

SOUTHWEST GAS CORP  
Form 10-Q  
November 09, 2010

**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, 2010**

**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.)**

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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.

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, 45,548,236 shares as of October 29, 2010.

SOUTHWEST GAS CORPORATION  
September 30, 2010

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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,<br>2010 | DECEMBER 31,<br>2009 |
|---|-----------------------|----------------------|
| <b>ASSETS</b>   |                       |                      |
| Utility plant:  |                       |                      |
| Gas plant   | \$ 4,528,995          | \$ 4,418,286         |
| Less: accumulated depreciation  | (1,514,483)           | (1,431,106)          |
| Acquisition adjustments, net  | 1,316                 | 1,451                |
| Construction work in progress   | 34,389                | 45,872               |
| <b>Net utility plant</b>  | <b>3,050,217</b>      | <b>3,034,503</b>     |
| Other property and investments  | 130,721               | 115,860              |
| Restricted cash   | 37,779                | 49,769               |
| Current assets:   |                       |                      |
| Cash and cash equivalents   | 19,854                | 65,315               |
| Accounts receivable, net of allowances  | 84,717                | 157,722              |
| Accrued utility revenue   | 31,600                | 71,700               |
| Income taxes receivable, net  | 16,415                | 8,549                |
| Deferred income taxes   | 30,558                | 22,410               |
| Deferred purchased gas costs  |                       | 3,251                |
| Prepays and other current assets  | 87,670                | 88,685               |
| <b>Total current assets</b>   | <b>270,814</b>        | <b>417,632</b>       |
| Deferred charges and other assets   | 282,950               | 288,528              |
| <b>Total assets</b>   | <b>\$ 3,772,481</b>   | <b>\$ 3,906,292</b>  |
| <b>CAPITALIZATION AND LIABILITIES</b>   |                       |                      |
| Capitalization:   |                       |                      |
| Common stock, \$1 par (authorized - 60,000,000 shares; issued and outstanding - 45,478,569 and 45,091,734 shares) | \$ 47,109             | \$ 46,722            |
| Additional paid-in capital  | 803,683               | 792,339              |

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|   |                     |                     |
|---|---------------------|---------------------|
| Accumulated other comprehensive income (loss), net      | (41,400)            | (22,250)            |
| Retained earnings                                       | 309,699             | 285,316             |
| <b>Total Southwest Gas Corporation equity</b>           | <b>1,119,091</b>    | <b>1,102,127</b>    |
| Noncontrolling interest                                 | (430)               | (41)                |
| <b>Total equity</b>                                     | <b>1,118,661</b>    | <b>1,102,086</b>    |
| Subordinated debentures due to Southwest Gas Capital II |                     | 100,000             |
| Long-term debt, less current maturities                 | 1,075,523           | 1,169,357           |
| <b>Total capitalization</b>                             | <b>2,194,184</b>    | <b>2,371,443</b>    |
| <b>Current liabilities:</b>                             |                     |                     |
| Current maturities of long-term debt                    | 83                  | 1,327               |
| Accounts payable  | 70,660              | 158,856             |
| Customer deposits                                       | 87,581              | 91,668              |
| Accrued general taxes                                   | 40,383              | 40,868              |
| Accrued interest  | 18,364              | 19,644              |
| Deferred purchased gas costs                            | 152,518             | 93,226              |
| Other current liabilities                               | 104,717             | 68,641              |
| <b>Total current liabilities</b>                        | <b>474,306</b>      | <b>474,230</b>      |
| <b>Deferred income taxes and other credits:</b>         |                     |                     |
| Deferred income taxes and investment tax credits        | 451,470             | 436,113             |
| Taxes payable   | 2,786               | 3,079               |
| Accumulated removal costs                               | 205,000             | 189,000             |
| Other deferred credits                                  | 444,735             | 432,427             |
| <b>Total deferred income taxes and other credits</b>    | <b>1,103,991</b>    | <b>1,060,619</b>    |
| <b>Total capitalization and liabilities</b>             | <b>\$ 3,772,481</b> | <b>\$ 3,906,292</b> |

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<br>SEPTEMBER 30, |                   | NINE MONTHS ENDED<br>SEPTEMBER 30, |                  | TWELVE MONTHS ENDED<br>SEPTEMBER 30, |                  |
|--|-------------------------------------|-------------------|------------------------------------|------------------|--------------------------------------|------------------|
|  | 2010                                | 2009              | 2010                               | 2009             | 2010                                 | 2009             |
| <b>Operating revenues:</b>   |                                     |                   |                                    |                  |                                      |                  |
| Gas operating revenues   | \$ 213,893                          | \$ 235,020        | \$ 1,133,671                       | \$ 1,186,870     | \$ 1,561,644                         | \$ 1,615,512     |
| Construction revenues  | 93,790                              | 82,489            | 228,588                            | 208,149          | 299,420                              | 288,917          |
| <b>Total operating revenues</b>                                    | <b>307,683</b>                      | <b>317,509</b>    | <b>1,362,259</b>                   | <b>1,395,019</b> | <b>1,861,064</b>                     | <b>1,904,429</b> |
| <b>Operating expenses:</b>   |                                     |                   |                                    |                  |                                      |                  |
| Net cost of gas sold   | 81,303                              | 104,518           | 581,294                            | 668,013          | 779,911                              | 884,681          |
| Operations and maintenance   | 86,746                              | 85,773            | 260,386                            | 257,281          | 352,047                              | 339,643          |
| Depreciation and amortization                                      | 47,582                              | 46,903            | 142,438                            | 143,152          | 189,368                              | 192,743          |
| Taxes other than income taxes                                      | 10,006                              | 8,265             | 29,388                             | 27,880           | 38,826                               | 36,747           |
| Construction expenses  | 81,862                              | 71,528            | 202,806                            | 180,757          | 264,510                              | 250,658          |
| <b>Total operating expenses</b>                                    | <b>307,499</b>                      | <b>316,987</b>    | <b>1,216,312</b>                   | <b>1,277,083</b> | <b>1,624,662</b>                     | <b>1,704,472</b> |
| <b>Operating income</b>  | <b>184</b>                          | <b>522</b>        | <b>145,947</b>                     | <b>117,936</b>   | <b>236,402</b>                       | <b>199,957</b>   |
| <b>Other income and (expenses):</b>                                |                                     |                   |                                    |                  |                                      |                  |
| Net interest deductions  | (19,266)                            | (19,296)          | (56,444)                           | (56,670)         | (75,044)                             | (77,319)         |
| Net interest deductions on subordinated debentures                 |                                     | (1,933)           | (1,912)                            | (5,798)          | (3,845)                              | (7,730)          |
| Other income (deductions)  | 6,715                               | 3,971             | 1,038                              | 4,719            | 2,964                                | (2,013)          |
| <b>Total other income and (expenses)</b>                           | <b>(12,551)</b>                     | <b>(17,258)</b>   | <b>(57,318)</b>                    | <b>(57,749)</b>  | <b>(75,925)</b>                      | <b>(87,062)</b>  |
| <b>Income (loss) before income taxes</b>                           | <b>(12,367)</b>                     | <b>(16,736)</b>   | <b>88,629</b>                      | <b>60,187</b>    | <b>160,477</b>                       | <b>112,895</b>   |
| <b>Income tax expense (benefit)</b>                                | <b>(7,403)</b>                      | <b>(8,439)</b>    | <b>30,126</b>                      | <b>19,097</b>    | <b>55,946</b>                        | <b>40,573</b>    |
| <b>Net income (loss)</b>   | <b>(4,964)</b>                      | <b>(8,297)</b>    | <b>58,503</b>                      | <b>41,090</b>    | <b>104,531</b>                       | <b>72,322</b>    |
| <b>Net income (loss) attributable to noncontrolling interest</b>   | <b>(141)</b>                        |                   | <b>(389)</b>                       |                  | <b>(753)</b>                         |                  |
| <b>Net income (loss) attributable to Southwest Gas Corporation</b> | <b>\$ (4,823)</b>                   | <b>\$ (8,297)</b> | <b>\$ 58,892</b>                   | <b>\$ 41,090</b> | <b>\$ 105,284</b>                    | <b>\$ 72,322</b> |
| <b>Basic earnings (loss) per share</b>                             | <b>\$ (0.11)</b>                    | <b>\$ (0.18)</b>  | <b>\$ 1.30</b>                     | <b>\$ 0.92</b>   | <b>\$ 2.33</b>                       | <b>\$ 1.63</b>   |
| <b>Diluted earnings (loss) per share</b>                           | <b>\$ (0.11)</b>                    | <b>\$ (0.18)</b>  | <b>\$ 1.29</b>                     | <b>\$ 0.91</b>   | <b>\$ 2.31</b>                       | <b>\$ 1.61</b>   |

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|  |           |           |           |           |           |           |
|--|-----------|-----------|-----------|-----------|-----------|-----------|
| Dividends declared per share                   | \$ 0.2500 | \$ 0.2375 | \$ 0.7500 | \$ 0.7125 | \$ 0.9875 | \$ 0.9375 |
| Average number of common shares outstanding    | 45,447    | 44,855    | 45,354    | 44,671    | 45,262    | 44,497    |
| Average shares outstanding (assuming dilution) |           |           | 45,756    | 44,960    | 45,657    | 44,785    |

The accompanying notes are an integral part of these statements.

