ATMOS ENERGY
Second Quarter Earnings Call
May-08-2019

Operator: Greetings, and welcome to the Atmos Energy Second Quarter Fiscal 2019 Earnings Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. If anyone should require operator assistance during the conference, please press *0 on your telephone keypad. As a reminder, this conference is being recorded. It is now my pleasure to introduce your host, Jennifer Hills, Vice President of Investor Relations. Please go ahead.

Jennifer Hills: Thank you, Kevin, and good morning, everyone. This is Jennifer Hills, Vice President of Investor Relations, and thank you for joining us for. This morning, I am joined by Mike Haefner, President and CEO, and Chris Forsythe, Senior Vice President and CFO. This call is being webcast live on the internet, and our earnings release and conference call slide presentation are available on our website at atmosenergy.com under Company and Investor Relations.

As we review these financial results and discuss future expectations, please keep in mind that some of our discussion might contain forward-looking statements within the meaning of the Securities Act and the Securities Exchange Act. Our forward-looking statements and projections could differ materially from actual results. The factors that could cause such material differences are outlined on Slide 27 and are more fully described in our SEC filings. Our first speaker is Chris Forsythe, Senior Vice President and CFO of Atmos Energy. Chris.

Chris Forsythe: Thank you, Jennifer, and good morning, everyone. We appreciate your interest in Atmos Energy. Last night, we reported fiscal 2019 second quarter earnings of $215 million, or $1.82 per diluted share, compared with adjusted earnings of $175 million or $1.57 per diluted share in the prior-year quarter. Adjusted earnings excluded a $4 million benefit related to the implementation of tax reform.

Year-to-date, earnings were $373 million or $3.21 per diluted share, compared with adjusted earnings of $327 million or $2.97 per diluted share, and adjusted earnings excluded a $166 million benefit related to the implementation of tax reform. Also yesterday, the Board of Directors approved the 142nd consecutive quarterly cash dividend of $0.525, which represents an indicated annual dividend of $2.10 per share in fiscal 2019, an 8.2% increase over fiscal 2018.

Our second quarter results were in line with our expectations. The recovery of the capital spending required to modernize our natural gas delivery network, continued customer growth and the plant increase and safety-related operating expenses were the primary drivers of the quarter's results.

Slides five and six provide details of the period-over-period changes to operating income for each of our segments. I will touch on a few highlights. In the second quarter, operating income in our distribution segment increased 8% to $229 million. Recovery provided by recent regulatory actions increased contribution margin by $24 million.

Additionally, we continue to experience solid customer growth. Over the last 12 months, we added a net 37,000 new customers, which represents 1.2% growth. We continued to experience strong customer growth in several of our service areas, including the DFW Metroplex, the suburbs of Nashville and to the north of Austin and Olathe, Kansas to the west of Kansas City.

This growth added $4 million in contribution margin for the quarter and almost $8 million year-to-date. However, despite weather that was 9% colder than the prior-year quarter, customer consumption declined due to varying weather patterns quarter-over-quarter, which reduced contribution margin by about $9 million.

Operating expenses decreased by about 1%. In the prior-year quarter, we incurred $23 million related to customer assistance and other non-recurring expenses related to the outage in Northwest Dallas. After adjusting for these expenses, operating expenses increased approximately 9%. More than half of this increase reflects higher depreciation and ad valorem taxes driven by last year's capital spending.

The remaining increase related to a planned increase in system integrity and maintenance work such as digital mapping of legacy assets and work to mitigate and reduce third-party damage to our system. Additionally, we experienced higher labor and training costs, as we have added service technicians and leak survey specialists to support our mid-Tex operations in the DFW Metroplex.

Operating income in our pipeline and storage segment increased about 16% to $69 million during the second quarter. New rates from our last year's GRIP filing contributed $12 million of this growth. Additionally, APT continued to benefit from the supply and demand dynamics in the Permian Basin.

APT's through system revenue increased about $1 million quarter-over-quarter and about $4.5 million year-to-date, net of the Rider REV mechanism. APT's tariff customers continue to benefit from this mechanism, while our distribution customers in Texas receive the benefit of the low cost of gas produced in this region.

