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SWX.N - Q4 2023 Southwest Gas Holdings Inc Earnings Call

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PRESENTATION

Operator

Welcome to the Southwest Gas Holdings fourth quarter and year end 2023 earnings conference call. Today's call is being recorded and our webcast is live. A replay will be available later today and for the next 12 months on the Southwest Gas Holdings website. (Operator Instructions)

I will now turn the call over to Justin Forsberg, Vice President of Investor Relations of Southwest Gas Holdings. Please go ahead.

Justin Forsberg - *Southwest Gas Holdings Inc - Vice President, Investor Relations*

Thank you, Rocco, and hello everyone. We appreciate you joining our call. This morning we issued and posted Southwest Gas Holdings website, our fourth quarter and full year 2023 earnings release and the associated Form 10-K. The slide accompanying today's call are also available on Southwest Gas Holdings website. We'll refer to those slides by number throughout the call today.

Please note that on today's call, we will address certain factors that may impact this year's earnings and provide some longer-term guidance. Some of the information that will be discussed today contains forward looking statements. These statements are based on management's assumptions on what the future holds, but are subject to several risks and uncertainties, including uncertainties surrounding the impacts future economic conditions and regulatory approvals.

This cautionary note, as well as in note regarding non-GAAP measures, is included on slides 2 and 3 of this presentation. Today's press release and our filings with the Securities and Exchange Commission, which we encourage you to review, these risks and uncertainties may cause actual results to differ materially from statements made today.

We caution you against placing undue reliance on any forward-looking statements, and we assume no obligation to update any such statement. As shown on slide 4 on today's call, we have Karen Haller, President and CEO of Southwest Gas Holdings; Rob Stefani, Chief Financial Officer of Southwest Gas Holdings; Justin Brown, President of Southwest Gas Corporation; and Bill Fehrman, President and CEO of Centuri Group. Along with other members of the management team available to answer your questions during the Q&A portion of the call today.

I'll now turn the call over to Karen.

Karen Haller - *Southwest Gas Holdings Inc - President & Chief Executive Officer*

Thanks, Justin. Thank you for joining us today to discuss Southwest Gas Holdings fourth quarter and full year results. Turning to slide 5, we are making good progress on our transformational strategy of returning Southwest Gas to its core foundation as the premier fully regulated natural gas utility, we achieved significant milestones throughout 2023 to position the utility for strength and success while also advancing the separation of Centuri into a stand-alone utility infrastructure services leader.

Notably, we made progress on the regulatory strategy at Southwest during the year and delivered record full year results, which were above our expectations. Customer growth and demand remains strong, and the entire Southwest Gas team is acutely focused on safely addressing the needs of our customers, investing in the communities we serve and delivering value for our shareholders.

We are strategically deploying capital and investing in our operations, so that we can meet the demand for safe, reliable and affordable energy solutions, while also working constructively with our regulators and legislators to complement our strong organic rate base growth.

We are confident in our momentum at Southwest, which delivered an 8.2% ROE in 2023, a 220 basis point improvement over 2022. Our confidence is also demonstrated by our expected 10% to 12% net income growth rate from 2024 to 2026.

While the nature of expected revenue increases, from rate cases will cause net income growth to be nonlinear over the forecast period. We are confident in our guidance. We expect to benefit from our refreshed rate structures to catch up with the historic inflationary environment we have experienced and, the significant system investments we have made for the benefit of our customers over the past few years.

Our confidence in our future is further demonstrated by an increase in our expected rate base CAGR over the same period in the range of 6.5% to 7.5%, and our commitment to maintaining a strong investment grade balance sheet and competitive dividend.

Additionally, Centuri has seen improved margins throughout the year as the team executed on their core utility infrastructure services lines of business and overcame much of the previous cost and supply chain headwind that have been faced during 2022.

As you can see on slide 6, we made excellent progress on our 2023 strategic priorities, and we are on track to achieve our 2024 priorities. 2023 was a year of achieving milestone after milestone, starting with the closing of the MountainWest sale a year ago and the completion of our [RAS/RES] process with the credit rating agencies.

