

SOUTHWEST GAS CORP
Form 10-Q
November 08, 2016

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
Form 10-Q
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2016
Commission File Number 1-7850
SOUTHWEST GAS CORPORATION
(Exact name of registrant as specified in its charter)

California
(State or other jurisdiction of
incorporation or organization)

88-0085720
(I.R.S. Employer
Identification No.)

5241 Spring Mountain Road
Post Office Box 98510
Las Vegas, Nevada
(Address of principal executive offices)

89193-8510
(Zip Code)

Registrant's telephone number, including area code: (702) 876-7237

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," "non-accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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Large accelerated filer ☒

Accelerated filer ☐

Non-accelerated filer ☐

Smaller reporting company ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date.

Common Stock, \$1 Par Value, 47,482,068 shares as of October 28, 2016.

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SOUTHWEST GAS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Thousands of dollars, except par value)

(Unaudited)

	SEPTEMBER 30, 2016	DECEMBER 31, 2015
ASSETS		
Utility plant:		
Gas plant	\$ 6,118,900	\$ 5,854,917
Less: accumulated depreciation	(2,158,099)	(2,084,007)
Acquisition adjustments, net	234	370
Construction work in progress	105,847	119,805
Net utility plant	4,066,882	3,891,085
Other property and investments	348,565	313,531
Current assets:		
Cash and cash equivalents	85,154	35,997
Accounts receivable, net of allowances	286,696	314,512
Accrued utility revenue	33,000	74,700
Income taxes receivable, net	38,369	34,175
Deferred purchased gas costs		3,591
Prepays and other current assets	101,081	95,199
Total current assets	544,300	558,174
Noncurrent assets:		
Goodwill	142,439	126,145
Deferred income taxes	783	428
Deferred charges and other assets	429,827	469,322
Total noncurrent assets	573,049	595,895
Total assets	\$ 5,532,796	\$ 5,358,685

CAPITALIZATION AND LIABILITIES

Capitalization:

Common stock, \$1 par (authorized - 60,000,000 shares; issued and outstanding - 47,482,068 and 47,377,575 shares)	\$ 49,112	\$ 49,007
Additional paid-in capital	901,966	896,448
Accumulated other comprehensive income (loss), net	(46,300)	(50,268)
Retained earnings	720,401	699,221
Total Southwest Gas Corporation equity	1,625,179	1,594,408
Noncontrolling interest	(2,263)	(2,083)
Total equity	1,622,916	1,592,325
Redeemable noncontrolling interest	17,379	16,108
Long-term debt, less current maturities	1,592,946	1,551,204
Total capitalization	3,233,241	3,159,637
Current liabilities:		
Current maturities of long-term debt	49,480	19,475
Short-term debt		18,000
Accounts payable	138,810	164,857
Customer deposits	72,039	72,631
Income taxes payable	219	940
Accrued general taxes	46,323	47,337
Accrued interest	20,152	16,173
Deferred purchased gas costs	123,399	45,601
Other current liabilities	162,622	150,031
Total current liabilities	613,044	535,045
Deferred income taxes and other credits:		
Deferred income taxes and investment tax credits	814,978	769,445
Accumulated removal costs	305,000	303,000
Other deferred credits and other long-term liabilities	566,533	591,558
Total deferred income taxes and other credits	1,686,511	1,664,003
Total capitalization and liabilities	\$ 5,532,796	\$ 5,358,685

The accompanying notes are an integral part of these statements.

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SOUTHWEST GAS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share amounts)

(Unaudited)

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,		TWELVE MONTHS ENDED SEPTEMBER 30,	
	2016	2015	2016	2015	2016	2015
Operating revenues:						
Gas operating revenues	\$ 200,179	\$ 219,420	\$ 980,927	\$ 1,059,178	\$ 1,376,388	\$ 1,457,266
Construction revenues	339,790	285,976	838,038	719,042	1,127,982	948,637
Total operating revenues	539,969	505,396	1,818,965	1,778,220	2,504,370	2,405,903
Operating expenses:						
Net cost of gas sold	39,056	64,268	324,072	427,045	460,836	570,052
Operations and maintenance	102,438	100,102	301,979	294,956	400,222	385,271
Depreciation and amortization	69,845	66,476	217,764	200,898	286,977	266,811
Taxes other than income taxes	12,480	11,652	39,480	37,063	51,810	50,059
Construction expenses	300,611	246,755	757,919	647,512	1,009,188	850,591
Total operating expenses	524,430	489,253	1,641,214	1,607,474	2,209,033	2,122,784
Operating income	15,539	16,143	177,751	170,746	295,337	283,119
Other income and (expenses):						
Net interest deductions	(18,158)	(18,401)	(54,100)	(54,095)	(71,884)	(73,919)
Other income (deductions)	2,565	(3,660)	6,756	(1,226)	10,861	966
Total other income and (expenses)	(15,593)	(22,061)	(47,344)	(55,321)	(61,023)	(72,953)
Income (loss) before income taxes	(54)	(5,918)	130,407	115,425	234,314	210,166
Income tax expense (benefit)	(2,961)	(1,708)	43,046	42,693	80,255	78,537
Net income (loss)	2,907	(4,210)	87,361	72,732	154,059	131,629
Net income attributable to noncontrolling interests	435	524	500	534	1,079	685

