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ONE Gas, Inc. (OGS)

Q2 2023 Earnings Call

CORPORATE PARTICIPANTS

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Caron A. Lawhorn

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Curtis L. Dinan

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

OTHER PARTICIPANTS

Jamieson Ward

Analyst, Guggenheim Securities LLC

Christopher Jeffrey

Analyst, Mizuho Securities USA LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good day and welcome to the ONE Gas 2023 Second Quarter Earnings Conference Call. Today's conference call is being recorded.

At this time, I would like to turn the conference over to Erin Dailey. Please go ahead. Ms. Dailey.

Erin Bender Dailey

Director-Investor Relations & Sustainability, ONE Gas, Inc.

Good morning, and thank you for joining us on our second quarter 2023 earnings conference call. This call is being webcast live and a replay will be available later today. After our prepared remarks, we will be happy to take your questions. A reminder that statements made during this call that might include ONE Gas expectations or predictions should be considered forward-looking statements and are covered by the Safe Harbor 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 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 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, Erin, and good morning, everyone. We're happy to be with you today to share our second quarter results and discuss our performance through the first half of the year. We continue our commitment to safely operating a growing system while cultivating long-term value. Our second quarter activities and financial results reflect focused management of both our business and external economic forces through diligent plan execution by our entire team. On last quarter's call, we shared our efforts to meet the needs of our expanding customer base while prioritizing safety, reliability and environmental responsibility. On June 30, we published our 2023 ESG report, which highlights our focus on supporting our co-workers and communities, employing sound governance practices and reducing our emissions. In addition to reporting Scope 2 emissions for the first time, we're pleased to report that we have reduced our Scope 1 emissions due to leaks on mains and services by 48% since 2005, keeping us on track to meet our 2035 goal.

As we manage the impact of macroeconomic conditions, we're also building work processes that increase efficiency and develop our workforce. Curtis will speak to our long-term strategy of reducing costs and improving outcomes when he describes our modified approach to damage prevention and line locating. This strategy is one example of how we're reacting to the current economic environment while also building our capacity for the future. Our service territory continues to experience robust growth as a favorable business environment and a more focused economic development effort bring new investment to our region. A recent example is the May announcement by Enel North America to locate one of the United States largest solar panel manufacturing facilities in Inola, Oklahoma, about 25 miles east of Tulsa. We remain well positioned to continue our support for the ongoing regional economic expansion across our service territory.

I'll turn it over to Caron to discuss financial details for the quarter and then to Curtis to review our regulatory, operations and commercial activities, before returning to offer a final perspective. Caron?

Caron A. Lawhorn

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

Thanks, Sid, and good morning, everyone. Before I get into the details, a reminder that revenues, depreciation and amortization and interest expense include the impact of the Kansas securitization. We provided tables in yesterday's earnings release that disclosed the balance sheet and income statement impacts. There is no impact on net income.

Net income for the second quarter was \$32.7 million or \$0.58 per diluted share, compared with \$32.1 million or \$0.59 per diluted share in the same period 2022. Second quarter operating income increased \$5.4 million over the same period last year, reflecting an increase of \$14.1 million from new rates, primarily due to interim regulatory filings completed in the second half of last year and the Texas Gas Service West-North rate case, which was approved in January. Continued growth in our residential and commercial customer base, primarily in Oklahoma and Texas, also contributed \$1.1 million to operating income year-over-year. Although weather across our service territories for the second quarter was 7% warmer than the prior year and 11% warmer than normal, the impact on earnings was mitigated by our weather normalization mechanisms. Quarter-over-quarter, we experienced a \$1.7 million reduction in operating income due to lower sales volumes.

Our operations and maintenance expenses increased \$8 million over the second quarter 2022, due primarily to increases in employee-related costs of \$6.7 million. As a reminder, we expected increased employee-related expenses due to market conditions and proactive workforce investments that we've made to enhance our capacity and in-source certain functions previously performed by contract labor. We have also modified our training programs to increase workforce flexibility amid these in-sourcing efforts, which are now beginning to yield benefits. Excluding the impact of the Kansas securitization, depreciation and amortization expense was \$5.3 million higher than the

prior year, reflecting an increase in net property, plant and equipment as a result of our higher level of capital investment.