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**SOUTHWEST GAS CORPORATION AND SUBSIDIARIES**

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Thousands of dollars)

(Unaudited)

|   | NINE MONTHS ENDED<br>SEPTEMBER 30, |           | TWELVE MONTHS ENDED<br>SEPTEMBER 30, |           |
|---|------------------------------------|-----------|--------------------------------------|-----------|
|   | 2010                               | 2009      | 2010                                 | 2009      |
| <b>CASH FLOW FROM OPERATING ACTIVITIES:</b>                                       |                                    |           |                                      |           |
| Net income  | \$ 58,503                          | \$ 41,090 | \$ 104,531                           | \$ 72,322 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                    |           |                                      |           |
| Depreciation and amortization   | 142,438                            | 143,152   | 189,368                              | 192,743   |
| Deferred income taxes   | 18,946                             | 37,255    | 24,489                               | 55,535    |
| Changes in current assets and liabilities:  |                                    |           |                                      |           |
| Accounts receivable, net of allowances  | 73,005                             | 83,051    | 1,061                                | 33,446    |
| Accrued utility revenue   | 40,100                             | 40,400    | 600                                  | 400       |
| Deferred purchased gas costs  | 62,543                             | 69,794    | 49,651                               | 69,123    |
| Accounts payable  | (88,196)                           | (124,594) | 3,820                                | (12,849)  |
| Accrued taxes   | (8,644)                            | (15,232)  | 29,085                               | (29,894)  |
| Other current assets and liabilities  | 12,807                             | 43,890    | 1,650                                | (10,454)  |
| Gains on sale   | (694)                              | (2,219)   | (1,766)                              | (2,185)   |
| Changes in undistributed stock compensation                                       | 3,863                              | 3,416     | 4,389                                | 4,080     |
| AFUDC and property-related changes  | (693)                              | (951)     | (963)                                | (1,226)   |
| Changes in other assets and deferred charges                                      | (5,673)                            | (11,126)  | (10,100)                             | (12,645)  |
| Changes in other liabilities and deferred credits                                 | 7,521                              | 11,109    | 6,778                                | 10,169    |
| Net cash provided by operating activities   | 315,826                            | 319,035   | 402,593                              | 368,565   |
| <b>CASH FLOW FROM INVESTING ACTIVITIES:</b>                                       |                                    |           |                                      |           |
| Construction expenditures and property additions                                  | (151,417)                          | (171,538) | (196,864)                            | (249,893) |
| Change in restricted cash   | 11,990                             |           | (37,779)                             |           |
| Changes in customer advances  | 317                                | (4,678)   | 2,519                                | (5,456)   |
| Miscellaneous inflows   | 2,304                              | 5,449     | 4,788                                | 6,628     |
| Miscellaneous outflows  | (2,800)                            | (3,567)   | (2,853)                              | (3,498)   |
| Net cash used in investing activities   | (139,606)                          | (174,334) | (230,189)                            | (252,219) |
| <b>CASH FLOW FROM FINANCING ACTIVITIES:</b>                                       |                                    |           |                                      |           |
| Issuance of common stock, net   | 7,475                              | 14,022    | 11,854                               | 26,208    |
| Dividends paid  | (33,455)                           | (31,271)  | (44,134)                             | (41,172)  |
| Issuance of long-term debt, net   |                                    |           | 49,834                               | 1,415     |
| Retirement of long-term debt  | (3,301)                            | (15,323)  | (3,632)                              | (81,510)  |
| Redemption of subordinated debentures   | (100,000)                          |           | (100,000)                            |           |
| Change in long-term portion of credit facility                                    | (92,400)                           | (50,700)  | (99,300)                             | (1,624)   |
| Change in short-term debt   |                                    | (55,000)  |                                      |           |

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|                                       |           |           |           |           |
|---------------------------------------|-----------|-----------|-----------|-----------|
| Net cash used in financing activities | (221,681) | (138,272) | (185,378) | (96,683)  |
| Change in cash and cash equivalents   | (45,461)  | 6,429     | (12,974)  | 19,663    |
| Cash at beginning of period           | 65,315    | 26,399    | 32,828    | 13,165    |
| Cash at end of period                 | \$ 19,854 | \$ 32,828 | \$ 19,854 | \$ 32,828 |

Supplemental information:

|   |           |           |           |           |
|---|-----------|-----------|-----------|-----------|
| Interest paid, net of amounts capitalized | \$ 57,454 | \$ 62,457 | \$ 75,768 | \$ 84,359 |
| Income taxes paid (received)              | 18,505    | (5,128)   | 2,017     | 12,066    |

The accompanying notes are an integral part of these statements.



**Note 1 Nature of Operations and Basis of Presentation**

*Nature of Operations.* Southwest Gas Corporation and its subsidiaries (the Company) are composed 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 in portions of Arizona, Nevada, and California. The 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 sales are seasonal, peaking during the winter months; therefore, results of operations for interim periods are not necessarily indicative of the results for a full year. Variability in weather from normal temperatures, primarily in Arizona, can materially impact results of operations. Natural gas purchases and the timing of related recoveries can materially impact liquidity. NPL Construction Co. (NPL or the construction services segment), a wholly owned subsidiary, is a full-service underground piping contractor that provides utility companies with trenching and installation, replacement, and maintenance services for energy distribution systems.

*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 generally accepted accounting principles (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 revenue and expense 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 the 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 2009 Annual Report to Shareholders, which is incorporated by reference into the 2009 Form 10-K, and the first and second quarter 2010 reports on Form 10-Q.

*Intercompany Transactions.* NPL recognizes revenues generated from contracts with Southwest (see Note 3 below). Accounts receivable for these services were \$7.7 million at September 30, 2010 and \$5.3 million at December 31, 2009. 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.

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

|                                    | Three Months Ended<br>September 30 |          | Nine Months Ended<br>September 30 |          | Twelve Months Ended<br>September 30 |            |
|------------------------------------|------------------------------------|----------|-----------------------------------|----------|-------------------------------------|------------|
|                                    | 2010                               | 2009     | 2010                              | 2009     | 2010                                | 2009       |
| Change in COLI policies            | \$ 7,750                           | \$ 4,870 | \$ 5,620                          | \$ 6,943 | \$ 7,223                            | \$ 1,202   |
| Interest income                    | 49                                 | 29       | 127                               | 244      | 154                                 | 458        |
| Miscellaneous income and (expense) | (1,084)                            | (928)    | (4,709)                           | (2,468)  | (4,413)                             | (3,673)    |
| Total other income (deductions)    | \$ 6,715                           | \$ 3,971 | \$ 1,038                          | \$ 4,719 | \$ 2,964                            | \$ (2,013) |

Reflected 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, the change in the cash surrender value components of COLI policies, as they progress toward the ultimate death benefits, is also recorded without tax consequences.

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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 benefits.

|   | <b>Qualified Retirement Plan</b>  |             |                    |             |                      |             |
|---|-----------------------------------|-------------|--------------------|-------------|----------------------|-------------|
|   | <b>Period Ended September 30,</b> |             |                    |             |                      |             |
|   | <b>Three Months</b>               |             | <b>Nine Months</b> |             | <b>Twelve Months</b> |             |
|   | <b>2010</b>                       | <b>2009</b> | <b>2010</b>        | <b>2009</b> | <b>2010</b>          | <b>2009</b> |
| (Thousands of dollars)                        |                                   |             |                    |             |                      |             |
| Service cost                                  | \$ 4,233                          | \$ 3,848    | \$ 12,699          | \$ 11,543   | \$ 16,546            | \$ 15,570   |
| Interest cost                                 | 8,904                             | 8,632       | 26,711             | 25,895      | 35,343               | 34,018      |
| Expected return on plan assets                | (9,135)                           | (8,805)     | (27,404)           | (26,416)    | (36,209)             | (35,095)    |
| Amortization of prior service costs (credits) |                                   | (1)         |                    | (2)         |                      | (5)         |
| Amortization of net loss                      | 2,620                             | 1,063       | 7,859              | 3,190       | 8,922                | 3,966       |
| Net periodic benefit cost                     | \$ 6,622                          | \$ 4,737    | \$ 19,865          | \$ 14,210   | \$ 24,602            | \$ 18,454   |

|                           | <b>SERP</b>                       |             |                    |             |                      |             |
|---------------------------|-----------------------------------|-------------|--------------------|-------------|----------------------|-------------|
|                           | <b>Period Ended September 30,</b> |             |                    |             |                      |             |
|                           | <b>Three Months</b>               |             | <b>Nine Months</b> |             | <b>Twelve Months</b> |             |
|                           | <b>2010</b>                       | <b>2009</b> | <b>2010</b>        | <b>2009</b> | <b>2010</b>          | <b>2009</b> |
| (Thousands of dollars)    |                                   |             |                    |             |                      |             |
| Service cost              | \$ 93                             | \$ 49       | \$ 279             | \$ 147      | \$ 327               | \$ 171      |
| Interest cost             | 511                               | 516         | 1,533              | 1,548       | 2,050                | 2,058       |
| Amortization of net loss  | 289                               | 227         | 867                | 681         | 1,095                | 930         |
| Net periodic benefit cost | \$ 893                            | \$ 792      | \$ 2,679           | \$ 2,376    | \$ 3,472             | \$ 3,159    |

|                                       | <b>PBOP</b>                       |             |                    |             |                      |             |
|---------------------------------------|-----------------------------------|-------------|--------------------|-------------|----------------------|-------------|
|                                       | <b>Period Ended September 30,</b> |             |                    |             |                      |             |
|                                       | <b>Three Months</b>               |             | <b>Nine Months</b> |             | <b>Twelve Months</b> |             |
|                                       | <b>2010</b>                       | <b>2009</b> | <b>2010</b>        | <b>2009</b> | <b>2010</b>          | <b>2009</b> |
| (Thousands of dollars)                |                                   |             |                    |             |                      |             |
| Service cost                          | \$ 214                            | \$ 183      | \$ 642             | \$ 547      | \$ 824               | \$ 729      |
| Interest cost                         | 623                               | 593         | 1,869              | 1,778       | 2,461                | 2,359       |
| Expected return on plan assets        | (523)                             | (401)       | (1,569)            | (1,202)     | (1,970)              | (1,736)     |
| Amortization of transition obligation | 216                               | 216         | 650                | 650         | 867                  | 867         |
| Amortization of net loss              | 122                               | 108         | 366                | 325         | 475                  | 325         |
| Net periodic benefit cost             | \$ 652                            | \$ 699      | \$ 1,958           | \$ 2,098    | \$ 2,657             | \$ 2,544    |

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### Note 3 Segment Information