The successful execution of our financing plan to get us through the balance sheet impacts of historic natural gas prices at the utility, along with eventual regulatory approvals to collect those costs from customers were significant achievements. Also at the utility, we filed a rate case in Nevada and worked through a considerable effort to identify and prioritize initiative to build an optimization playbook. And finally, we made substantial progress toward the separation of Centuri.

We have already made notable strides in 2024 and with the onboarding of new Centuri leadership, our plan to separate Centuri into an independent utility infrastructure services company, remains on track as we seek to unlock value for Southwest Gas shareholders. As you can appreciate, we are in a quiet period with respect to the intended IPO, and we are not in a position to provide specific details on our process. However, we are continuing to make progress.

Following execution of the expected IPO, Southwest Gas Holdings may ultimately separate the business through a series of sell-downs or share exchanges or depending on market conditions, we could distribute the balance of Centuri shares to Southwest Gas Holdings shareholders through a spin.

Any of these would follow, any required lockup period associated with an IPO. Because of the successful execution of an IPO with sell-downs, our share exchange is contingent on market and other conditions, we continue to preserve potential for a tax-free spend, but we expect our significant net operating loss balance could serve as an offset to taxable transaction. We remain committed to separating Centuri, and we believe we have taken the appropriate steps and actions that will benefit all shareholders.

At the utility we continue to execute on our business plan and regulatory strategy. We are nearing the end of the process for establishing new rates in Nevada, which we expect to be in place in April. We have filed refresh rates in Arizona, and we'll be filing with for Great Basin shortly and to refresh rates in California later this year.

We also continue our focus on utility optimization as we have prioritize or identified initiatives and are executing our plan. We are very pleased with our continued progress and our strategic plan is on track.

On slide 7, we highlight our strong 2023 performance at Southwest and at Centuri. We are proud to announce that we delivered record performance across the utility. We experienced another year of strong customer growth, adding more than 40,000 new meter sets in 2023, while continuing to make additional investments to ensure our system remains safe and reliable for the benefit of our customers.

We also achieved several constructive regulatory outcomes during the year. And I'm please to highlight that for the fourth consecutive year, Southwest ranked number one in customer satisfaction among business and large residential gas utilities in the West by J.D. Power. I'm so proud of our team for their excellent effort every day that has led these achievements.

At Centuri, we announced strong full year revenue and adjusted EBITDA, which resulted in adjusted EBITDA approximately $283 million. This solid performance was driven by an increase in electric infrastructure services revenues, including storm restoration services as well as sustainable energy projects.

As Bill will discuss later, Centuri continues to win new business based on the strength of its relationships and capabilities and is well positioned to play a critical role in replacement of aging electric and gas infrastructure and the continued energy transition.

Turning to slide 8, we have challenged our employees to identify opportunities for improvement and optimization. After evaluating initiatives across the organization, we have identified several initiatives that we believe will drive value and long-term improvement, this includes near term investments in systems, technology and processes such as in-sourcing and, fleet optimization. And longer-term initiatives such as modernizing, our capitalization policy and our work management system, deploying advanced mobile leaked detection and storage optimization.

I'll detail our forward-looking guidance later on this call, but we currently expect our optimization efforts lead to a flat O&M per customer spending trend over the next forecast period.

For now, I'll turn the call over to Rob, who will review our financial performance for the year.

Robert Stefani - *Southwest Gas Holdings Inc - Chief Financial Officer, Senior Vice President*

Thanks, Karen. On slide 10, we outline our earnings per share performance for the year. The companies consolidated GAAP and adjusted EPS are set are shown by each operating company. As Karren mentioned earlier, the utility and Centuri each had an excellent year. The utility generated strong net income and adjusted net income, while Centuri also produced record revenue and adjusted EBITDA.

On an adjusted basis, Southwest Gas Holdings ended 2023 with EPS of $3.36 per share, an improvement of $1.26 per share when compared to 2022, which had included 12 months of MountainWest compared to less than two months of MountainWest in 2023.

