This is Caron. No, it really doesn't. Certainly, that pullback is great news for us and for our customers. Just to talk about the customer impact, based on the current strip, we estimate that that translates into a reduction in about \$10 per month for our customers, which is really good. That's relative to what we had anticipated when we released our guidance back in November. Of course, it also has a positive impact on our cash flow, working capital needs and our storage injections. So, while that's really good news, it's just one factor among many that we have our eye on.

Paul Zimbardo

Analyst, BofA Securities, Inc.

Okay. Great. And just to follow up on that, could you quantify what the improvement for working capital and perhaps like the short-term debt balance that you anticipate year end 2023, just given the benefits on lower gas costs?

Caron A. Lawhorn

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

I don't – I don't have a specific number. Like I said, there's a number of moving pieces and parts. Gas prices are a part, important, but just one piece of that puzzle.

Paul Zimbardo

Analyst, BofA Securities, Inc.

Okay. And then, I heard about that update on the commercial development project, the 15% increase potential there. Are there any kind of similar projects that you have on the drawing board that you think could manifest over the next 12 to 18 months?

Curtis L. Dinan

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

Paul, this is Curtis, and we do, I haven't highlighted all the ones over the past year, but there are a number of projects in various phases, whether we're still developing them commercially, they're in design phases or they're in execution phases, like the one I just highlighted. Sometimes, when they're in the construction phase, we identify more opportunities and the ability to further expand those. So, the economic activity in our three states continues to be very robust and we see a high demand for natural gas and the service we provide.

Robert Sid McAnnally

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

And, Paul, I'd just add that we also continue to see the in-migration patterns that we talked about at the end of the year, the knock-on growth that we see with economic development. The reason that we mention the surpluses in our three states is these states have become very active in engaging and pursuing economic development opportunities. And we see industries pursuing the opportunities created by affordable energy. So, we think the future remains bright for us and we continue to prepare for that.

Paul Zimbardo

Analyst, BofA Securities, Inc.

Okay. Excellent. Great. Thank you all very much.

Q

Robert Sid McAnnally

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

You bet. Thank you for the questions.

A

Operator: Thank you. And the next question goes to Shar Pourreza of Guggenheim Partners. Shar, please go ahead. Your line is open.

Jamieson Ward

Analyst, Guggenheim Securities LLC

Hi. It's actually James Ward on for Shar. How are you guys?

Q

Robert Sid McAnnally

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

We're well, James. Thank you.

A

Jamieson Ward

Analyst, Guggenheim Securities LLC

Terrific. So, Paul asked one of the questions that I had there. I'll ask another that I had on the backlog. Basically as the backlog shrinks, how do you – how long are you thinking that it's going to take to fill it and just as we've seen the change and sort of the rate of customer growth and, obviously, with the macro backdrop, it's sort of slowed a bit in the key region there in Texas. How should we think about the \$185 million really, new customer connect capital that's in the budget this year? And then what maybe next year and the year after look like? We're just trying to shape out kind of that portion of the CapEx.

Q

Robert Sid McAnnally

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

Sure. James, one macro observation. While the larger economic context does impact the country as a whole and our region to some degree, we continue to see scarcity of available housing. We were just this morning looking at National Association of Realtors numbers that showed the inventory in our service territory. The available inventory is about 3.4 months, which is still historically low.

A

And with the in-migration, we can – we think we'll continue to see some build out. I'll ask Curtis to speak to the specific statistics in the shorter term, to speak to your question. But we continue to like the fact that we live in the most affordable region in the country, when you take the region as a whole. And all of that bodes well when you think about in-migration, the population, affordability of existing housing, housing, housing stock that needs to be replenished at scale, that all supports our growth theory and we continue to have confidence in it and to pursue it. Curtis, what would you add?

Curtis L. Dinan

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

A

Just one thing, James. I want to clarify one of the items from my comments, and that is we ended the year with a record number of future meter sets in our backlog.

So, it's not declining. It is growing. And our commercial teams continue to have success at exactly what Sid was describing, that there is continuing building going on in our service territories. And they continue to win new projects, some of them smaller, some of them much larger. But just like my example in Oklahoma City, developers are still active because they're meeting immediate demand that the marketplace has. And that's all very positive for us.

Jamieson Ward

Analyst, Guggenheim Securities LLC

Q

Got you. No, that's helpful color. I guess just to get a bit more detail there just to make sure I'm understanding correctly. Last year, your average annual sales customer growth of 1.2% that you're guiding to over the five-year period, that was ending 2026, it was led by Texas with I believe it was just under 2%, I think it was 1.9%. And then in the 2023 guidance, from the end of last year, it's now 1%, so 20 basis points lower with Texas at 1.6%. So, if you could just help me understand how the backlog is still growing. I guess, were you not at a point previously of being able to kind of meet it in real time?

It's a good problem to have. It's a high-cost problem, don't get me wrong. I just want to make sure I'm understanding correctly why the backlog is still growing, if the rate of customer growth is declining. Or are you thinking that there might be an opportunity to revise that lower customer growth guidance from the end of last year based on what you're seeing now? And it might sort of return to where it had been. How should we think about it?

Curtis L. Dinan

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

A

Sure. James, let me take a stab at answering all those questions. And if I skip past something, pull me back in. So, when we gave the guidance at the end of last year, our 2023 initial guidance, we were looking at the economic landscape and seeing the increase in mortgage rates just as your question alluded to. We thought that would perhaps slow things a little bit. But by slow things, that's from a torrid pace to just a really hot pace. So, a little bit less than what we saw in 2022, we were anticipating that mortgage rates might have that impact.

We continue to see, just a few months later, the building activity continuing. I think it is a positive that things have slowed down a little bit, because it's allowed developers and builders to get caught up on several projects that they have. So, when we talk about our backlog, we've got to kind of separate the short term from the long term. So, when we're talking about our backlog, those might be additions just like my Oklahoma City example that are five- to seven-year build-outs, sometimes quicker, sometimes a little bit longer. In the near term, we were trying to gauge what impact of economic activity we would see in 2023 compared to 2022. And we thought that might be a little bit less, but still at a really good pace. And as the increase in our backlog demonstrates, there's still a lot of activity happening, even with the backdrop that you were describing.

So, did I skip anything in your questions or did that hit all the points you were getting?

Jamieson Ward

Analyst, Guggenheim Securities LLC

Q

No, that was terrific. Thank you very much. I really appreciate the clarification, and thank you for taking my questions.

Curtis L. Dinan

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

A

Thank you for the question.

Operator: Thank you. [Operator Instructions] Thank you. We have no further questions. I'll hand back to Brandon for any 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 it in early May. We'll provide details on the conference call on a later date. Have a great day.

Operator: Thank you. This concludes the ONE Gas 2022 fourth quarter and year end earnings conference call and webcast. Thank you so much for joining. You may now disconnect.

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