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

|   | Natural Gas<br>Operations | Construction<br>Services | Total        |
|---|---------------------------|--------------------------|--------------|
| <b>Three months ended September 30, 2010</b>  |                           |                          |              |
| Revenues from external customers              | \$ 213,893                | \$ 76,125                | \$ 290,018   |
| Intersegment revenues                         |                           | 17,665                   | 17,665       |
| Total   | \$ 213,893                | \$ 93,790                | \$ 307,683   |
| Segment net income (loss)                     | \$ (8,813)                | \$ 3,990                 | \$ (4,823)   |
| <b>Three months ended September 30, 2009</b>  |                           |                          |              |
| Revenues from external customers              | \$ 235,020                | \$ 69,923                | \$ 304,943   |
| Intersegment revenues                         |                           | 12,566                   | 12,566       |
| Total   | \$ 235,020                | \$ 82,489                | \$ 317,509   |
| Segment net income (loss)                     | \$ (11,367)               | \$ 3,070                 | \$ (8,297)   |
| <b>Nine months ended September 30, 2010</b>   |                           |                          |              |
| Revenues from external customers              | \$ 1,133,671              | \$ 183,875               | \$ 1,317,546 |
| Intersegment revenues                         |                           | 44,713                   | 44,713       |
| Total   | \$ 1,133,671              | \$ 228,588               | \$ 1,362,259 |
| Segment net income                            | \$ 52,403                 | \$ 6,489                 | \$ 58,892    |
| <b>Nine months ended September 30, 2009</b>   |                           |                          |              |
| Revenues from external customers              | \$ 1,186,870              | \$ 168,707               | \$ 1,355,577 |
| Intersegment revenues                         |                           | 39,442                   | 39,442       |
| Total   | \$ 1,186,870              | \$ 208,149               | \$ 1,395,019 |
| Segment net income                            | \$ 35,749                 | \$ 5,341                 | \$ 41,090    |
| <b>Twelve months ended September 30, 2010</b> |                           |                          |              |
| Revenues from external customers              | \$ 1,561,644              | \$ 241,575               | \$ 1,803,219 |
| Intersegment revenues                         |                           | 57,845                   | 57,845       |
| Total   | \$ 1,561,644              | \$ 299,420               | \$ 1,861,064 |

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|   |                     |                   |                     |
|---|---------------------|-------------------|---------------------|
| Segment net income                            | \$ 96,074           | \$ 9,210          | \$ 105,284          |
| <b>Twelve months ended September 30, 2009</b> |                     |                   |                     |
| Revenues from external customers              | \$ 1,615,512        | \$ 233,367        | \$ 1,848,879        |
| Intersegment revenues                         |                     | 55,550            | 55,550              |
| <b>Total</b>                                  | <b>\$ 1,615,512</b> | <b>\$ 288,917</b> | <b>\$ 1,904,429</b> |
| Segment net income                            | \$ 64,748           | \$ 7,574          | \$ 72,322           |

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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. In 2008, Southwest also began utilizing 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 of its natural gas portfolios, ranging from 25 percent to 50 percent, depending on the jurisdiction. The maturities of the Swaps highly correlate to forecasted purchases of natural gas, during time frames ranging from October 2010 through October 2011. Under such contracts, Southwest pays the counterparty at 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 (approximately 13.2 million dekatherms at September 30, 2010 and 13.6 million dekatherms at December 31, 2009). 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 months, nine months, and twelve months ended September 30, 2010 and 2009 and their location in the income statement (thousands of dollars):

#### Derivatives not designated as hedging instruments:

| Location of Gain or (Loss) |                      | Amount of Gain or (Loss) Recognized in Income on Derivative |              |                   |              |                     |              |
|----------------------------|----------------------|---|--------------|-------------------|--------------|---------------------|--------------|
|                            |                      | Recognized in Income on                                     |              | Derivative        |              |                     |              |
| Derivative                 |                      | Three Months Ended  |              | Nine Months Ended |              | Twelve Months Ended |              |
|                            |                      | September 30  | September 30 | September 30      | September 30 | September 30        | September 30 |
|                            |                      | 2010  | 2009         | 2010              | 2009         | 2010                | 2009         |
| Swaps                      | Net cost of gas sold | \$ (12,046)   | \$ 6,872     | \$ (30,013)       | \$ (410)     | \$ (33,994)         | \$ (7,622)   |
| Swaps                      | Net cost of gas sold | 12,046 *  | (6,872) *    | 30,013 *          | 410 *        | 33,994 *            | 7,622 *      |
| <b>Total</b>               |                      | \$  | \$           | \$                | \$           | \$                  | \$           |

\* Represents the impact of regulatory deferral accounting treatment under U.S. GAAP for rate-regulated entities.

In January 2010, Southwest entered into two forward starting interest rate swaps ( FSIRS ) to hedge the risk of interest rate variability during the period leading up to the planned issuance of fixed-rate debt to replace \$200 million of debt maturing in February 2011 and \$200 million maturing in May 2012. The counterparties to each agreement are four major banking institutions. The first FSIRS has a notional amount of \$125 million (with Southwest as the fixed-rate payer at a rate of 4.26%) and has a mandatory termination date on or before December 7, 2010. The second FSIRS has a notional amount of \$100 million (with Southwest as the fixed-rate payer at a rate of 4.78%) and has a mandatory termination date on or before March 20, 2012.

Southwest has designated the FSIRS agreements as cash flow hedges of forecasted future interest payments. At the inception of the hedges, the terms of the derivatives were the same as perfect hypothetical derivatives; thus, there is an expectation that there will be no ineffectiveness, and that the effective portion of unrealized gains and losses on the FSIRS leading up to the forecasted debt issuances will be reported as a component of other comprehensive income. At termination, the final values will be reclassified from accumulated other comprehensive income into earnings over the terms of the debt issuances which is the same period the hedged forecasted transaction affects earnings. However, should conditions occur that indicate the existence of ineffectiveness (e.g., deterioration of counterparty creditworthiness, delay in the forecasted debt

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issuances, etc.), Southwest will measure ineffectiveness by comparing changes in the fair value of each FSIRS with changes in the fair value of a hypothetical swap (the hypothetical derivative method). Gains and losses due to ineffectiveness will be recognized immediately as part of interest expense. See **Note 7 Equity and Comprehensive Income** for additional information. At September 30, 2010, the FSIRS were effective hedges. There was no gain or (loss) reclassified from accumulated other comprehensive income ( AOCI ) into income (effective portion) and no gain or (loss) recognized in income (ineffective portion) for the Company's derivatives designated as hedging instruments.

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The following table sets forth the gains and (losses) recognized on the Company's FSIRS (thousands of dollars):

**Derivatives designated as hedging instruments:**

**Gains (losses) on derivatives in cash flow hedging relationships:**

|  | Gains (losses) on interest rate swaps - FSIRS |  |  |
|--|---|--|--|
|  | Three Months Ended<br>September 30,<br>2010   | Nine Months Ended<br>September 30,<br>2010 | Twelve Months Ended<br>September 30,<br>2010 |
| <b>Amount of Gain or (Loss) Recognized in Other<br/>Comprehensive Income on Derivative (Effective Portion)</b> | \$ (11,281)                                   | \$ (32,540)                                | \$ (32,540)                                  |

The following table sets forth the fair values of the Company's Swaps and FSIRS and their location in the balance sheets (thousands of dollars):

**Fair values of derivatives not designated as hedging instruments:**

| September 30, 2010 |                           | Asset       | Liability   |             |
|--------------------|---------------------------|-------------|-------------|-------------|
|                    | Balance Sheet Location    | Derivatives | Derivatives | Net Total   |
| Swaps              | Other current liabilities | \$          | \$ (16,491) | \$ (16,491) |
| Swaps              | Other deferred credits    |             | (1,452)     | (1,452)     |
| <b>Total</b>       |                           | \$          | \$ (17,943) | \$ (17,943) |

| December 31, 2009 |                                   | Asset       | Liability   |           |
|-------------------|-----------------------------------|-------------|-------------|-----------|
|                   | Balance Sheet Location            | Derivatives | Derivatives | Net Total |
| Swaps             | Deferred charges and other assets | \$ 85       | \$ (27)     | \$ 58     |
| Swaps             | Prepays and other current assets  | 2,921       | (361)       | 2,560     |
| Swaps             | Other current liabilities         | 309         | (1,730)     | (1,421)   |
| Swaps             | Other deferred credits            | 25          | (100)       | (75)      |
| <b>Total</b>      |                                   | \$ 3,340    | \$ (2,218)  | \$ 1,122  |

**Fair values of derivatives designated as hedging instruments:**

| September 30, 2010 |                           | Asset       | Liability   |             |
|--------------------|---------------------------|-------------|-------------|-------------|
|                    | Balance Sheet Location    | Derivatives | Derivatives | Net Total   |
| FSIRS              | Other current liabilities | \$          | \$ (18,180) | \$ (18,180) |
| FSIRS              | Other deferred credits    |             | (14,360)    | (14,360)    |
| <b>Total</b>       |                           | \$          | \$ (32,540) | \$ (32,540) |

There were no derivatives designated as hedging instruments at December 31, 2009.





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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 of all contracts through a single payment. As applicable, the Company has elected to reflect the net amounts in its balance sheets.

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 settle, 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. During the three months and nine months ended September 30, 2010, Southwest paid counterparties \$4.5 million and \$11.8 million, respectively, in settlements of matured Swaps. During the nine months ended September 30, 2010, Southwest received \$831,000 from counterparties (all received in the first quarter of 2010) in settlements of matured Swaps. Neither changes in the fair value of the Swaps nor settled amounts have a direct effect on earnings or other comprehensive income. At September 30, 2010, regulatory assets/liabilities offsetting the amounts in the balance sheet were recorded in Prepaids and other current assets (\$16.5 million) and Deferred charges and other assets (\$1.5 million). At December 31, 2009, regulatory assets/liabilities offsetting the amounts in the balance sheet were recorded in Prepaids and other current assets (\$1.4 million), Other current liabilities (\$2.6 million), Other deferred credits (\$58,000), and Deferred charges and other assets (\$75,000).

*Fair Value Measurements.* The estimated fair values of Southwest's Swaps were determined at September 30, 2010 and December 31, 2009 using NYMEX futures settlement prices for delivery of natural gas at Henry Hub adjusted by the price of NYMEX ClearPort basis Swaps, which reflect the difference between the price of natural gas at a given delivery basin and the Henry Hub pricing points. These Level 2 inputs are observable in the marketplace throughout the full term of the Swaps, but have been credit-risk adjusted with no significant impact to the overall fair value measure.