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Net income (loss) attributable to Southwest Gas Corporation	\$	2,472	\$	(4,734)	\$	86,861	\$	72,198	\$	152,980	\$	130,944
Basic earnings (loss) per share	\$	0.05	\$	(0.10)	\$	1.83	\$	1.54	\$	3.22	\$	2.80
Diluted earnings (loss) per share	\$	0.05	\$	(0.10)	\$	1.82	\$	1.53	\$	3.20	\$	2.77
Dividends declared per share	\$	0.450	\$	0.405	\$	1.350	\$	1.215	\$	1.755	\$	1.580
Average number of common shares outstanding		47,481		47,102		47,464		46,863		47,442		46,777
Average shares outstanding (assuming dilution)		47,830				47,802		47,261		47,787		47,194

The accompanying notes are an integral part of these statements.

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SOUTHWEST GAS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Thousands of dollars)

(Unaudited)

	THREE MONTHS ENDED		NINE MONTHS ENDED		TWELVE MONTHS ENDED	
	SEPTEMBER 30,		SEPTEMBER 30,		SEPTEMBER 30,	
	2016	2015	2016	2015	2016	2015
Net income	\$ 2,907	\$ (4,210)	\$ 87,361	\$ 72,732	\$ 154,059	\$ 131,629
Other comprehensive income (loss), net of tax						
Defined benefit pension plans:						
Net actuarial gain (loss)					(18,922)	(107,661)
Amortization of prior service cost	207	207	621	621	828	676
Amortization of net actuarial loss	4,196	5,329	12,586	15,987	17,915	19,654
Prior service cost						(4,130)
Regulatory adjustment	(3,796)	(4,828)	(11,388)	(14,484)	(404)	82,137
Net defined benefit pension plans	607	708	1,819	2,124	(583)	(9,324)
Forward-starting interest rate swaps:						
Amounts reclassified into net income	518	519	1,556	1,556	2,073	2,074
Net forward-starting interest rate swaps	518	519	1,556	1,556	2,073	2,074
Foreign currency translation adjustments	(238)	(510)	614	(1,573)	233	(2,232)
Total other comprehensive income (loss), net of tax	887	717	3,989	2,107	1,723	(9,482)
Comprehensive income (loss)	3,794	(3,493)	91,350	74,839	155,782	122,147
Comprehensive income (loss) attributable to noncontrolling interests	427	504	521	479	1,089	608
Comprehensive income (loss) attributable to Southwest Gas Corporation	\$ 3,367	\$ (3,997)	\$ 90,829	\$ 74,360	\$ 154,693	\$ 121,539

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SOUTHWEST GAS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Thousands of dollars)

(Unaudited)

	NINE MONTHS ENDED SEPTEMBER 30		TWELVE MONTHS ENDED SEPTEMBER 30	
	2016	2015	2016	2015
CASH FLOW FROM OPERATING ACTIVITIES:				
Net income	\$ 87,361	\$ 72,732	\$ 154,059	\$ 131,629
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	217,764	200,898	286,977	266,811
Deferred income taxes	43,702	5,961	86,526	32,580
Changes in current assets and liabilities:				
Accounts receivable, net of allowances	28,531	6,570	(17,889)	(31,792)
Accrued utility revenue	41,700	41,700	(800)	(200)
Deferred purchased gas costs	81,389	131,495	79,460	122,257
Accounts payable	(24,942)	(38,878)	10,445	5,137
Accrued taxes	(7,055)	(4,427)	(11,033)	(1,131)
Other current assets and liabilities	9,903	8,333	19,870	(11,938)
Gains on sale	(4,117)	(3,019)	(4,200)	(3,529)
Changes in undistributed stock compensation	4,347	2,119	5,142	5,480
AFUDC	(1,893)	(2,011)	(2,890)	(2,435)
Changes in other assets and deferred charges	3,926	(14,423)	4,183	(18,735)
Changes in other liabilities and deferred credits	(4,813)	5,348	702	2,783
Net cash provided by operating activities	475,803	412,398	610,552	496,917
CASH FLOW FROM INVESTING ACTIVITIES:				
Construction expenditures and property additions	(404,388)	(336,569)	(555,819)	(440,191)
Acquisition of businesses, net of cash acquired	(17,000)	(9,261)	(17,000)	(199,758)
Restricted cash		785		2,018
Changes in customer advances	5,445	14,300	9,445	21,539
Miscellaneous inflows	7,965	11,593	4,726	13,424
Miscellaneous outflows				(1,400)
Net cash used in investing activities	(407,978)	(319,152)	(558,648)	(604,368)