Operating expenses increased $6 million or about 9%. About half of this increase reflects higher depreciation expense as a result of last year's capital spending. Additionally, we plan for incremental pipeline integrity work, which was the primary driver for the remainder of the increase in operating expenses.

Consolidated capital spending increased 12% to $778 million year-to-date. About 84% of the spending was dedicated to safety and reliability projects. We remain on track to achieve our capital spending target of $1.65 billion to $1.75 billion for the fiscal year.

From a financing perspective, we had another busy quarter, as we completed over $600 million of financing. We refinanced our $450 million, 8.5% 10-year notes with 4.125% 30-year notes. As a result of the financing, our overall cost of debt decreased to 4.6%, and our weighted average maturity is increased to 22 years.

Additionally, as most of you are aware, we moved to the S&P 500 from the S&P MidCap 400 in mid-February. We took advantage of this unplanned and unique liquidity event to issue 1.7 million shares through forward sales arrangements executed under our ATM program. The net proceeds of $159 million from these forward sales arrangements will be used towards our equity needs for fiscal 2020 and will not be fully diluted until issued in fiscal 2020.

These net proceeds combined with the $245 million in net proceeds issued under forward sales arrangements to during our November equity issuance leaves us with just over $400 million to help fund our capital spending through March 31, 2020, when all of these forward sales arrangements mature. Based on the execution of these forward arrangements, the remaining availability under our ATM program, and our current capital spending outlook, we do not foresee the need for a discrete equity issuance through the end of fiscal 2020.

As a result of our financing activities this year, our equity to total capitalization was 60%, and our short-term debt balance was 0 at quarter-end. Including the $108 million in cash on hand at the end of March and the $404 million in net proceeds available under the forward sales arrangements, we have approximately $2.1 billion of total available liquidity.
After resetting most of our regulatory mechanisms last year, our fiscal 2019 regulatory calendar has returned to a more traditional cadence. To date, we had implemented $86 million of annualized regulatory outcomes and have about $90 million in progress. Annual filings in Texas, Louisiana, and Mississippi are among the most significance of these findings.

Before I turn the call over to Mike, I wanted to comment on our fiscal 2019 earnings per share guidance. Yesterday, we narrowed our guidance to a range of $4.25 to $4.35 per diluted share. Slides 12 and 13 provide additional details of our updated guidance. Earnings for the first half of fiscal year were in line with our expectations. We see potential for a modest uptick in APT contribution margins as a result of the supply and demand dynamics affecting the Permian Basin. However, as we've communicated before, summer months are focused on preparing APT for winter operations for the next fiscal year, and we do not expect the impact to be material. Additionally, we have completed our fiscal 2019 financing program, and we now have clarity on how that financing will impact fiscal 2019 results.

Finally, during the first half of the fiscal year, we initiated several efforts that will further mitigate long-term risk. Following the incident in New England last fall, we are now assessing our low-pressure systems and implementing additional procedures to continue to safely manage these systems. Additionally, during the first half of the fiscal year, we initiated a multi-year effort to implement new leak detection technology. The preliminary results from the initial pilot efforts have been encouraging, and we'll continue to methodically implement this technology in certain of our jurisdictions during the second half of the fiscal year. And in the second half of the fiscal year, we are planning to run additional in-line inspections in our pipeline and storage segment to facilitate capital allocation decisions for fiscal 2020 and beyond. Our performance for the first half of the fiscal year and additional clarity we have for the second half of the fiscal year leaves us well-positioned to meet our 6% to 8% earnings per share growth target for fiscal 2019. I'll now turn the call over to Mike for some closing remarks. Mike?

Mike Haefner: Thank you, Chris for that great update on the quarter. Our results for the first half of the fiscal year reflect the ongoing disciplined execution of the investments we're making in the safety and reliability of our system while continuing to mitigate long-term risk.

Capital spending increased 12% during the first six months of the fiscal year, which demonstrates our commitment to modernizing our system. As we plan to increase our spending 9% to 10% per year through fiscal 2023, we're also investing in our people and technology to support these higher spending levels.