The estimated fair values of Southwest's FSIRS were determined using a discounted cash flow model that utilizes forward interest rate curves. The inputs to the model are the terms of the FSIRS. These Level 2 inputs are observable in the marketplace throughout the full term of the FSIRS, but have been credit-risk adjusted with no significant impact to the overall fair value measure.

The following table sets forth, by level within the three-level fair value hierarchy that ranks the inputs used to measure fair value by their reliability, the Company's financial assets and liabilities that were accounted for at fair value:

#### Level 2 - Significant other observable inputs

| (Thousands of dollars)                    | September 30, 2010 | December 31, 2009 |
|---|--------------------|-------------------|
| Assets at fair value:                     |                    |                   |
| Prepaids and other current assets - Swaps | \$                 | \$ 2,560          |
| Deferred charges and other assets - Swaps |                    | 58                |
| Liabilities at fair value:                |                    |                   |
| Other current liabilities - Swaps         | (16,491)           | (1,421)           |
| Other deferred credits - Swaps            | (1,452)            | (75)              |
| Other current liabilities - FSIRS         | (18,180)           |                   |
| Other deferred credits - FSIRS            | (14,360)           |                   |
| <b>Net Assets (Liabilities)</b>           | <b>\$ (50,483)</b> | <b>\$ 1,122</b>   |

No financial assets or liabilities accounted for at fair value fell within Level 1 or Level 3 of the fair value hierarchy.

**Note 5 Redemption of Subordinated Debentures**

In June 2003, the Company created Southwest Gas Capital II ( Trust II ), a wholly owned subsidiary, as a financing trust for the sole purpose of issuing preferred trust securities for the benefit of the Company. In August 2003, Trust II publicly issued \$100 million of 7.70% Preferred Trust Securities ( Preferred Trust Securities ). In connection with the Trust II issuance of the Preferred Trust Securities and the related purchase by the Company for \$3.1 million of all of the Trust II common securities ( Common Securities ), the Company issued \$103.1 million principal amount of its 7.70% Junior Subordinated Debentures ( Subordinated Debentures ) to Trust II. The Subordinated Debentures became redeemable at the option of the Company in August 2008.

In February 2010, the Company notified holders of the Subordinated Debentures that all of these debentures (and the associated preferred and common securities) would be redeemed (at par) by the Company in March 2010. All of the outstanding Subordinated Debentures were redeemed in March 2010. The Company accomplished the redemption using existing cash and borrowings under the \$300 million credit facility.

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**Note 6 Long-Term Debt**

Carrying amounts of the Company's long-term debt and their related estimated fair values as of September 30, 2010 and December 31, 2009 are disclosed in the following table. The fair value of the revolving credit facility and the variable-rate IDRBs approximates carrying value. Market values for the debentures, fixed-rate IDRBs, and other indebtedness were determined based on dealer quotes using trading records for September 30, 2010 and December 31, 2009, as applicable, and other secondary sources which are customarily consulted for data of this kind.

|  | September 30, 2010 |              | December 31, 2009 |              |
|--|--------------------|--------------|-------------------|--------------|
|  | Carrying Amount    | Market Value | Carrying Amount   | Market Value |
| (Thousands of dollars)                                   |                    |              |                   |              |
| Debentures:  |                    |              |                   |              |
| Notes, 8.375%, due 2011                                  | \$ 200,000         | \$ 205,316   | \$ 200,000        | \$ 213,012   |
| Notes, 7.625%, due 2012                                  | 200,000            | 218,924      | 200,000           | 219,240      |
| 8% Series, due 2026                                      | 75,000             | 98,007       | 75,000            | 87,005       |
| Medium-term notes, 7.59% series, due 2017                | 25,000             | 30,448       | 25,000            | 27,858       |
| Medium-term notes, 7.78% series, due 2022                | 25,000             | 31,546       | 25,000            | 28,275       |
| Medium-term notes, 7.92% series, due 2027                | 25,000             | 32,575       | 25,000            | 28,848       |
| Medium-term notes, 6.76% series, due 2027                | 7,500              | 8,800        | 7,500             | 7,723        |
| Unamortized discount                                     | (1,680)            |              | (2,196)           |              |
|  | 555,820            |              | 555,304           |              |
| Revolving credit facility and commercial paper, due 2012 |                    |              | 92,400            | 92,400       |
| Industrial development revenue bonds:                    |                    |              |                   |              |
| Variable-rate bonds:                                     |                    |              |                   |              |
| Tax-exempt Series A, due 2028                            | 50,000             | 50,000       | 50,000            | 50,000       |
| 2003 Series A, due 2038                                  | 50,000             | 50,000       | 50,000            | 50,000       |
| 2008 Series A, due 2038                                  | 50,000             | 50,000       | 50,000            | 50,000       |
| 2009 Series A, due 2039                                  | 50,000             | 50,000       | 50,000            | 50,000       |
| Fixed-rate bonds:  |                    |              |                   |              |
| 6.10% 1999 Series A, due 2038                            | 12,410             | 12,460       | 12,410            | 11,443       |
| 5.95% 1999 Series C, due 2038                            | 14,320             | 14,274       | 14,320            | 12,922       |
| 5.55% 1999 Series D, due 2038                            | 8,270              | 7,948        | 8,270             | 7,038        |
| 5.45% 2003 Series C, due 2038 (rate resets in 2013)      | 30,000             | 32,185       | 30,000            | 31,422       |
| 5.25% 2003 Series D, due 2038                            | 20,000             | 18,684       | 20,000            | 16,701       |
| 5.80% 2003 Series E, due 2038 (rate resets in 2013)      | 15,000             | 15,742       | 15,000            | 15,683       |
| 5.25% 2004 Series A, due 2034                            | 65,000             | 62,609       | 65,000            | 55,979       |
| 5.00% 2004 Series B, due 2033                            | 31,200             | 29,287       | 31,200            | 26,096       |
| 4.85% 2005 Series A, due 2035                            | 100,000            | 90,865       | 100,000           | 79,469       |
| 4.75% 2006 Series A, due 2036                            | 24,855             | 22,033       | 24,855            | 19,139       |
| Unamortized discount                                     | (3,537)            |              | (3,644)           |              |
|  | 517,518            |              | 517,411           |              |
| Other  | 2,268              | 2,577        | 5,569             | 5,712        |
|  | 1,075,606          |              | 1,170,684         |              |
| Less: current maturities                                 | (83)               |              | (1,327)           |              |

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|   |              |              |
|---|--------------|--------------|
| Long-term debt, less current maturities | \$ 1,075,523 | \$ 1,169,357 |
|---|--------------|--------------|

As noted in the table above, the Company has \$200 million of 8.375% notes maturing in February 2011. The Company currently intends to provide funding for this maturing obligation through the issuance of new debt, or availability under the Company's \$300 million credit facility. The Company's \$300 million credit facility, which expires in May 2012, has sufficient current and forecasted capacity to provide funding for the \$200 million of maturing notes, to the extent needed. Therefore, the \$200 million of debentures due February 2011 continue to be shown as long-term obligations.

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### Note 7 Equity and Comprehensive Income

The table below provides details of activity in equity during the nine months ended September 30, 2010.

|   | Southwest Gas Corporation Equity |           |                                  |  |                      |                                 |              |
|---|----------------------------------|-----------|----------------------------------|--|----------------------|---------------------------------|--------------|
|   | Common Stock                     |           | Additional<br>Paid-in<br>Capital | Other<br>Comprehensive<br>Income<br>(Loss) | Retained<br>Earnings | Non-<br>controlling<br>Interest | Total        |
|   | Shares                           | Amount    |                                  |  |                      |                                 |              |
| (In thousands, except per share amounts)  |                                  |           |                                  |  |                      |                                 |              |
| <b>DECEMBER 31, 2009</b>  | 45,092                           | \$ 46,722 | \$ 792,339                       | \$ (22,250)                                | \$ 285,316           | \$ (41)                         | \$ 1,102,086 |
| Common stock issuances  | 387                              | 387       | 11,344                           |  |                      |                                 | 11,731       |
| Net income (loss)   |                                  |           |                                  |  | 58,892               | (389)                           | 58,503       |
| Other comprehensive income (loss):  |                                  |           |                                  |  |                      |                                 |              |
| Net actuarial gain (loss) arising during period, less amortization of unamortized benefit plan cost, net of tax |                                  |           |                                  | 1,025                                      |                      |                                 | 1,025        |
| FSIRS unrealized gains (losses), net of tax   |                                  |           |                                  | (20,175)                                   |                      |                                 | (20,175)     |
| Dividends declared  |                                  |           |                                  |  |                      |                                 |              |
| Common: \$0.25 per share  |                                  |           |                                  |  | (34,509)             |                                 | (34,509)     |
| <b>SEPTEMBER 30, 2010</b>   | 45,479                           | \$ 47,109 | \$ 803,683                       | \$ (41,400)                                | \$ 309,699           | \$ (430)                        | \$ 1,118,661 |

The tables below are designed to provide details of comprehensive income and year-to-date activity in AOCI. See **Note 4 Derivatives and Fair Value Measurements** for additional information on the FSIRS.