CASH FLOW FROM FINANCING ACTIVITIES:

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Issuance of common stock, net	530	35,419	507	35,405
Dividends paid	(61,950)	(55,060)	(81,138)	(72,040)
Centuri distribution to redeemable noncontrolling interest	(99)		(198)	
Issuance of long-term debt, net	408,946	123,816	420,946	355,325
Retirement of long-term debt	(196,351)	(143,325)	(240,999)	(260,952)
Change in credit facility and commercial paper	(150,000)	(53,000)	(97,000)	47,000
Change in short-term debt	(18,000)	(5,000)		
Principal payments on capital lease obligations	(1,125)	(1,096)	(1,449)	(1,530)
Other	(605)	(504)	(60)	(1,002)
Net cash provided by (used in) financing activities	(18,654)	(98,750)	609	102,206
Effects of currency translation on cash and cash equivalents	(14)	(1,103)	(318)	(961)
Change in cash and cash equivalents	49,157	(6,607)	52,195	(6,206)
Cash and cash equivalents at beginning of period	35,997	39,566	32,959	39,165
Cash and cash equivalents at end of period	\$ 85,154	\$ 32,959	\$ 85,154	\$ 32,959
Supplemental information:				
Interest paid, net of amounts capitalized	\$ 47,134	\$ 45,312	\$ 68,445	\$ 68,169
Income taxes paid	6,530	39,856	9,899	49,280

The accompanying notes are an integral part of these statements.

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Note 1 Nature of Operations and Basis of Presentation

Nature of Operations. Southwest Gas Corporation and its subsidiaries (the Company) consist of two segments: natural gas operations (Southwest or the natural gas operations segment) and construction services. Southwest is engaged in the business of purchasing, distributing, and transporting natural gas for customers in portions of Arizona, Nevada, and California. Public utility rates, practices, facilities, and service territories of Southwest are subject to regulatory oversight. The timing and amount of rate relief can materially impact results of operations. Natural gas purchases and the timing of related recoveries can materially impact liquidity. Results for the natural gas operations segment are higher during winter periods due to the seasonality incorporated in its regulatory rate structures. Centuri Construction Group, Inc. (Centuri or the construction services segment), a 96.6% owned subsidiary, is a full-service underground piping contractor that primarily provides utility companies with trenching and installation, replacement, and maintenance services for energy distribution systems, and industrial construction solutions. Centuri operations are generally conducted under the business names of NPL Construction Co. (NPL), NPL Canada Ltd. (NPL Canada, formerly Link-Line Contractors Ltd.), W.S. Nicholls Construction, Inc. and related companies (W.S. Nicholls), and Brigadier Pipelines Inc. (Brigadier). In May 2016, Centuri completed the acquisition of two privately held, affiliated construction businesses by means of asset purchase: Enterprise Trenchless Technologies, Inc. and ETTI Holdings (collectively, ETTI). See *Acquisition of Construction Services Businesses* below for more information. Typically, Centuri revenues are lowest during the first quarter of the year due to unfavorable winter weather conditions. Operating revenues typically improve as more favorable weather conditions occur during the summer and fall months.

Basis of Presentation. The condensed consolidated financial statements included herein have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with United States generally accepted accounting principles (U.S. GAAP) have been condensed or omitted pursuant to such rules and regulations. The preparation of the condensed consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. In the opinion of management, all adjustments, consisting of normal recurring items and estimates necessary for a fair presentation of results for the interim periods, have been made. It is suggested that these condensed consolidated financial statements be read in conjunction with the consolidated financial statements and the notes thereto included in the 2015 Annual Report to Shareholders, which is incorporated by reference into the 2015 Form 10-K.

During the third quarter of 2016, Centuri evaluated the estimated useful lives of its depreciable assets, and in so doing determined that certain equipment lives should be extended. This change in estimate reduced current-quarter depreciation by approximately \$2 million.

Prepays and other current assets. Prepays and other current assets includes gas pipe materials and operating supplies of \$30 million at September 30, 2016 and \$24 million at December 31, 2015 (carried at weighted average cost), and also includes natural gas stored underground and liquefied natural gas, in addition to prepaid assets.