Last fall, we started to implement new technology that will digitally capture all the data we're required to collect and retain for compliance purposes. We completed the rollout to about 20% of the nearly 1,000 company and contractor crews working on our system. We're on track to expand the rollout to about 50% of these crews by fiscal year end. This is just one example of the various initiatives we have underway to build scale and efficiency to sustain our ability to invest in safety and reliability.

During the first half of the fiscal year, we also continued to find ways to mitigate risk for the long-term. The increased O&M spending that Chris referred to in the second half of the fiscal year for low-pressure system assessment, systematic rollout, and newly survey technology and in-line inspections on our transmission system will help us implement new procedures and technology that will enhance our ability to safely operate our system and support our risk-based capital allocation program. This spending does not affect our anticipated 6% to 8% annual earnings per share and dividend per share growth through fiscal 2023.

Additionally, as Chris mentioned, our move to the S&P 500, created an unplanned and unique liquidity event to issue equity under forward sales arrangements through our ATM that will be used toward our fiscal 2020 equity needs. These are just a couple of examples of how we remain agile when conditions evolve to mitigate operational and execution risk for the long-term. These equity forward arrangements combined with the additional $1.8 billion of debt and equity financing further strengthen our balance sheet and provide the capacity necessary to finance our capital spending plans over the next five years. As we look toward the back half of the fiscal year, we have more clarity around our regulatory outcomes, our O&M spending, and our financing costs. This clarity gives us the confidence to tighten our EPS guidance range to $4.25 to $4.35, which leaves us well-positioned to meet our earnings per share growth targets for fiscal 2019.

In closing, I'd like to thank our employees for their continued outstanding efforts. Our highly qualified gas professionals come to work every day laser-focused on safety while providing excellent customer service, closely monitoring and maintaining our system, and executing our capital spending program. They are accomplishing these critical services while striving to improve every day as we deliver safe, reliable, and affordable natural gas service to the nearly 3.3 million customers we serve in over 1,400 communities in our eight-state footprint. We certainly appreciate your time this morning, and we'll take any questions you may have. Kevin?

Operator: Our first question today is coming from Christopher Turnure from JPMorgan. Your line is now live.

Mike Haefner: Good morning, Chris.

Christopher Turnure: Hey, Mike. Hey, Chris. I wanted to make sure we were understanding the equity situation correctly. Going back to last fall, my understanding was you guys priced around $750 million of equity, a $150 of which had a forward component to it that your message was you would pull down before I think the first half of fiscal '20. And then separately, you had a forward component to a $500 million ATM. So, what exactly occurred this quarter and kind of when is that going to hit your share count?

Chris Forsythe: Chris backing up to November, it was a $748 million total equity issuance, of which $500 million before costs were taken into the first quarter, $245 million was allocated to forward sales arrangements that expire in March of 2020. Our plan was to draw down the $245 million between January of 2019 and March 31 of 2020. When the opportunity presented to us that was unplanned when we moved to the S&P 500 in February, we issued $160 million under our ATM, under forward sales arrangements. So, we have a total of $404 million in total forward arrangements available to us through the end of March of 2020. We'll take that down over the next 11 to 12 months based on our cash needs, but again, all of this had been contemplated in our 6% to 8% earnings per share growth target for fiscal '19 and in the five-year plan and the net forward arrangements that we took out in February are going to be applied against our fiscal 2020 equity needs. It will not be dilutive to fiscal '19.

Christopher Turnure: Okay, I think I understand now, but there's still a lot in there. So, the amount that you did in February, uh, was simply priced under the forward ATM, and you do not intend to pull that down during fiscal, uh, 2019?

Chris Forsythe: Correct.

Christopher Turnure: You are still kind of leaving the forward component of the $750 from November as loose. You're not specifying when you'll pull that down.

Chris Forsythe: That's correct. We'll certainly start towards the end of fiscal '19, the exact amount will be to be determined based upon our cash flow projections and cash needs.

Christopher Turnure: Okay, and--

Chris Forsythe: We have to utilize all of that equity by the end of March of 2020, because the forward sales arrangements expire March 31st of 2020.

Christopher Turnure: And then, your comment on these actions covering you through fiscal 2020, just to want to make sure that I'm understanding properly. You're committing that there will be no more equity issuances in the normal course of business.