The utility performance during the year was driven by our ability to achieve constructive regulatory outcomes, lower overall non-pension related costs and an increase in interest income from the PGA. We also saw unexpected increases in company-owned life insurance, which are difficult to predict and were more than $5 million above the upper end of our guided range.

In the fourth quarter, higher than expected COLI results, lower OEM expenses and lower income tax expense related to higher excess accumulated deferred income taxes resulted in full year 2023, utility net income above what we had forecasted last November. At Centuri, we continued to see significant improvements in GAAP and adjusted earnings. We increased core electric infrastructure services revenues, continued to advance offshore wind projects and generated margin improvement throughout the year as a resulted improved master service agreement terms.

In the appendix, we provide a reconciliation of adjustments by operating company. The vast majority of the annual adjustments relate to the Centuri separation costs, consulting fees related to utility optimization and costs associated with the impairment and sale of MountainWest that was completed in February of 2023.

Now I'll provide a walk through on the performance of each operating company.

Moving on slide 11, you will see the year over year performance drivers for our utility Southwest Gas Corporation. In 2023, Utility operating margin increased by nearly $107 million compared to last year. This improvement was driven primarily by $56 million of increased recovery on prior investments in our Arizona utility infrastructure and for the first part of the year by our previous Nevada rate change and $19 million of additional recoveries associated with regulatory account balances as well as $14 million as a result of continued customer growth throughout our service areas.

You might recall that some of the improvement year over year relates to an $8 million out of period adjustment we made in early 2023 related to net cost of gas sold that benefited 2023 earnings and is not expected to recur. The remainder of the increase in margin includes changes in miscellaneous revenue and revenue from customers outside of the decoupling mechanism, partially offset by comparably lower Arizona Vintage steel pipe and customer-owned yard line revenue.

The increase in OEM was driven by a $10 million increase in external contractor and professional consulting services costs that was primarily related to utility optimization planning efforts as well as higher labor leak survey in line locating activities as well as fuel costs. These increases were partially offset by lower service component of post-retirement benefit and legal claim related costs.

The approximate $37 million increase in depreciation, amortization and general taxes was primarily due to the corresponding 6% increase in average gas plant and service compared to 2022, along with the $19 million of increased amortization of prior investments in our Arizona utility infrastructure and other associated regulatory account balances that offsets the corresponding amount of margin improvement I mentioned a moment ago in margin.

We also saw an increase in property taxes in Arizona and California, again driven by higher plant and service. Other income increased about $78 million compared with last year, $35 million of this improvement was driven by increased interest income related to carrying costs associated with regulatory account balances largely related to the purchased gas cost recovery mechanisms.

We expect this source of income to decline by about $30 million in 2024 compared to 2023. The higher interest income earned on the elevated PGA balances was partially offset by the roughly $5 million of higher interest expenses Southwest Gas Holdings year over year.

COLI results were $16 million higher than 2022 and favorable year over year changes in non-service related components of employee post-retirement benefits improved other income by $21 million. Recall also that a nonrecurring $9 million reserve for a software project deemed nonrecoverable from utility operations was recorded in 2022 and resulted in a favorable other income variance by looking at 2023.

Interest expense at the utility increased by approximately $34 million from the prior year, primarily due to the full year impact of interest associated with senior notes issued in March 2022 and December 2022. As well as the impact of $300 million of senior notes issued in March 2023.

In addition, for part of the year, the $450 million Southwest Gas Corporation, PGA related term loan issued in January of 2023 to support gas purchases was repaid in April 2023, contributed as well to the increase. Overall, this was a significantly improved year for the utility and as Karren highlighted, resulted in ROE of approximately 8.2%.

Moving on to slide 12, we review Centuri's results and the drivers behind Centuri's annual GAAP net income. Centuri's 2023 revenues increased by approximately $139 million compared with the prior year. This increase was driven by an increase in core electric infrastructure services work, progress on offshore wind projects and improved master service agreement terms, partially offset by declines in volume with certain existing gas infrastructure services customers, primarily in Canada.