### Comprehensive Income

| (Thousands of dollars)  | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |           | Twelve Months Ended<br>September 30, |           |
|---|-------------------------------------|------------|------------------------------------|-----------|--------------------------------------|-----------|
|   | 2010                                | 2009       | 2010                               | 2009      | 2010                                 | 2009      |
| Net income (loss)   | \$ (4,964)                          | \$ (8,297) | \$ 58,503                          | \$ 41,090 | \$ 104,531                           | \$ 72,322 |
| Net actuarial gain (loss) arising during period, less amortization of unamortized benefit plan cost, net of tax | 342                                 | 207        | 1,025                              | 620       | (2,419)                              | (6,564)   |
| FSIRS unrealized gains (losses), net of tax   | (6,994)                             |            | (20,175)                           |           | (20,175)                             |           |
| Comprehensive income (loss)   | (11,616)                            | (8,090)    | 39,353                             | 41,710    | 81,937                               | 65,758    |
| Comprehensive income (loss) attributable to noncontrolling interest   | (141)                               |            | (389)                              |           | (753)                                |           |
| Comprehensive income (loss) attributable to Southwest Gas Corporation   | \$ (11,475)                         | \$ (8,090) | \$ 39,742                          | \$ 41,710 | \$ 82,690                            | \$ 65,758 |
| Tax (expense) benefit associated with net actuarial gain (loss) arising during period                           | \$ (209)                            | \$ (126)   | \$ (628)                           | \$ (380)  | \$ 1,484                             | \$ 4,022  |

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|   |    |       |    |        |    |        |
|---|----|-------|----|--------|----|--------|
| Tax (expense) benefit associated with FSIRS unrealized gain |    |       |    |        |    |        |
| (loss) recognized in other comprehensive income (loss)      | \$ | 4,287 | \$ | 12,365 | \$ | 12,365 |

**AOCI - Rollforward**

(Thousands of dollars)

|   | Defined Benefit Plans |                             |               | FSIRS       |                             |             | AOCI        |
|---|-----------------------|-----------------------------|---------------|-------------|-----------------------------|-------------|-------------|
|   | Before-Tax            | Tax<br>(Expense)<br>Benefit | After-<br>Tax | Before-Tax  | Tax<br>(Expense)<br>Benefit | After-Tax   |             |
| <b>Beginning Balance AOCI December 31, 2009</b> | \$ (35,887)           | \$ 13,637                   | \$ (22,250)   | \$          | \$                          | \$          | \$ (22,250) |
| Current period change                           | 1,653                 | (628)                       | 1,025*        | (32,540)    | 12,365                      | (20,175)**  | (19,150)    |
| <b>Ending Balance AOCI September 30, 2010</b>   | \$ (34,234)           | \$ 13,009                   | \$ (21,225)   | \$ (32,540) | \$ 12,365                   | \$ (20,175) | \$ (41,400) |

\* Net actuarial gain (loss), less amortization of unamortized benefit plan cost

\*\* FSIRS unrealized gain (loss) recognized in other comprehensive income

Based on the current FSIRS position, approximately \$1.5 million of the FSIRS existing losses reported in AOCI at September 30, 2010 is expected to be reclassified into expense within the next twelve months.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Southwest Gas Corporation and its subsidiaries (the Company) consist of two business 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 in portions of Arizona, Nevada, and California. Southwest is the largest distributor in Arizona, selling and transporting natural gas in most of central and southern Arizona, including the Phoenix and Tucson metropolitan areas. Southwest is also the largest distributor of natural gas in Nevada, serving the Las Vegas metropolitan area and northern Nevada. In addition, Southwest distributes and transports natural gas in portions of California, including the Lake Tahoe area and the high desert and mountain areas in San Bernardino County.

On a seasonally adjusted basis as of September 30, 2010, Southwest had 1,820,000 residential, commercial, industrial, and other natural gas customers, of which 980,000 customers were located in Arizona, 659,000 in Nevada, and 181,000 in California. Residential and commercial customers represented over 99 percent of the total customer base. During the twelve months ended September 30, 2010, 55 percent of operating margin was earned in Arizona, 35 percent in Nevada, and 10 percent in California. During this same period, Southwest earned 86 percent of operating margin from residential and small commercial customers, 4 percent from other sales customers, and 10 percent from transportation customers. These general patterns are expected to remain materially consistent for the foreseeable future.

Southwest recognizes operating revenues from the distribution and transportation of natural gas (and related services) to customers. Operating margin is the measure of gas operating revenues less the net cost of gas sold. Management uses operating margin as a main benchmark in comparing operating results from period to period. The principal factors affecting operating margin are general rate relief, weather, conservation and efficiencies, and customer growth. Of these, weather is the primary reason for volatility in margin. Variances in temperatures from normal levels, primarily in Arizona, can have a significant impact on the margin and associated net income of the Company. A decoupled rate structure adopted as part of the Nevada general rate case, effective November 2009, is designed to mitigate the impact of weather variability as well as conservation on margin in the Nevada service territories. Weather impacts and conservation are also offset by the margin tracking mechanism in Southwest's California service territories.

NPL Construction Co. (NPL or the construction services segment), a wholly owned subsidiary, is a full-service underground piping contractor that provides utility companies with trenching and installation, replacement, and maintenance services for energy distribution systems. NPL operates in 17 major markets nationwide. Construction activity is cyclical and can be significantly impacted by changes in general and local economic conditions, including the housing market, interest rates, employment levels, job growth, the equipment resale market, and local and federal tax rates. Generally, revenues and profits are lowest during the first quarter of the year due to less favorable winter weather conditions. Operating results typically improve as more favorable weather conditions occur during the summer and fall months.

This Management's Discussion and Analysis (MD&A) of Financial Condition and Results of Operations should be read in conjunction with the consolidated financial statements and the notes thereto, as well as the MD&A, included in the 2009 Annual Report to Shareholders, which is incorporated by reference into the 2009 Form 10-K, and the first and second quarter 2010 reports on Form 10-Q.

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## Executive Summary

The items discussed in this Executive Summary are intended to provide an overview of the results of the Company's operations. As needed, certain items are covered in greater detail in later sections of management's discussion and analysis. As reflected in the table below, the natural gas operations segment accounted for an average of 91 percent of twelve-month-to-date consolidated net income over the past two years. As such, management's discussion and analysis is primarily focused on that segment. Natural gas sales are seasonal, peaking during the winter months; therefore, results of operations for interim periods are not necessarily indicative of the results for a full year.

### Summary Operating Results

|   | Three Months                             |             | Period Ended September 30,<br>Nine Months |            | Twelve Months |            |
|---|--|-------------|---|------------|---------------|------------|
|   | 2010                                     | 2009        | 2010                                      | 2009       | 2010          | 2009       |
|   | (In thousands, except per share amounts) |             |   |            |               |            |
| <u>Contribution to net income (loss)</u>    |  |             |   |            |               |            |
| Natural gas operations                      | \$ (8,813)                               | \$ (11,367) | \$ 52,403                                 | \$ 35,749  | \$ 96,074     | \$ 64,748  |
| Construction services                       | 3,990                                    | 3,070       | 6,489                                     | 5,341      | 9,210         | 7,574      |
| Net income (loss)                           | \$ (4,823)                               | \$ (8,297)  | \$ 58,892                                 | \$ 41,090  | \$ 105,284    | \$ 72,322  |
| Average number of common shares outstanding | 45,447                                   | 44,855      | 45,354                                    | 44,671     | 45,262        | 44,497     |
| <u>Basic earnings (loss) per share</u>      |  |             |   |            |               |            |
| Consolidated                                | \$ (0.11)                                | \$ (0.18)   | \$ 1.30                                   | \$ 0.92    | \$ 2.33       | \$ 1.63    |
| <u>Natural Gas Operations</u>               |  |             |   |            |               |            |
| Operating margin                            | \$ 132,590                               | \$ 130,502  | \$ 552,377                                | \$ 518,857 | \$ 781,733    | \$ 730,831 |

Consolidated results for the third quarter of 2010 improved compared to the same period in 2009. The improvement primarily resulted from an increased contribution from the construction services segment and higher other income.

### 3rd Quarter 2010 Overview

Natural gas operations highlights include the following:

Operating margin increased approximately \$2 million compared to the prior-year quarter primarily due to rate relief in Nevada (\$1 million) and customer growth (\$1 million)

Operations and maintenance expense increased only \$1 million or 1% between periods due to effective cost containment efforts

Other income increased \$2.8 million between periods primarily due to COLI policy cash surrender value increases and recognition of death benefits



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Net financing costs declined \$1.7 million between quarters

Liquidity position remains strong

Issuance of draft Arizona decoupling Policy Statement in October 2010

*Company-Owned Life Insurance ( COLI ).* Southwest has life insurance policies on members of management and other key employees to indemnify itself against the loss of talent, expertise, and knowledge, as well as to provide indirect funding for certain nonqualified benefit plans. The COLI policies have a combined net death benefit value of approximately \$193 million at September 30, 2010. The net cash surrender value of these policies (which is the cash amount the Company would receive if it voluntarily terminated the policies) is approximately \$66 million at September 30, 2010 and is included in the caption "Other property and investments" on the balance sheet. Cash surrender values are directly influenced by the investment portfolio underlying the insurance policies. This portfolio includes both equity and fixed income (mutual fund) investments. As a result, generally the cash surrender value (but not the net death benefit) moves up and down consistent with the movements in the broader stock and bond markets. Current tax regulations provide for tax-free treatment of life insurance (death benefit) proceeds. Therefore, the changes in the cash surrender value components of COLI policies as they progress towards the ultimate death benefits are also recorded without tax consequences. Currently, the Company intends to hold the COLI policies for their duration and purchase additional policies as necessary.

*Weather and Conservation.* The rate structures in each of Southwest's three states provide varying levels of protection from risks that drive operating margin volatility, particularly weather risk and conservation efforts. Southwest's exposure to these risks on operating margin is largely limited to its Arizona operating areas as both Nevada and California operations are now under decoupled rate structures. During the first nine months of 2010, weather had a positive influence on operating margin as temperatures in Arizona were relatively normal, whereas, in the first nine months of 2009, the estimated weather impact on operating margin was a reduction of \$17 million.

Additionally, throughout 2009 Southwest experienced a decline in consumption over and above the more typical impacts of conservation from improvements in new construction practices and energy efficient appliances. This excess decline was attributed to the impact of the difficult economic environment and, in particular, vacant homes. Southwest continues to note an excessive number of vacant homes as compared to historical levels. Consequently, further economic-related declines are possible. Southwest continues to work with Arizona regulators on decoupling initiatives to mitigate the impacts of declining consumption.

*Customer Growth.* Southwest completed 18,000 first-time meter sets over the last twelve months. These meter sets led to 17,000 net additional active customers. Southwest continues to project net customer growth of 1% or less for the year.

*Liquidity.* Southwest believes its liquidity position remains strong. Southwest has a \$300 million credit facility maturing in May 2012, \$150 million of which is designated for working capital needs. The facility is provided through a consortium of eight major banking institutions. Usage of the facility was minimal during the third quarter of 2010 and there was no balance outstanding at September 30, leaving the entire \$300 million available for long-term and working capital needs. The lower usage was primarily due to existing cash reserves, typical reduced third quarter gas purchase requirements, natural gas prices that were relatively stable, and gas cost related rate mechanisms that favorably impacted operating cash flows. The current slowdown in housing construction has also allowed Southwest to fund construction expenditures primarily with internally generated cash.