Chris Forsythe: I'm committing that we will not have a discrete equity need such as a largescale block trade that we've done the last couple of years. The ATM remains available to us, and we intend to consider using that as we go forward as part of our overall financing strategy and needs. As you think back to our five-year plan that we rolled out last fall, we had $5 to $6 billion of incremental financing needs and we intend to satisfy those needs through a balance of long-term debt and equity. We're still executing towards that plan.

Christopher Turnure: Okay. That's pretty clear. A second question, you mentioned gas basis in Texas is helping you guys at least a little bit here. Can you give us more detail on how you're thinking about that over the next six or 12 months? I think you said that you were making some preparations there in some way?

Chris Forsythe: Yes, that's correct, and in the summer months, as you know, Chris, we have to reduce pressure on the pipeline for maintenance work and get ready for winter operations. So, we don't have as much opportunity to take advantage of those spreads. We do see some modest uptick, but between the fact that the pressure's going to be coming down on the system for maintenance work and the fact that we have Rider REV in place, where we always share in 25% of that upside, like I said, we do anticipate a modest uptick that we've contemplated in our guidance. But we don't anticipate that to be all that material in the grand scheme of things.

Mike Haefner: And Chris, as you look into 2020, the expectation is the Gulf Coast Express is expected to be in service in the October/November timeframe. So, we expect that to begin affecting spreads in the 2020 timeframe. And the key is that our customers are benefiting from lower cost gas and then also through the Rider REV mechanism in terms of their transport gas costs.

Christopher Turnure: That makes sense. All right, thank you, guys.

Mike Haefner: Thank you, Chris.

Operator: Thank you. Our next question today is coming from Charles Fishman from Morningstar. Your line is now live.

Charles Fishman: Good morning. Just going back to the equity, your guidance--the average diluted shares goes down a little bit. The net income guidance for '19 went down a little bit on the upper end, but correct me if I'm wrong, what happened basically was you went out for the equity you needed and were able to get it at a little better pricing. And then, that drove your diluted shares down, or is it just you issuing them at a later date? What basically drove the average diluted share quantity down

Chris Forsythe: Generally pricing, generally pricing.

Charles Fishman: Okay. That's what I would've assumed. Okay. Second question, operational. Certainly, a tragic event in Boston in the fall. The final report isn't in, but it sounds like a low-pressure event. That utility is putting in low-pressure sensing devices through their whole system. Is that something you already have? Is that something you're doing? Is that something you will be doing, or what's the status as far as the Atmos System with respect to low-pressure sensing?

Mike Haefner: --No, it's a good question, Charles, we've operated our low-pressure systems for a long time and we're constantly working on them. As Chris mentioned, we have been pretty proactive in terms of doing a full-system evaluation design--evaluation, and we've reaffirmed and reviewed all of our procedures, re-communicated them. We've created geo-fencing in our GIS systems. So, when there are line locate calls that are anywhere near a low-pressure systems, we'll have individuals from the company there to monitor any construction or digging near our assets. And then, this review of our system design will then guide our next set of actions, which, you know, may involve, bifurcating those systems or providing--putting other kind of technical solutions like slam-shut devices or additional releases on based on the need. So, we're well along that process. We haven't seen anything that concerns us at this time.

Charles Fishman: But I suspect the technology is rapidly changing on this stuff. But do you have some device or some way of sensing a low-pressure event that has occurred, or excuse me, I guess it was a high-pressure event in Boston. I had it backwards. Uh, do you have the capability of sensing that now in most of your system?

Chris Forsythe: Yes, since the systems were put in over a longer period of time, there are various solutions to that, but yes, we have pressure sensors. We have pressure release devices as well. So, we've got that type of protection in the system, and what we're doing now is just going back through and doing a comprehensive review and seeing if there are other interim--or other steps we should take as it relates to low pressure.

Charles Fishman: Yeah, I guess the events that really drive you nuts is a contractor doing work, that has nothing to do with your people, but obviously, that contractor could do something stupid that creates a problem for you. And that I would assume is an ongoing issue that you have to address.