Other income, net, increased \$6.2 million compared with the same period last year, primarily due to a \$5.9 million increase in the market value of investments associated with our non-qualified employee benefit plans. Interest expense in the quarter was \$11.2 million higher than the same period in 2022 and includes \$4.7 million of additional expense associated with the Kansas securitization. The remainder of the increase is predominantly attributable to two items. One is the issuance of \$300 million of 4.25% senior notes in August of last year. The second is interest on our commercial paper. While our average commercial paper balance was down 50% when compared to last year, our weighted average CP interest rate was approximately 5.5%, which is more than 4 times higher than the 1.3% rate we incurred in the second quarter of 2022.

Relative to our initial 2023 financial expectations, lower natural gas prices are positively impacting our investment in gas storage as we execute our traditional summertime storage refill. However, elevated short-term interest rates continue to present a headwind. Our capital expenditures and asset removal costs for the second quarter were approximately \$190 million, compared to \$149 million in 2022. Our capital investments for the full year remain on track with our \$675 million forecast. Our authorized rate base was \$4.84 billion as of June 30, and we estimate our average rate base for 2023 will be approximately \$5.15 billion.

Turning to our liquidity, we ended the quarter with \$783 million of capacity under our \$1 billion commercial paper program and no borrowings under our credit facility. Our next maturities of long-term debt are in the first quarter of 2024, when we have \$300 million of 3.6% notes and \$473 million of 1.1% notes coming due. By continuing to issue equity with forward settlements, we have addressed our 2023 equity needs and greatly de-risk our anticipated 2024 market exposure. In March, we executed a forward sales agreement for 2 million shares of our common stock with settlement by December 29, 2023 for 1.4 million shares and by the end of 2024 for the remaining shares. And in the second quarter, we utilized our \$300 million at-the-market equity program, which we put in place in February, to execute forward sale agreements for an additional 926,000 shares to be settled by the end of 2024. Had all forward shares been settled at June 30, we would have received net proceeds of approximately \$249 million. On July 17, the ONE Gas board of directors declared a dividend of \$0.65 per share, unchanged from the previous quarter.

And lastly, we reaffirm our 2023 financial guidance, including net income of \$224 million to \$238 million and earnings per diluted share of \$4.02 to \$4.26. As always, we remain focused on prudent expense management, and as Curtis will discuss, our outlook for rate base and customer growth remains steady.

Curtis, I'll turn it over to you.

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 our regulatory activities. On March 1, we filed our annual performance based rate change application in Oklahoma, reflecting a 2022 test year and seeking a \$27.6 million rate increase to recover \$243 million in capital investments and other cost increases. In July 2023, the Oklahoma Corporation Commission issued an order approving a settlement with a revenue increase of \$26.3 million. New rates went into effect on June 29.

In Texas, we filed the Gas Reliability Infrastructure Program for the consolidated West-North Region on March 10, seeking \$7.4 million to recover cost associated with \$54 million in capital investments. El Paso and two other municipalities denied the requested increase, while all other municipalities and the Railroad Commission

approved an increase of \$7.3 million or allowed it to take effect with no action. Texas Gas Service appealed the denied request and implemented the new rates in all municipalities in June 2023, subject to the outcome of the appeal. The Central-Gulf GRIP that was filed on February 9 went into effect during the first billing cycle for June, with a rate increase of \$11.5 million. In June 2023, Texas Gas Service filed a rate case for all customers in the Rio Grande Valley service area, requesting a \$9.8 million increase. New rates are expected to take effect in late 2023 or early 2024. Also in Texas, Governor Abbott signed legislation establishing a statewide energy efficiency program for gas utilities that will be overseen by the Railroad Commission. This legislation will allow Texas Gas Service to expand its energy efficiency programs throughout our service territory in Texas.