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## Results of Natural Gas Operations

### Quarterly Analysis

|   | Three Months Ended<br>September 30, |                    |
|---|-------------------------------------|--------------------|
|   | 2010                                | 2009               |
|   | (Thousands of dollars)              |                    |
| Gas operating revenues                                | \$ 213,893                          | \$ 235,020         |
| Net cost of gas sold                                  | 81,303                              | 104,518            |
| <b>Operating margin</b>                               | <b>132,590</b>                      | <b>130,502</b>     |
| Operations and maintenance expense                    | 86,746                              | 85,773             |
| Depreciation and amortization                         | 42,574                              | 41,401             |
| Taxes other than income taxes                         | 10,006                              | 8,265              |
| <b>Operating income (loss)</b>                        | <b>(6,736)</b>                      | <b>(4,937)</b>     |
| Other income (deductions)                             | 6,704                               | 3,952              |
| Net interest deductions                               | 19,115                              | 18,904             |
| Net interest deductions on subordinated debentures    |                                     | 1,933              |
| <b>Income (loss) before income taxes</b>              | <b>(19,147)</b>                     | <b>(21,822)</b>    |
| Income tax expense (benefit)                          | (10,334)                            | (10,455)           |
| <b>Contribution to consolidated net income (loss)</b> | <b>\$ (8,813)</b>                   | <b>\$ (11,367)</b> |

Contribution from natural gas operations improved by \$2.6 million in the third quarter of 2010 compared to the same period a year ago. The improvement was primarily due to an increase in other income.

Operating margin increased \$2 million in the third quarter of 2010 compared to the third quarter of 2009. Rate relief in Nevada provided \$1 million of the operating margin increase and customer growth provided \$1 million as 17,000 net new customers were added during the last twelve months.

Operations and maintenance expense increased \$1 million, or one percent, between quarters primarily due to effective cost containment efforts.

Depreciation expense increased \$1.2 million, or three percent, as a result of additional plant in service. Average gas plant in service for the current period increased \$127 million, or three percent, compared to the corresponding period a year ago.

General taxes increased \$1.7 million largely as a result of a change in Arizona property tax rates received and recognized in the third quarter of 2010, but retroactive to January 2010.

Other income increased \$2.8 million between quarters primarily due to higher COLI policy-related amounts (including death benefits). Both quarters experienced very favorable COLI cash surrender value increases due to significant upswings in the associated investment portfolio underlying the policies.

Net financing costs decreased \$1.7 million between periods primarily due to the redemption of \$100 million of Subordinated Debentures in March 2010.



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Nine-Month Analysis

|  | Nine Months Ended<br>September 30, |                  |
|--|------------------------------------|------------------|
|  | 2010                               | 2009             |
|  | (Thousands of dollars)             |                  |
| Gas operating revenues                             | \$ 1,133,671                       | \$ 1,186,870     |
| Net cost of gas sold                               | 581,294                            | 668,013          |
| <b>Operating margin</b>                            | <b>552,377</b>                     | <b>518,857</b>   |
| Operations and maintenance expense                 | 260,386                            | 257,281          |
| Depreciation and amortization                      | 127,416                            | 125,613          |
| Taxes other than income taxes                      | 29,388                             | 27,880           |
| <b>Operating income</b>                            | <b>135,187</b>                     | <b>108,083</b>   |
| Other income (deductions)                          | 997                                | 4,589            |
| Net interest deductions                            | 56,001                             | 55,617           |
| Net interest deductions on subordinated debentures | 1,912                              | 5,798            |
| <b>Income before income taxes</b>                  | <b>78,271</b>                      | <b>51,257</b>    |
| Income tax expense                                 | 25,868                             | 15,508           |
| <b>Contribution to consolidated net income</b>     | <b>\$ 52,403</b>                   | <b>\$ 35,749</b> |

Contribution to consolidated net income from natural gas operations increased by \$16.7 million in the current nine-month period as compared to the corresponding period a year ago. The improvement in contribution primarily resulted from higher operating margin, partially offset by an increase in operating expenses and a reduction in other income.

Operating margin increased \$33 million between periods. Rate relief provided approximately \$15 million of the increase, consisting of \$13 million in Nevada and \$2 million in California. Differences in heating demand caused primarily by weather variations in Arizona between periods resulted in a \$17 million operating margin increase as temperatures in the current nine-month period were relatively normal, while temperatures were significantly warmer than normal in the same period of 2009. Customer growth contributed \$1 million toward the operating margin increase.

Operations and maintenance expense increased \$3.1 million, or one percent, primarily due to effective cost containment efforts. The increase was mitigated by a decrease in uncollectible costs, principally in Nevada where a tracking mechanism for gas cost-related uncollectible expense is in place.

Depreciation expense increased \$1.8 million, or one percent, as a result of additional plant in service, partially offset by lower depreciation rates in the Nevada rate jurisdictions, effective June 2009. Average gas plant in service for the current period increased \$141 million, or three percent, compared to the corresponding period a year ago. This was attributable to new business, reinforcement work, franchise requirements and routine pipe replacement activities.

General taxes increased \$1.5 million primarily due to higher property tax rates in Arizona.

Other income decreased \$3.6 million between the nine-month periods of 2010 and 2009. Income related to changes in the values of COLI policies (including recognized death benefits) contributed \$5.6 million in the current-year period, while increases in cash surrender values of COLI policies during the nine-month period of 2009 contributed \$6.9 million in income, a decline of \$1.3 million. In addition, costs associated with certain Arizona non-recoverable pipe replacement work increased \$1.6 million between periods.

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Net financing costs decreased \$3.5 million between the nine-month periods of 2010 and 2009 primarily due to the redemption of the Subordinated Debentures in March 2010.

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Twelve-Month Analysis

|  | Twelve Months Ended<br>September 30, |              |
|--|--------------------------------------|--------------|
|  | 2010                                 | 2009         |
|  | (Thousands of dollars)               |              |
| Gas operating revenues                             | \$ 1,561,644                         | \$ 1,615,512 |
| Net cost of gas sold                               | 779,911                              | 884,681      |
| Operating margin                                   | 781,733                              | 730,831      |
| Operations and maintenance expense                 | 352,047                              | 339,643      |
| Depreciation and amortization                      | 168,653                              | 168,385      |
| Taxes other than income taxes                      | 38,826                               | 36,747       |
| Operating income                                   | 222,207                              | 186,056      |
| Other income (deductions)                          | 2,998                                | (2,170)      |
| Net interest deductions                            | 74,475                               | 75,902       |
| Net interest deductions on subordinated debentures | 3,845                                | 7,730        |
| Income before income taxes                         | 146,885                              | 100,254      |
| Income tax expense                                 | 50,811                               | 35,506       |
| Contribution to consolidated net income            | \$ 96,074                            | \$ 64,748    |

Contribution to consolidated net income from natural gas operations increased by \$31.3 million in the current twelve-month period as compared to the corresponding period a year ago. The increase in contribution was a result of higher operating margin, an improvement in other income, and reduced financing costs, partially offset by an increase in operating expenses.

Operating margin increased \$51 million between periods. Rate relief provided \$23 million of the increase, consisting of \$15 million in Nevada, \$5 million in Arizona, and \$3 million in California. Differences in heating demand caused primarily by weather variations between periods contributed \$29 million toward the operating margin increase as temperatures in the current period were relatively normal, while temperatures were significantly warmer than normal in the prior-year period. Customer growth contributed \$2 million in operating margin. Conservation, resulting from economic conditions and energy efficiency, negatively impacted operating margin by an estimated \$3 million.

Operations and maintenance expense increased \$12.4 million, or four percent, primarily due to higher employee-related and general costs. The increase was mitigated by a decrease in uncollectible costs, principally in Nevada where a tracking mechanism for gas cost-related uncollectible expense has been in place since November 2009.

Depreciation expense increased \$268,000 as a result of additional plant in service, partially offset by lower depreciation rates in the California (\$3 million annualized reduction) and Nevada (\$2.3 million annualized reduction) rate jurisdictions effective in January and June 2009, respectively. Average gas plant in service for the current period increased \$148 million, or three percent, compared to the corresponding period a year ago. This was attributable to new business, reinforcement work, franchise requirements and routine pipe replacement activities.

General taxes increased \$2.1 million primarily due to higher property tax rates in Arizona.

Other income (deductions) improved \$5.2 million between the twelve-month periods of 2010 and 2009. This was primarily due to \$7.2 million in income related to the Company's COLI policies (including recognized death benefits) in the current period compared to \$1.2 million in income in the prior-year period. Costs associated with certain Arizona non-recoverable pipe replacement work increased \$1.1 million between periods.

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Net financing costs decreased \$5.3 million between the twelve-month periods of 2010 and 2009 primarily due to a reduction in outstanding debt, the redemption of the Subordinated Debentures, and lower interest rates associated with Southwest's commercial credit and other variable-rate facilities.



**Results of Construction Services**

*Quarter.* Contribution to consolidated net income from construction services for the three months ended September 30, 2010 increased \$920,000 compared to the same period of 2009. Despite the general slowdown in the new housing market and the current economic environment, NPL has been able to offset reductions in new construction with additional replacement contract activity and bid work.

Revenues increased \$11.3 million when compared to the same period of the prior year primarily due to an increase in replacement construction contracts, while revenue from new construction remained at a low level. Bid projects saw a slight increase during the third quarter of 2010 in comparison to the same quarter of 2009. Construction expenses increased \$10.3 million. Gains on sales of equipment were \$138,000 and \$310,000 for the third quarters of 2010 and 2009, respectively. Depreciation expense declined \$493,000 between the quarters. During the past two years, NPL reduced its inventory of construction equipment due to the overall lower volume of construction contracts, resulting in a decline in depreciation and lower gains on sale of equipment.

*Year-to-Date.* Contribution to consolidated net income from construction services for the nine months ended September 30, 2010 increased \$1.1 million compared to the same period of 2009.