Cash and Cash Equivalents. For purposes of reporting consolidated cash flows, cash and cash equivalents include cash on hand and financial instruments with a purchase-date maturity of three months or less. In general, cash and cash equivalents fall within Level 1 (quoted prices for identical financial instruments) of the three-level fair value hierarchy that ranks the inputs, used to measure fair value, by their reliability. However, cash and cash equivalents at

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September 30, 2016 and December 31, 2015 also include money market fund investments totaling approximately \$68.3 million and \$250,000, respectively, which fall within Level 2 (significant other observable inputs) of the fair value hierarchy, due to the asset valuation methods used by money market funds.

Significant non-cash investing and financing activities for the natural gas operations segment included the following: Upon contract expiration, customer advances of approximately \$3.6 million and \$2.8 million, during the first nine months of 2016 and 2015, respectively, were applied as contributions toward utility construction activity and represent non-cash investing activity.

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Goodwill. Goodwill is assessed as of October each year for impairment, or otherwise, if circumstances indicate impairment to the carrying value of goodwill may have occurred. No such circumstances indicating impairment were deemed to have occurred in the first nine months of 2016. The business acquisition of ETTI was deemed an asset purchase for tax purposes. As a result, approximately \$11 million in goodwill associated with ETTI is expected to be tax deductible.

(In thousands of dollars)	Natural Gas Operations	Construction Services	Consolidated
December 31, 2015	\$ 10,095	\$ 116,050	\$ 126,145
Additional goodwill from ETTI acquisition		10,726	10,726
Foreign currency translation adjustment		5,568	5,568
September 30, 2016	\$ 10,095	\$ 132,344	\$ 142,439

Acquisition of Construction Services Businesses. In May 2016, Centuri completed the acquisition of ETTI, which is based in Lisbon Falls, Maine, and has a primary focus on underground utility installation using horizontal directional drilling technology. The acquisition of ETTI will provide complementary operational support to Brigadier and expand operations into Maine. Neither the acquisition itself nor the impacts to assets and operations are material to the construction services segment or the Company.

Assets acquired in the transaction were recorded at their acquisition date fair values. The final purchase accounting has not yet been completed. Further refinement could occur; however, no material changes are expected. The preliminary estimated fair values of assets acquired as of May 6, 2016, the acquisition date, are as follows (in millions of dollars):

	Acquisition Date
Property, plant and equipment	\$ 4.3
Intangible assets	2.9
Goodwill	10.7
Total assets acquired	\$ 17.9

The purchase price consisted of \$17 million in cash on the acquisition date with the remaining amount being deferred over four years.

Intercompany Transactions. Centuri recognizes revenues generated from contracts with Southwest (see **Note 3 - Segment Information** below). Centuri's accounts receivable for these services are presented in the table below (thousands of dollars):

	September 30, 2016	December 31, 2015
Centuri accounts receivable for services provided to Southwest	\$ 12,402	\$ 10,006

The accounts receivable balance, revenues, and associated profits are included in the condensed consolidated financial statements of the Company and were not eliminated during consolidation in accordance with accounting treatment for rate-regulated entities.

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Other Property and Investments. Other property and investments includes (thousands of dollars):

	September 30, 2016	December 31, 2015
Centuri property and equipment	\$ 460,165	\$ 423,369
Centuri accumulated provision for depreciation and amortization	(228,230)	(221,028)
Net cash surrender value of COLI policies	104,940	99,276
Other property	11,690	11,914
Total	\$ 348,565	\$ 313,531

Other Income (Deductions). The following table provides the composition of significant items included in Other income (deductions) in the condensed consolidated statements of income (thousands of dollars):

	Three Months Ended September 30		Nine Months Ended September 30		Twelve Months Ended September 30	
	2016	2015	2016	2015	2016	2015
Change in COLI policies	\$ 2,300	\$ (3,900)	\$ 5,400	\$ (2,600)	\$ 7,500	\$ (200)
Interest income	522	624	1,280	1,375	2,078	2,096
Equity AFUDC	611	878	1,893	2,011	2,890	2,435
Foreign transaction gain (loss)	(3)	(302)	(22)	(874)	28	(1,052)
Miscellaneous income and (expense)	(865)	(960)	(1,795)	(1,138)	(1,635)	(2,313)
Total other income (deductions)	\$ 2,565	\$ (3,660)	\$ 6,756	\$ (1,226)	\$ 10,861	\$ 966

Included in the table above is the change in cash surrender values of company-owned life insurance (COLI) policies (including net death benefits recognized). These life insurance policies on members of management and other key employees are used by Southwest to indemnify itself against the loss of talent, expertise, and knowledge, as well as to provide indirect funding for certain nonqualified benefit plans. Current tax regulations provide for tax-free treatment of life insurance (death benefit) proceeds. Therefore, changes in the cash surrender values of COLI policies, as they progress towards the ultimate death benefits, are also recorded without tax consequences.