Turning to commercial and operating activities, capital execution remains a focus as we work to serve an expanding customer base and internal process improvements permitted us to deploy a record amount of capital in the first half of the year. As we had expected, amid rising and elevated interest rates, the pace of new meter sets for the second quarter decelerated slightly compared to 2022. However, in the 12 months ended June 30, 2023, we set approximately 25,800 new customer connections, which is 2% higher year-over-year. We continue to see a strong demand for natural gas and a robust backlog of future projects.

As a reminder, COVID-related moratoria have fully lifted across our territories, allowing us to resume traditional disconnection activities that affect our reported customer counts. We had noted at the outset of COVID that such moratoria while in place would inflate our average customer count and the resumption of normal operating practices is now serving to unwind those impacts. We had expected bad debt expense to be elevated this year and saw an additional \$2.4 million impact in the first half of the year compared with the same period in 2022, in line with our expectations. While we continue to see inflation affecting material supply and labor cost across our industry, we are addressing these impacts through disciplined resource management and prudent operating practices. One example we've discussed previously was our decision to begin in-sourcing certain field activities such as line locating. While Caron has noted the upfront investment costs related to this decision, we are beginning to see the anticipated benefits of improved efficiency and enhanced workforce flexibility. In addition, these in-sourcing efforts have reintroduced important entry-level field positions, reestablishing a meaningful workforce pipeline for the company.

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, Caron and Curtis. Good governance is essential to maintaining our high performance and we're pleased to share that we have a recent addition to our board of directors. Deborah Hersman was appointed to the board on June 29 and brings deep safety-related experience that includes service as the former Chair of the National Transportation Safety Board and Chief Executive Officer of the National Safety Council. We look forward to all that we will gain from Ms. Hersman's insight and expertise.

Safety and service are two of our core values, and our co-workers exemplified those values as we faced and recovered from storms in Shawnee and Tulsa, Oklahoma, during the quarter. While we did not experience significant service interruptions, the April tornado in Shawnee and near hurricane-force winds on Father's Day weekend in Tulsa caused widespread property damage. Our teams were quick to respond to the disruption these storms caused, ensuring that our customers were safe and had reliable gas service for their homes, businesses and backup generators. I want to thank each of my co-workers for their dedication to living our core values as we work every day to keep people safe and enjoying the benefits that natural gas provides.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question today comes from the line of Shahriar Pourreza from Guggenheim Partners. Your line is now open. Please go ahead.

Jamieson Ward

Analyst, Guggenheim Securities LLC

Hi, guys. It's Jamieson Ward on for Shar. How are you?

Q

Robert Sid McAnnally

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

Really well, Jamieson. Good to hear from you this morning.

A

Jamieson Ward

Analyst, Guggenheim Securities LLC

Terrific. Macro question for you first. As we continue to see inflation pressures cool at a national level, could you touch on how that compares to what you're seeing in your service territories? And as a follow up, are you still expecting roughly 2% inflation by 2026? Or could we see that timeline move up?

Q

Robert Sid McAnnally

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

So let me ask Curtis to speak to the impacts that we're seeing from the commercial side and then Caron to speak to the inflation forecast. Curtis?

A

Curtis L. Dinan

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

Yes. So a lot of our contracts price based off of what's happening with national CPI, so I would say we're in line with – if you're looking at it nationally. So in our territories, it's not an abnormality from, again, that national average.

A

Caron A. Lawhorn

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

With respect to inflation, it continues to be sticky. The news is encouraging that we've seen it's coming down a bit. I think the timeline may be a bit elongated, but I'm optimistic about being able to manage the impact to us in our O&M expenses going into 2024 and 2025.

A

Jamieson Ward

Analyst, Guggenheim Securities LLC

Got you . So just on that note, do you have much ability to pull forward O&M or would continued lower than expected cost pressures this year mostly fall to the bottom line?