Revenues increased \$20.4 million during the first nine months of 2010 as compared to the same period of 2009 primarily due to an increase in replacement construction contracts during the second and third quarters of 2010. Construction expenses increased \$22 million due primarily to the increased work load and a decrease in gains on sales of equipment between the current and prior-year periods. Gains on sales of equipment were \$695,000 and \$2.2 million for the nine-month periods ended September 30, 2010 and 2009, respectively. Depreciation expense declined \$2.5 million between the nine-month periods due to reduced construction equipment inventory.

*Twelve Months-to-Date.* Contribution to consolidated net income from construction services for the twelve-month period of 2010 increased \$1.6 million compared to the same period of 2009.

Revenues increased \$10.5 million and construction expenses increased \$13.9 million between the twelve-month periods primarily due to the increase in replacement construction work, while depreciation expense declined \$3.6 million due to the reduction in construction equipment. Interest expense decreased \$849,000 between the twelve-month periods due to lower outstanding debt balances. Gains on sales of equipment were \$1.8 million and \$2.2 million for the twelve-month periods ended September 30, 2010 and 2009, respectively.

NPL's revenues and operating profits are influenced by weather, customer requirements, mix of work, local economic conditions, bidding results, and the equipment resale market. Generally, revenues and profits are lowest during the first quarter of the year due to unfavorable winter weather conditions. Operating results typically improve as more favorable weather conditions occur during the summer and fall months.

**Rates and Regulatory Proceedings**

*Arizona General Rate Case.* The Company anticipates filing its next general rate case with the Arizona Corporation Commission (ACC) in November 2010. While details of the filing are still being finalized at this time, the Company anticipates requesting an increase in operating revenues to reflect increased operating costs, investments in infrastructure, and costs of capital, as well as margin attrition due to decreased average usage by customers.

The upcoming rate case filing will also request a rate structure to decouple recovery of the Company's fixed costs from fluctuations in usage, both higher and lower, and enable the Company to aggressively advocate for increased energy efficiency by its customers, as discussed in the *Arizona energy efficiency and decoupling proceeding* section below. The pursuit of increased energy efficiency by customers will be supported by requested approval of a detailed demand side management implementation plan; the plan will recommend new and expanded conservation and energy efficiency programs and budgets. A decision by the Commission is expected in early 2012.

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*California General Rate Cases.* Effective January 2009, Southwest received general rate relief in California. The California Public Utilities Commission ( CPUC ) decision authorized an overall increase of \$2.8 million in 2009 with an additional \$400,000 deferred to 2010. In addition, attrition increases were approved to be effective for the years 2010-2013 of 2.95% in southern and northern California and approximately \$100,000 per year for the South Lake Tahoe rate jurisdiction. In October 2009, Southwest filed for attrition increases which were approved effective January 2010 in the amount of \$2.7 million (including the \$400,000 previously deferred).

*FERC General Rate Case.* Paiute Pipeline Company ( Paiute ), a subsidiary of the Company, filed a general rate case with the FERC in February 2009. The filing fulfilled an obligation from the settlement agreement reached in the 2005 Paiute general rate case. The application requested an increase in operating revenues of approximately \$3.9 million. In accordance with FERC requirements, the requested new rates went into effect in September 2009, subject to refund. In April 2010, the FERC approved an offer of settlement from Paiute which resolved all issues related to its general rate case. The settlement provided for an increase of approximately \$900,000 in Paiute s annual operating income. Paiute had been accruing a liability for the difference between the requested rates and the anticipated settlement rates since September 2009 and refunded the over-collected amounts in the second quarter of 2010.

*Arizona energy efficiency and decoupling proceeding.* The ACC convened a series of workshops starting in 2009 to evaluate rate and regulatory incentives and establish standards to promote energy efficiency and conservation for utility customers. In conjunction with these workshops, Southwest and other interested parties submitted proposed regulations to the ACC in June 2009. Rate designs which would decouple revenues from customer usage were the topic of much discussion in the proceeding, and were incorporated in several of the parties draft regulations. In August 2010, the ACC issued a Notice of Proposed Rulemaking on Gas Energy Efficiency, which adopted an energy efficiency requirement for Arizona s gas utilities, including Southwest, to achieve cumulative annual energy savings of six percent by December 2020. In October 2010, the Chairman of the ACC issued a draft Policy Statement, which if approved by the full Commission, would allow utilities to file proposals for alternative mechanisms to address the financial disincentives to utilities of energy efficiency, including revenue per customer decoupling, in their next general rate case. A full commission vote on this matter may occur by year-end.

### PGA Filings

The rate schedules in all of Southwest s service territories contain provisions that permit adjustments to rates as the cost of purchased gas changes. These deferred energy provisions and purchased gas adjustment clauses are collectively referred to as PGA clauses. Differences between gas costs recovered from customers and amounts paid for gas by Southwest result in over- and under-collections. At September 30, 2010, over-collections in all service territories resulted in a liability of \$153 million on the Company s balance sheet. Filings to change rates in accordance with PGA clauses are subject to audit by state regulatory commission staffs. PGA changes impact cash flows but have no direct impact on profit margin. However, gas cost deferrals and recoveries can impact comparisons between periods of individual income statement components. These include Gas operating revenues, Net cost of gas sold, Net interest deductions, and Other income (deductions).

As of September 30, 2010, December 31, 2009, and September 30, 2009, Southwest had the following outstanding PGA balances payable (millions of dollars):

|                 | September 30, 2010 | December 31, 2009 | September 30, 2009 |
|-----------------|--------------------|-------------------|--------------------|
| Arizona         | \$ (56.7)          | \$ (33.2)         | \$ (38.8)          |
| Northern Nevada | (12.9)             | 1.2               | (3.5)              |
| Southern Nevada | (77.9)             | (60.0)            | (54.7)             |
| California      | (5.0)              | 2.0               | (5.9)              |
|                 | \$ (152.5)         | \$ (90.0)         | \$ (102.9)         |

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*Nevada Annual Rate Adjustment (ARA) Application.* In June 2010, Southwest filed its annual ARA application with the Public Utilities Commission of Nevada (PUCN) to establish revised Deferred Energy Account Adjustment (DEAA) rates (in addition to adjustments to the Variable Interest Expense Recovery, the Uncollectible Gas Cost Expense rates, and other rate-related items). In October 2010, Southwest filed a stipulation to settle all issues in this case, which was approved by the PUCN effective November 2010. Accordingly, this settlement reduces customer DEAA rates and is designed to result in decreases over the fourteen-month period ending December 2011 of \$42.1 million, or 9.58%, in southern Nevada and \$11.9 million, or 9.75%, in northern Nevada, which should allow the Company to significantly decrease the Nevada PGA balances.

### **Capital Resources and Liquidity**

Cash on hand and cash flows from operations have generally been sufficient over the past two years to provide for net investing activities (primarily construction expenditures and property additions). During the past two years, the Company has been able to use cash inflows to reduce the net amount of debt outstanding (including short-term borrowings). The Company's capitalization strategy is to maintain an appropriate balance of equity and debt (including short-term borrowings as necessary).

To facilitate future financings, the Company has a universal shelf registration statement providing for the issuance and sale of registered securities from time to time, which may consist of secured debt, unsecured debt, preferred stock, or common stock. The number and dollar amount of securities issued under the universal shelf registration statement, which was filed with the SEC and automatically declared effective in December 2008, will be determined at the time of the offerings, if any, and presented in the applicable prospectuses.

#### *Cash Flows*

*Operating Cash Flows.* Cash flows provided by consolidated operating activities decreased \$3.2 million in the first nine months of 2010 as compared to the same period in 2009. The primary drivers of the change were temporary fluctuations in working capital components partially offset by an increase in net income between periods.

*Investing Cash Flows.* Net cash used in consolidated investing activities decreased \$34.7 million in the first nine months of 2010 as compared to the same period in 2009. The decrease was primarily due to reductions in construction expenditures and equipment purchases, a result of the new housing market slowdown. The current period also includes cash inflows from the draw-down of restricted funds associated with a previous industrial development revenue bond issuance.

*Financing Cash Flows.* Cash used in consolidated financing activities increased \$83.4 million during the first nine months of 2010 as compared to the same period in 2009 primarily due to debt repayments, including the redemption of the Subordinated Debentures. Dividends paid increased in the first nine months of 2010 as compared to 2009 as a result of a quarterly dividend increase and an increase in the number of shares outstanding.

The capital requirements and resources of the Company generally are determined independently for the natural gas operations and construction services segments. Each business activity is generally responsible for securing its own financing sources. The capital requirements and resources of the construction services segment are not material to the overall capital requirements and resources of the Company.

#### *Gas Segment Construction Expenditures, Debt Maturities, and Financing*

During the twelve-month period ended September 30, 2010, construction expenditures for the natural gas operations segment were \$174 million. Approximately 38 percent of these expenditures represented new construction and the balance represented costs associated with routine replacement of existing transmission, distribution, and general plant. Cash flows from operating activities of Southwest were \$375 million which provided sufficient funding for construction expenditures and dividend requirements of the natural gas operations segment.

Southwest estimates natural gas segment construction expenditures during the three-year period ending December 31, 2012 will be approximately \$570 million. During the three-year period, cash flows from operating activities of Southwest are expected to provide sufficient funding for the gas operations total construction expenditures and dividend requirements. During the three-year period, the Company expects to raise \$8 million to \$10 million from its various common stock programs. Any cash requirements not met by operating activities are expected to be provided by existing credit facilities and/or other external financing sources. The timing, types, and amounts of these additional external

financings will be dependent on a number of factors, including conditions in the

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capital markets, timing and amounts of rate relief, growth levels in Southwest's service areas, and earnings. These external financings may include the issuance of both debt and equity securities, bank and other short-term borrowings, and other forms of financing.

In March 2010, the Company redeemed the \$100 million, 7.70% Subordinated Debentures (Preferred Securities) at par. The Company facilitated the redemption using existing cash and borrowings under the \$300 million credit facility.