Income taxes. The Company claimed a federal income tax credit, which resulted in a recognized benefit of approximately \$1.6 million during the third quarter of 2016.

Recently Issued Accounting Standards Updates. In May 2014, the Financial Accounting Standards Board (FASB) issued the update Revenue from Contracts with Customers (Topic 606). The update replaces much of the current guidance regarding revenue recognition including most industry-specific guidance. In accordance with the update, an entity will be required to identify the contract with the customer, identify the performance obligations in the contract, determine the transaction price, allocate the transaction price to the performance obligations in the contract, and

recognize revenue when (or as) the entity satisfies a performance obligation. In addition to the new revenue recognition requirements, entities will be required to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Entities may choose between two retrospective transition methods when applying the update. In July 2015, the FASB approved a one-year deferral of the effective date (annual periods beginning after December 15, 2017) and permitted entities to adopt one year earlier (i.e., the original effective date) if they choose. In March, April, and May of 2016, the FASB issued the updates Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net) , Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing , and Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients . The amendments in the first two updates, respectively, provide guidance when another party, along with the entity, is involved in providing a good or service to a customer, and provide clarification with regard to identifying performance obligations and of the licensing implementation guidance in Topic 606. The third update includes narrow-scope improvements to the guidance on collectability, noncash consideration, and completed contracts at transition. In addition, a practical expedient is provided for contract modifications at transition and an accounting policy election related to the presentation of sales taxes and other similar taxes collected from customers. The combined amendments do not change the core principle of the guidance in Topic 606. The Company plans to adopt all of these updates at the required adoption date, which is for interim and annual reporting periods commencing January 1, 2018. The Company is evaluating what impact these updates might have on its consolidated financial statements and disclosures.

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In August 2014, the FASB issued the update *Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*, which requires management to assess a company's ability to continue as a going concern and to provide related footnote disclosures in certain circumstances. Under the update, disclosures are required when conditions give rise to substantial doubt about a company's ability to continue as a going concern within one year from the financial statement issuance date. The update is effective for the annual period ending after December 15, 2016, and all annual and interim periods thereafter. This update and changes thereto are not expected to have a material impact on the Company's disclosures.

In January 2016, the FASB issued the update *Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities* in order to improve the recognition and measurement of financial instruments. The update makes targeted improvements to existing U.S. GAAP by: 1) requiring equity investments to be measured at fair value with changes in fair value recognized in net income; 2) requiring the use of the exit price notion when measuring the fair value of financial instruments for disclosure purposes; 3) requiring separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements; 4) eliminating the requirement to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; and 5) requiring a reporting entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in instrument-specific credit risk when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. The update is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. All entities can early adopt the provision to record fair value changes for financial liabilities under the fair value option resulting from instrument-specific credit risk in other comprehensive income. The Company is evaluating what impact, if any, this update might have on its consolidated financial statements and disclosures.

In February 2016, the FASB issued the update *Leases (Topic 842)*. Under the update, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date:

A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and

A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term.

Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, *Revenue from Contracts with Customers*. Though companies have historically been required to make disclosures regarding leases and of contractual obligations, leases (with terms longer than a year) will no longer exist off-balance sheet. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. Early application is permitted. The Company currently plans to adopt the update at the required adoption date, which is for interim and annual reporting periods commencing January 1, 2019.

The Company is evaluating what impact this update might have on its consolidated financial statements and disclosures.

In March 2016, the FASB issued the update Compensation Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting . The amendments are intended to improve the accounting for employee share-based payments and affect all organizations that issue share-based payment awards to their employees. The update requires the recording of all of the tax effects related to share-based payments at settlement (or expiration) through the income statement. Currently, tax benefits in excess of compensation cost (windfalls) are recorded in equity, and tax deficiencies (shortfalls) are recorded in equity to the extent of previous windfalls, and then recorded in the income statement. While the simplification will reduce some of the administrative complexities by eliminating the need to track a windfall pool, it will increase the volatility of income tax expense. The update also allows entities to withhold shares for the employee tax burden up to the employees maximum individual tax rate in the relevant jurisdiction without resulting in a liability classification of the award (currently such withholding is limited to the employer s minimum statutory withholding). The update clarifies that all cash payments made to taxing authorities

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on the employees' behalf for withheld shares should be presented as financing activities on the statement of cash flows. Also, the update requires all tax-related cash flows resulting from share-based payments be reported as operating activities on the statement of cash flows, a change from the current requirement to present windfall tax benefits as an inflow from financing activities and an outflow from operating activities. The update is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. Early adoption is permitted. The Company issues share-based payment awards to its employees and is evaluating the impacts this update might have on its consolidated financial statements and disclosures.