Mike Haefner: Yes, certainly, 70% of our hazardous leaks are caused by third-party damage. It's a very significant focus of our efforts and advocacy, and it'll continue to be. And as I mentioned for the low-pressure systems, we've taken the steps to geo-fence them in electronically within our GIS system, so that as line locates come in, if we have anybody working near those systems, we're going to have somebody monitoring it.

Charles Fishman: Okay. Thank you very much. That's all I had.

Mike Haefner: Thank you, Charles--

Operator: Thank you. Our next question today is coming from Stephen Byrd from Morgan Stanley. Your line is now live.

Dave Arcaro: Hi, this is Dave Arcaro on for Stephen Byrd. Thanks for taking my question.

Chris Forsythe: Good morning.

Dave Arcaro: Uh, good morning. I was wondering what are your latest thoughts following some of the commentary coming out of the Dallas City Council, over the last couple of days with the rate request there? Does that change your views of the overall process for that rate request?

Mike Haefner: Yes, I think what we're seeing is a normal part of the process, Dave. I mean, earlier this year, we filed the $10.1 million rate increase request in accordance with the annual mechanism we agreed to early in 2017. That request is on the City Council agenda today. City staff, we've been working with them and their consultants and representatives, and they've acknowledged the efforts on both sides to try to reach an agreement. However, we haven't been able to do so in time for their needed approval. So, the staff's recommended is that the City Council deny the request. Now, that denial would trigger an appeal process to the Railroad Commission, which we've, as you know, been down that path before, and you know, our plan is to continue to work with the city. We share common interests certainly in replacing aging infrastructure, and we've been investing for many, many years in Dallas. And we expect to reach an agreement in some point in time in the future.

Our Company's made a $119 million of infrastructure improvements in the City of Dallas during that test year, and we also agreed to accelerate our cast iron replacement at the city's request to 2021, getting the last of that removed in 2021 versus 2023. So, maybe a longer answer than you were looking for, but we're continuing to have discussions. And we'll continue to move down a path to try to find a win-win solution.

Dave Arcaro: Okay, great. That's helpful, and I was just wondering your latest thoughts on expectations for the NTSB process?

Mike Haefner: Sure. We don't have much of an update, but the core of engineers completed soil samples. They were requested in the area. They were requested to do that by the NTSB, and in a public release in late February or early March, the NTSB indicated that a fact--or factual report would be expected in June.

That's the next step that would come from them, and that would not at that time include any probable cause or safety recommendations. Those would be sometime later and there's no timeframe on them. In the meantime, we continue to work with the NTSB, and we continue to move forward on improvements in our processes around safety and our safety investment in our systems.

Dave Arcaro: Okay, got it, that's helpful. And then, maybe one last question. I wanted to clarify on the increased O&M expected this year for some of the low-pressure system investments. I was wondering how you anticipated getting recovery of those investments. It sounds like that's anticipated, but does that flow through mechanisms, or how do you think about that?

Chris Forsythe: Yes, we will seek to recover those costs through the annual mechanisms that we have in the various jurisdictions. Again, it's safety related, and I think everyone has got a keen eye on what happened last fall and all of our regulators have a commitment to safety. And we would seek to recover those costs in our next round of filings.

Dave Arcaro: Okay, great. Thanks very much.

Mike Haefner: Thank you.

Operator: Thank you. Our next question is coming from Ryan Levine from Citi. Your line is now live.

Ryan Levine: Good morning. Um, just to follow up on the on the Permian, Waha, Katy, places movements. Is there a way to quantify exactly what the impact was for the first quarter or for the first calendar quarter, given your sharing mechanism?

Chris Forsythe: In the first calendar quarter--so, year-over-year, we're up about $4.5 million. Quarter-over-quarter we're up about $1 million. So, it was about 3.5 million in the first quarter quarter-over-quarter last fiscal year.

Ryan Levine: -Great. And then in terms of going into the second quarter, are you seeing that directionally move up relative to this past quarter?

Chris Forsythe: Yes, as we look into our third and fourth fiscal quarters, we do see the opportunity for a modest uptick in those spreads. But, as I indicated, with the maintenance work that we have planned for the pipe in the summer combined with the effect of the Rider REV mechanism and how we share, 75% of that upside benefit flows back to the tariff customers on APT. We expect that impact to be modest for us.