Southwest has \$200 million of long-term debt maturing in February 2011. The Company currently intends to provide funding for this maturing obligation through the issuance of new debt, or availability under the Company's \$300 million credit facility. Southwest also has \$200 million of long-term debt maturing in May 2012 and plans to fund that obligation by issuing \$200 million of debentures by the maturity date. In connection with the planned debt issuances, the Company, in January 2010, entered into two forward-starting interest rate swap (FSIRS) agreements to hedge the risk of interest rate variability during the period leading up to the planned issuances. See **Note 4 Derivatives and Fair Value Measurements** for more information on the FSIRS.

During the nine months ended September 30, 2010, the Company issued shares of common stock for exercised stock options and through the Dividend Reinvestment and Stock Purchase Plan (DRSPP), raising approximately \$7 million. Beginning in the second quarter of 2010, the Company ceased issuing new common stock under the DRSPP (the DRSPP will purchase shares on the open market as needed).

In September 2010, the Small Business Jobs Act of 2010 (Act) was signed into law. This Act provides a 50 percent bonus tax depreciation deduction for qualified property acquired or constructed and placed in service in 2010. Based on forecasted qualifying construction expenditures, Southwest estimates the bonus depreciation deduction will defer the payment of approximately \$15 million of federal income taxes during 2010.

#### *Dividend Policy*

The Company has a common stock dividend policy which states that common stock dividends will be paid at a prudent level that is within the normal dividend payout range for its respective businesses, and that the dividend will be established at a level considered sustainable in order to minimize business risk and maintain a strong capital structure throughout all economic cycles. In February 2010, the Board of Directors increased the quarterly dividend payout from 23.75 cents to 25 cents per share, effective with the June 2010 payment.

#### *Liquidity*

Liquidity refers to the ability of an enterprise to generate sufficient amounts of cash through its operating activities and external financing to meet its cash requirements. Several general factors (some of which are out of the control of the Company) that could significantly affect liquidity in future years include variability of natural gas prices, changes in the ratemaking policies of regulatory commissions, regulatory lag, customer growth in the natural gas segment's service territories, Southwest's ability to access and obtain capital from external sources, interest rates, changes in income tax laws, pension funding requirements, inflation, and the level of Company earnings. Natural gas prices and related gas cost recovery rates have historically had the most significant impact on Company liquidity.

Pension funding requirements for the Southwest pension plan during calendar-year 2010 were initially estimated at \$24 million. In October 2010, Southwest voluntarily contributed an incremental \$30 million to the pension plan in order to improve the plan's funded status. Funds for the contribution were provided by cash on hand and borrowings under the Company's credit facility.

On an interim basis, Southwest generally defers over- or under-collections of gas costs to PGA balancing accounts. In addition, Southwest uses this mechanism to either refund amounts over-collected or recoup amounts under-collected as compared to the price paid for natural gas during the period since the last PGA rate change went into effect. At September 30, 2010, the combined balance in the PGA accounts totaled an over-collection of \$153 million. See **PGA Filings** for more information on recent regulatory filings.

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The Company has a \$300 million credit facility that expires in May 2012. Southwest has designated \$150 million of the \$300 million facility as long-term debt and the remaining \$150 million for working capital purposes. At September 30, 2010, no borrowings were outstanding on either the long-term or short-term portion of the credit facility. The short-term portion of the facility was not used during the third quarter of 2010. Usage of the long-term portion was minimal. The credit facility can be used as necessary to meet liquidity requirements, including temporarily financing under-collected PGA balances, if any, or meeting the refund needs of over-collected balances. This credit facility has been, and is expected to continue to be, adequate for Southwest's working capital needs outside of funds raised through operations and other types of external financing. Management believes the Company currently has a solid liquidity position.

The following table sets forth the ratios of earnings to fixed charges for the Company. Due to the seasonal nature of the Company's business, these ratios are computed on a twelve-month basis:

|                                    | For the Twelve Months Ended |                      |
|------------------------------------|-----------------------------|----------------------|
|                                    | September 30,<br>2010       | December 31,<br>2009 |
| Ratio of earnings to fixed charges | 2.87                        | 2.46                 |

Earnings are defined as the sum of pretax income plus fixed charges. Fixed charges consist of all interest expense including capitalized interest, one-third of rent expense (which approximates the interest component of such expense), and net amortized debt costs.

#### *Credit Rating Upgrades*

In April 2009, Standard & Poor's Ratings Services (S&P) upgraded the Company's unsecured long-term debt ratings from BBB- (with a positive outlook) to BBB (with a stable outlook). In April 2010, S&P affirmed the BBB rating and revised the Company's outlook to positive. S&P cited the Company's stronger financial performance and an improved debt to capital ratio. S&P debt ratings range from AAA (highest rating possible) to D (obligation is in default). The S&P rating of BBB indicates the issuer of the debt is regarded as having an adequate capacity to pay interest and repay principal.

In May 2010, Moody's Investors Service, Inc. (Moody's) upgraded the Company's senior unsecured debt rating to Baa2 from Baa3 (the outlook remains stable). Moody's cited improvements in the Company's cash flow credit metrics and generally robust financial results in 2009. Moody's applies a Baa rating to obligations which are considered medium grade obligations with adequate security. A numerical modifier of 1 (high end of the category) through 3 (low end of the category) is included with the Baa to indicate the approximate rank of a company within the range.

In June 2010, Fitch, Inc. (Fitch) upgraded the Company's rating outlook to positive from stable. Fitch affirmed the Company's unsecured long-term debt rating at BBB. Fitch debt ratings range from AAA (highest credit quality) to D (defaulted debt obligation). The Fitch rating of BBB indicates a credit quality that is considered prudent for investment.

#### **Forward-Looking Statements**

This quarterly report contains statements which constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 (Reform Act). All statements other than statements of historical fact included or incorporated by reference in this quarterly report are forward-looking statements, including, without limitation, statements regarding the Company's plans, objectives, goals, projections, strategies, future events or performance, and underlying assumptions. The words may, will, should, could, expect, plan, anticipate, be estimate, predict, continue, forecast, and similar words and expressions are generally used and intended to identify forward-looking statements. For example, statements regarding operating margin earned, customer growth, the composition of our customer base, price volatility, seasonal patterns, the Company's COLI strategy, risks and costs associated with having non-performing assets associated with new homes, timing of improvements in the housing market, amount and timing for completion of estimated future construction expenditures, forecasted operating cash flows and results of operations, funding sources of cash

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requirements, sufficiency of working capital, bank lending practices, the Company's views regarding its liquidity position, ability to raise funds and receive external financing, the amount and form of any such financing, future financing cost savings, the effectiveness of forward-starting interest rate swap agreements in hedging against changing interest rates, liquidity, the impact of the application of certain accounting standards, statements regarding future gas prices, gas purchase contracts and derivative financial interests, the impact of certain legal proceedings, and the timing and results of future rate hearings and approvals are forward-looking statements. All forward-looking statements are intended to be subject to the safe harbor protection provided by the Reform Act.

A number of important factors affecting the business and financial results of the Company could cause actual results to differ materially from those stated in the forward-looking statements. These factors include, but are not limited to, the impact of weather variations on customer usage, customer growth rates, conditions in the housing market, our ability to recover costs through our PGA mechanisms, the effects of regulation/deregulation, the timing and amount of rate relief, changes in rate design, changes in gas procurement practices, changes in capital requirements and funding, the impact of conditions in the capital markets on financing costs, changes in construction expenditures and financing, renewal of franchises, easements and rights-of-way, changes in operations and maintenance expenses, effects of pension expense forecasts, accounting changes, future liability claims, changes in pipeline capacity for the transportation of gas and related costs, acquisitions and management's plans related thereto, competition, and our ability to raise capital in external financings. In addition, the Company can provide no assurance that its discussions regarding certain trends relating to its financing and operations and maintenance expenses will continue in future periods. For additional information on the risks associated with the Company's business, see **Item 1A. Risk Factors** and **Item 7A. Quantitative and Qualitative Disclosures About Market Risk** in the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

All forward-looking statements in this quarterly report are made as of the date hereof, based on information available to the Company as of the date hereof, and the Company assumes no obligation to update or revise any of its forward-looking statements even if experience or future changes show that the indicated results or events will not be realized. **We caution you not to unduly rely on any forward-looking statement(s).**

#### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

See **Item 7A. Quantitative and Qualitative Disclosures about Market Risk** in the Company's 2009 Annual Report on Form 10-K filed with the SEC. No material changes have occurred related to the Company's disclosures about market risk.

#### **ITEM 4. CONTROLS AND PROCEDURES**

The Company has established disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) that are designed to provide reasonable assurance that information required to be disclosed in reports filed or submitted under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms and to provide reasonable assurance that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosures. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and benefits of controls must be considered relative to their costs. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or management override of the control. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and may not be detected.

Based on the most recent evaluation, as of September 30, 2010, management of the Company, including the Chief Executive Officer and Chief Financial Officer, believe the Company's disclosure controls and procedures are effective at attaining the level of reasonable assurance noted above.

There have been no changes in the Company's internal controls over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act) during the third quarter of 2010 that have materially affected, or are likely to materially affect, the Company's internal controls over financial reporting.





**PART II - OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

The Company is named as a defendant in various legal proceedings. The ultimate dispositions of these proceedings are not presently determinable; however, it is the opinion of management that none of this litigation individually or in the aggregate will have a material adverse impact on the Company's financial position or results of operations.

**ITEMS 1A. through 3.** None.

**ITEM 4. REMOVED AND RESERVED**

**ITEM 5.** None.

**ITEM 6. EXHIBITS**

The following documents are filed, or furnished, as applicable, as part of this report on Form 10-Q:

- Exhibit 10.01 - Appendix A to Southwest Gas Corporation 2006 Restricted Stock/Unit Plan, amended and restated May 7, 2008.
- Exhibit 12.01 - Computation of Ratios of Earnings to Fixed Charges.
- Exhibit 31.01 - Section 302 Certifications.
- Exhibit 32.01 - Section 906 Certifications.
- Exhibit 101 - The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2010, formatted in Extensible Business Reporting Language (XBRL): (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Income, (iii) the Condensed Consolidated Statements of Cash Flows, and (iv) the Notes to the Condensed Consolidated Financial Statements, tagged as blocks of text.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: November 9, 2010

Southwest Gas Corporation  
(Registrant)

/s/ Gregory J. Peterson  
Gregory J. Peterson  
Vice President/Controller and Chief Accounting Officer