In June 2016, the FASB issued the update *Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. The update amends guidance on reporting credit losses for financial assets held at amortized cost basis and available for sale debt securities. For assets held at amortized cost basis, the update eliminates the *probable* threshold for initial recognition of credit losses in current U.S. GAAP and, instead, requires an entity to reflect its current estimate of all expected credit losses. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset to present the net amount expected to be collected. For available for sale debt securities, credit losses should be measured in a manner similar to current U.S. GAAP, however the update will require that credit losses be presented as an allowance rather than as a write-down. This update affects entities holding financial assets and net investment in leases that are not accounted for at fair value through net income. The update affects loans, debt securities, trade receivables, net investments in leases, off-balance sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash. The update is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. All entities may adopt the amendments in this update earlier as of fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is evaluating what impact, if any, this update might have on its consolidated financial statements and disclosures.

In August 2016, the FASB issued the update *Classification of Certain Cash Receipts and Cash Payments*. This update addresses the following eight specific cash flow issues: debt prepayment or debt extinguishment costs; settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing; contingent consideration payments made after a business combination; proceeds from the settlement of insurance claims; proceeds from the settlement of corporate-owned life insurance (COLI) policies; distributions received from equity method investees; beneficial interests in securitization transactions; and separately identifiable cash flows, including identification of the predominant nature in cases where cash receipts and payments have aspects of more than one class of cash flows. The update is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted. The Company is evaluating the impacts this update might have on its consolidated cash flow statements and disclosures.

In October 2016, the FASB issued the update *Accounting for Income Taxes: Intra-Entity Asset Transfers of Assets Other than Inventory*. This update eliminates the current U.S. GAAP exception for all intra-entity sales of assets other than inventory. As a result, a reporting entity would recognize the tax expense from the sale of the asset in the seller's tax jurisdiction when the transfer occurs, even though the pre-tax effects of that transaction are eliminated in consolidation. Any deferred tax asset that arises in the buyer's jurisdiction would also be recognized at the time of the transfer. The update is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted; however, the guidance can only be adopted in the first interim period of a fiscal year. The modified retrospective approach will be required for transition to the new guidance, with a cumulative-effect adjustment recorded in retained earnings as of the beginning of the period of adoption. The

Company is evaluating the impacts this update might have on its consolidated financial statements.

In October 2016, the FASB issued the update Consolidation (Topic 810): Interests Held through Related Parties That Are under Common Control. The amendments affect reporting entities that are required to evaluate whether they should consolidate a variable interest entity in certain situations involving entities under common control. The update is effective for fiscal and interim periods beginning after December 15, 2016. Early adoption is permitted. The Company is evaluating what impacts, if any, this update might have on its consolidated financial statements.

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Note 2 Components of Net Periodic Benefit Cost

Southwest has a noncontributory qualified retirement plan with defined benefits covering substantially all employees and a separate unfunded supplemental retirement plan (SERP), which is limited to officers. Southwest also provides postretirement benefits other than pensions (PBOP) to its qualified retirees for health care, dental, and life insurance.

During the third quarter of 2016, qualifying term-vested participants were offered a lump-sum present value payout of their pensions. The offer was primarily intended to reduce insurance and ongoing maintenance costs associated with qualifying participant balances. About one-half of the approximate 800 participants subject to the offer accepted the offer, resulting in an approximate \$30 million payment from pension assets to be made in the fourth quarter of 2016. This lump sum payout will have no impact on net periodic benefit cost or pension funding requirements during 2016.

Net periodic benefit costs included in the table below are components of an overhead loading process associated with the cost of labor. The overhead process ultimately results in allocation of net periodic benefit costs to the same accounts to which productive labor is charged. As a result, net periodic benefit costs become components of various accounts, primarily operations and maintenance expense, net utility plant, and deferred charges and other assets.

	Qualified Retirement Plan					
	Period Ended September 30,					
	Three Months		Nine Months		Twelve Months	
	2016	2015	2016	2015	2016	2015
(Thousands of dollars)						
Service cost	\$ 5,708	\$ 6,281	\$ 17,125	\$ 18,842	\$ 23,406	\$ 24,182
Interest cost	11,507	11,057	34,520	33,172	45,577	44,031
Expected return on plan assets	(14,140)	(14,452)	(42,419)	(43,356)	(56,871)	(56,691)
Amortization of net actuarial loss	6,317	8,186	18,950	24,557	27,136	30,276
Net periodic benefit cost	\$ 9,392	\$ 11,072	\$ 28,176	\$ 33,215	\$ 39,248	\$ 41,798