Ryan Levine: Okay. And then last question, to the extent that you're able to comment, is there any update on the Georgetown incident?

Mike Haefner: Sure, for others on the call, the Georgetown situation is pretty much behind us right now. It goes back to February 20th, and there was a leak reported. We responded and identified two leaks and repaired those leaks, and then, what we identified was residual gas in the soil that had migrated. And that led us to evacuate up to at a peak 85 structures that affected approximately 140 combined businesses and residents, and then, we worked on getting that residual gas out of the soil. So, all the evacuations have been listed except for one business, and during this process, we provided financial support. And we've been processing any claims for affected businesses and residences. We've got business interruption insurance. We believe it'll cover any cost that get into that territory, and we don't expect the impact to be material on the year. But it's largely behind us, and I'll tell you what, our team did just an absolutely phenomenal job responding to the situation there, working with the community and with all the regulators and city and state leaders.

Ryan Levine: Okay, great. That's all for me.

Mike Haefner: Thank you, Ryan.

Operator: Thank you. As a reminder, that's *1 to be placed in the question queue. Our next question is coming from Dennis Coleman from Bank of America. Your line is now live.

Mike Haefner: Dennis, good morning.

Dennis Coleman: Good morning, everyone. This may be a question that has a little more detail, than this, and I'm happy to take it offline if you--if you would like, but I'm wondering--there's quite a big swing in cash flow. And I'm sort of working through the various statements trying to figure out where this is coming from, but is there a simple explanation? You know, we said drop of close to 200 million in cash flows for the six months?

Chris Forsythe: Virtually, all of that is the timing of our deferred gas cost, uh, recoveries. We were somewhat over-recovered last year and we began working that balance down, returning those monies back to customers through the PGA. And that continued into this year. So, that's virtually all the decrease. And that was planned as we moved into fiscal '19.

Dennis Coleman: Okay, so, that's--that all encompassed in the--the, uh, financing plans and whatnot--

Chris Forsythe: --Exactly--

Dennis Coleman: --and what is the 2019 run rate, is this more of what we should expect?

Chris Forsythe: --Yes, it should level out now. We got in the situation, where last year we just moved a lot of volumes, because it was cold, and this happens to us from time to time, you know, under those PGA mechanisms. And every jurisdiction's got a different time period in which those rates are reset, and so, we're just working through that standard process. So, we should be back to more of I'm going to call it a quote-unquote normal run rate going forward.

Dennis Coleman: Okay, thanks. Then, just to make sure I understand the equity forwards. Are you able to do sort of fives and 10s on this? Does it have to be discrete draws, or is there one-time mechanism? And are there any differences in that regard for the $106 related to the S&P 500 move versus the prior forward?

Chris Forsythe: Well, a couple of things. We issued the forwards in February under the ATM program. So we can go out and issue shares on--on a daily basis if you want. In the past where we've executed, what I would call, more of a regular way issuance, where we would take in those shares, and it would become diluted daily as we move forward. This forward--or the ATM program that we sent out last fall, we added a forward feature to it that gives us the ability to access the market on a daily basis and then basically, allocate those shares under forward arrangements. So, it could be daily, it can be around an unplanned liquidity event, like we did in February. It's all subject to the average daily trading volumes, how ATM programs generally work. So, we don't have any specifics around it. We'll just look at the market conditions and we'll take advantage of pricing as we see it.

Dennis Coleman: But, when you actually call for the cash, are there any limits in that regard?

Chris Forsythe: No, no.

Dennis Coleman: Okay.

Chris Forsythe: Yes, the only limit we have is that we have to utilize all of the forwards and all that cash of those net proceeds under those arrangements by March 31 of 2020, when those arrangements expire.

Dennis Coleman: Okay. That's it for me. Thanks.

Chris Forsythe: All right. Thanks, Dennis.

Operator: Thank you. We reached the end of our question-and-answer session. I'd like to turn the floor back over to management for any further or closing comments.

Jennifer Hills: Thank you for joining us today. A recording of this call is available for a replay on our website through August 8, 2019. We appreciate your interest in Atmos Energy.