Q

Caron A. Lawhorn

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

A

We don't really have a huge opportunity. We're highly compliant business. We've got a lot of work that's got to get done every year. And so our approach is to have a steady, stable work flow for our employees, easier to manage, get efficiencies from doing that so we don't try to really manipulate it and we don't have a lot of opportunity to do that either.

Jamieson Ward

Analyst, Guggenheim Securities LLC

Got it. Thank you. And final question, if inflation were to, let's say, normalize by next year, all else equal, where would that put you in your current 4% to 6% EPS growth range versus what you'd been expecting back in November when CPI, as per your slides, was 8.2%?

Robert Sid McAnnally

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

So, Jamieson, you'll recall that we were speaking to the fact that short term dislocation of rates would impact us because of our capital structure. And so we've tested that and really looked at is this the most appropriate structure for us. And we continue to believe that if you go back to 2014, since the spin from ONEOK, you see that that our approach has served our stakeholders well and we think that will be true going forward. We'll continue to have exposure to short term rates, but as rates normalize and we have the opportunity to continue to take advantage of the inflow of people into our service territory and the economic development opportunities that you're aware of, we really like our positioning. So you can expect us to continue to manage the short term, but really focus on long term value creation.

Jamieson Ward

Analyst, Guggenheim Securities LLC

Thank you very much.

Robert Sid McAnnally

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

Thank you.

Operator: [Operator Instructions] And our next question today is from the line of Christopher Jeffrey of Mizuho. Christopher, your line is open.

Christopher Jeffrey

Analyst, Mizuho Securities USA LLC

Hi. Thanks for taking my question. Maybe just quickly on the energy efficiency program that Curtis mentioned in his remarks, just kind of wondering the puts and takes of that for ONE Gas in Texas.

Curtis L. Dinan

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

So we're currently working with the commission and others and the industry are working with the commission as to how to apply the statute and how that will roll out. But I expect that in the near term that we'll have more clarity around that part of it. We currently have programs in our Central Texas service territory and in the Rio Grande Valley. They're not the same programs because they're tailored to each of those service areas. And we would envision doing that same type of thing where a program that's appropriate for a specific service area gets tailored

to that area similar to what we've already done. And again, that's what we're working through and expect to have more on that in the fairly near term.

Christopher Jeffrey

Analyst, Mizuho Securities USA LLC

Q

Great. Thanks. And then, maybe just the addition of the 900,000 shares through the ATM program from last quarter, just kind of wondering how you're thinking about that compared with the forward agreements and how you're thinking about maybe cadence of future financing and how much we can expect more for 2024?

Caron A. Lawhorn

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

A

So as I said on the – in my remarks, we feel good about what we've gotten done for 2023 and are well into our 2024. As always, we just try to think to be opportunistic. When we like the price, we feel like we have the need, ATM gives us the flexibility and the forwards are this added flexibility on top of that. So I don't have any specific updates. We'll just continue to monitor as market conditions warrant.

Christopher Jeffrey

Analyst, Mizuho Securities USA LLC

Q

Great. Thanks. And then, maybe just an update on timing for any full general rate cases in the jurisdictions that we should expect, just as far as truing up some of those cost pressures or rate increases that we've seen, anything in that vein?

Curtis L. Dinan

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

A

Yeah. Nothing other than the rate case we just filed in the Rio Grande Valley service area to highlight at this time.

Christopher Jeffrey

Analyst, Mizuho Securities USA LLC

Q

Great. Thanks, everyone.

Operator: Thank you. We have no further questions in the queue at this time, so it'd be my pleasure to hand back to Ms. Erin Dailey for any closing remarks.

Erin Bender Dailey

Director-Investor Relations & Sustainability, ONE Gas, Inc.

Thank you, all, again for your interest in ONE Gas. Our quiet period for the third quarter starts when we close our books in early October and extends until we release earnings in late October. We'll provide details on the conference call at a later date. Have a great day.

Operator: This concludes the ONE Gas 2023 Second Quarter Earnings Conference Call and Webcast. You may now disconnect.

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