	SERP					
	Period Ended September 30,					
	Three Months		Nine Months		Twelve Months	
	2016	2015	2016	2015	2016	2015
(Thousands of dollars)						
Service cost	\$ 83	\$ 80	\$ 248	\$ 240	\$ 328	\$ 313
Interest cost	464	424	1,394	1,271	1,818	1,708
Amortization of net actuarial loss	346	323	1,038	970	1,361	1,165
Net periodic benefit cost	\$ 893	\$ 827	\$ 2,680	\$ 2,481	\$ 3,507	\$ 3,186

PBOP

Period Ended September 30,

	Three Months		Nine Months		Twelve Months	
	2016	2015	2016	2015	2016	2015
(Thousands of dollars)						
Service cost	\$ 375	\$ 410	\$ 1,124	\$ 1,231	\$ 1,534	\$ 1,506
Interest cost	795	750	2,386	2,249	3,136	2,956
Expected return on plan assets	(787)	(866)	(2,362)	(2,598)	(3,228)	(3,414)
Amortization of prior service costs	333	334	1,001	1,001	1,335	1,090
Amortization of net actuarial loss	104	86	312	259	398	259
Net periodic benefit cost	\$ 820	\$ 714	\$ 2,461	\$ 2,142	\$ 3,175	\$ 2,397

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Note 3 Segment Information

The following tables present revenues from external customers, intersegment revenues, and segment net income (thousands of dollars):

	Natural Gas Operations	Construction Services	Total
Three months ended September 30, 2016			
Revenues from external customers	\$ 200,179	\$ 312,531	\$ 512,710
Intersegment revenues		27,259	27,259
Total	\$ 200,179	\$ 339,790	\$ 539,969
Segment net income (loss)	\$ (12,405)	\$ 14,877	\$ 2,472

Three months ended September 30, 2015			
Revenues from external customers	\$ 219,420	\$ 255,088	\$ 474,508
Intersegment revenues		30,888	30,888
Total	\$ 219,420	\$ 285,976	\$ 505,396
Segment net income (loss)	\$ (18,939)	\$ 14,205	\$ (4,734)

	Natural Gas Operations	Construction Services	Total
Nine months ended September 30, 2016			
Revenues from external customers	\$ 980,927	\$ 762,835	\$ 1,743,762
Intersegment revenues		75,203	75,203
Total	\$ 980,927	\$ 838,038	\$ 1,818,965
Segment net income	\$ 67,536	\$ 19,325	\$ 86,861

Nine months ended September 30, 2015			
Revenues from external customers	\$ 1,059,178	\$ 645,289	\$ 1,704,467
Intersegment revenues		73,753	73,753
Total	\$ 1,059,178	\$ 719,042	\$ 1,778,220
Segment net income	\$ 59,325	\$ 12,873	\$ 72,198

	Natural Gas Operations	Construction Services	Total
Twelve months ended September 30, 2016			
Revenues from external customers	\$ 1,376,388	\$ 1,022,416	\$ 2,398,804
Intersegment revenues		105,566	105,566
Total	\$ 1,376,388	\$ 1,127,982	\$ 2,504,370
Segment net income	\$ 119,836	\$ 33,144	\$ 152,980
Twelve months ended September 30, 2015			
Revenues from external customers	\$ 1,457,266	\$ 854,312	\$ 2,311,578
Intersegment revenues		94,325	94,325
Total	\$ 1,457,266	\$ 948,637	\$ 2,405,903
Segment net income	\$ 113,252	\$ 17,692	\$ 130,944

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Note 4 Derivatives and Fair Value Measurements

Derivatives. In managing its natural gas supply portfolios, Southwest has historically entered into fixed- and variable-price contracts, which qualify as derivatives. Additionally, Southwest utilizes fixed-for-floating swap contracts (Swaps) to supplement its fixed-price contracts. The fixed-price contracts, firm commitments to purchase a fixed amount of gas in the future at a fixed price, qualify for the normal purchases and normal sales exception that is allowed for contracts that are probable of delivery in the normal course of business, and are exempt from fair value reporting. The variable-price contracts have no significant market value. The Swaps are recorded at fair value.

The fixed-price contracts and Swaps are utilized by Southwest under its volatility mitigation programs to effectively fix the price on a portion (up to 25% in the Arizona and California jurisdictions) of its natural gas supply portfolios. The maturities of the Swaps highly correlate to forecasted purchases of natural gas, during time frames ranging from October 2016 through March 2018. Under such contracts, Southwest pays the counterparty a fixed rate and receives from the counterparty a floating rate per MMBtu (dekatherm) of natural gas. Only the net differential is actually paid or received. The differential is calculated based on the notional amounts under the contracts, which are detailed in the table below (thousands of dekatherms):

	September 30, 2016	December 31, 2015
Contract notional amounts	11,985	7,407

Southwest does not utilize derivative financial instruments for speculative purposes, nor does it have trading operations.

The following table sets forth the gains and (losses) recognized on the Company's Swaps (derivatives) for the three-, nine-, and twelve-month periods ended September 30, 2016 and 2015 and their location in the Condensed Consolidated Statements of Income:

Gains (losses) recognized in income for derivatives not designated as hedging instruments:

(Thousands of dollars)

Instrument	Location of Gain or (Loss) Recognized in Income on Derivative	Three Months Ended September 30		Nine Months Ended September 30		Twelve Months Ended September 30	
		2016	2015	2016	2015	2016	2015
Swaps	Net cost of gas sold	\$ (2,072)	\$ (3,282)	\$ 2,253	\$ (4,689)	\$ (656)	\$ (10,682)
Swaps	Net cost of gas sold	2,072*	3,282*	(2,253)*	4,689*	656*	10,682*
Total		\$	\$	\$	\$	\$	\$

* Represents the impact of regulatory deferral accounting treatment under U.S. GAAP for rate-regulated entities. No gains (losses) were recognized in net income or other comprehensive income during the periods presented for derivatives designated as cash flow hedging instruments. Previously, Southwest entered into two forward-starting interest rate swaps (FSIRS), both of which were designated cash flow hedges, to partially hedge the risk of interest rate variability during the period leading up to the planned issuance of debt. The first FSIRS terminated in December 2010, and the second, in March 2012. Losses on both FSIRS are being amortized over ten-year periods from Accumulated other comprehensive income (loss) into interest expense.

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The following table sets forth, the fair values of the Company's Swaps and their location in the Condensed Consolidated Balance Sheets (thousands of dollars):

Fair values of derivatives not designated as hedging instruments:

September 30, 2016		Asset	Liability	
Instrument	Balance Sheet Location	Derivatives	Derivatives	Net Total
Swaps	Deferred charges and other assets	\$ 226	\$ (33)	\$ 193
Swaps	Prepays and other current assets	1,852	(182)	1,670
Swaps	Other current liabilities	16	(982)	(966)
Total		\$ 2,094	\$ (1,197)	\$ 897

December 31, 2015		Asset	Liability	Net
Instrument	Balance Sheet Location	Derivatives	Derivatives	Total
Swaps	Other current liabilities	\$	\$ (4,267)	\$ (4,267)
Swaps	Other deferred credits	4	(1,223)	(1,219)
Total		\$ 4	\$ (5,490)	\$ (5,486)

The estimated fair values of the natural gas derivatives were determined using future natural gas index prices (as more fully described below). The Company has master netting arrangements with each counterparty that provide for the net settlement (in the settlement month) of all contracts through a single payment. As applicable, the Company has elected to reflect the net amounts in its balance sheets. The Company had no outstanding collateral associated with the Swaps during any period presented in the above table.

Pursuant to regulatory deferral accounting treatment for rate-regulated entities, Southwest records the unrealized gains and losses in fair value of the Swaps as a regulatory asset and/or liability. When the Swaps mature, Southwest reverses any prior positions held and records the settled position as an increase or decrease of purchased gas under the related purchased gas adjustment (PGA) mechanism in determining its deferred PGA balances. Neither changes in fair value, nor settled amounts, of Swaps have a direct effect on earnings or other comprehensive income.

The following table shows the amounts Southwest paid to counterparties for settlements of matured Swaps.

	Three Months Ended	Nine Months Ended	Twelve Months Ended
(Thousands of dollars)	September 30, 2016	September 30, 2016	September 30, 2016
Paid to counterparties	\$	\$ 4,483	\$ 6,792
Received from counterparties	\$ 351	\$ 351	\$ 351

The following table details the regulatory assets/(liabilities) offsetting the derivatives at fair value in the Condensed Consolidated Balance Sheets (thousands of dollars).

September 30, 2016		
Instrument	Balance Sheet Location	Net Total
Swaps	Other deferred credits	\$ (193)
Swaps	Other current liabilities	(1,670)
Swaps	Prepays and other current assets	966
December 31, 2015		
Instrument	Balance Sheet Location	Net Total
Swaps	Prepays and other current assets	\$ 4,267
Swaps	Deferred charges and other assets	1,219

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Fair Value Measurements. The estimated fair values of Southwest's Swaps were determined at September 30, 2016 and December 31, 2015 using New York Mercantile Exchange (NYMEX) futures settlement prices for delivery of natural gas at Henry Hub adjusted by the price of NYMEX ClearPort basis Swaps, which reflect the