Centuri's revenues were partially offset by corresponding increases in operating expenses, driven by the higher volume of utility infrastructure services provided to customers, higher incentive compensation and increased subcontractor costs on offshore wind projects.

Additionally, Centuri saw about $36 million of increased interest expense, primarily due to higher interest rates on approximately $1 billion of outstanding variable rate borrowings that is largely associated with the Riggs Distiler acquisition. Overall, we continue to be encouraged by improved EBITDA margins at Centuri over the previous year as Bill will touch on later.

On slide 13, we have provided our 2024 financing plan for both Southwest Gas Holdings and Southwest Gas Corporation. Of note as the Centuri IPO and potential sell down of shares is expected to result in the fully consolidated Centuri at Southwest Gas Holdings for much, if not all of 2024, we have included Centuri in the holdco expectation. In to the extent Centuri ceases to be consolidated in 2024, we will adjust our guidance accordingly.

In addition, we would highlight that the whole co balance sheet could improve further depending on the IPO and post IPO market condition, it divestiture of those shares results in increased cash at Southwest Gas Holdings. We expect cash flow from operations driven in part by significant cash collection of outstanding PGA balances to more than fund the entire capital expenditure program forecasted in 2024 for the utility.

In addition, based on the strength of our balance sheet and the successful refinancing efforts in 2023. We continue to anticipate very modest additional near-term equity needs during 2024, and we do not foresee any debt financing or refinancing needs at the utility in 2024.

At holdings, we reiterate our plan to target a solid investment grade balance sheet, it's important to note that in addition to our limited equity needs of approximately $150 million in the next two years, inclusive of $75 million this year expected through an ATM we have very limited refinancing needs through the end of 2026 outside of our $550 million Southwest Holdings term loan.

As we have said previously, Southwest Gas Holdings remains committed to paying a competitive dividend to our stockholders. As you can see on this slide, we plan to hold the dividend flat again in 2024, which we expect would result in a competitive payout ratio.

We will continue to balance factors such as projected capital, requirements, impacts to credit ratings, the competitiveness of the dividend yield, economic conditions and other factors, will review the dividend policy for any changes post Centuri IPO when we will have better clarity regarding the planned separation and sell-down.

Moving to slide 14, we take a look at our balance sheet strength, our commitment to maintaining an investment grade profile. On the left-hand side, we walk through net debt by operating company. When looking at the utility debt levels, we continue to highlight the PGA balance, which represents working capital that Southwest has spent for prior commodity purchases and is owed to Southwest by customers.

We expect to timely recovery of this PGA balance and earn the carrying cost on these balances as reflected in the chart in the appendix on slide 29, which provides additional detail. While I noted earlier that in 2024 interest income is expected to decline by about $30 million due to lower PGA balances, you'll see here on slide 14 at the significant collection of outstanding PGA balances from customers significantly reduces the need for us to pursue additional financing in the near term.

On the right-hand side of slide 14, we note that we had no changes to our credit ratings or outlook from the three rating agencies since the time of our third quarter earnings call, except for the Centuri downgrade by Moody's investor services in early December to BA3 from BA2 with a negative outlook. This downgrade had been expected as Moody's had previously placed Centuri under review for downgrade as credit metrics had been weaker and needed to support the higher rating.

I'll now turn the call over to Justin Brown and slide 16 to discuss the utility.

Justin Brown - *Southwest Gas Corporation - President*

Thanks Rob. There are exciting things happening in Las Vegas, Phoenix and other parts of our service area, which are driving expansions in both core and new business sectors. We added more than 40,000 first-time meter sets during 2023 and we expect to continue to benefit from strong demographic and economic growth as Phoenix and Las Vegas continue to be among the top destinations for relocation and economic development.

In Arizona, particularly in Phoenix jobs we're back to their pre-pandemic trend in 2023 and according to the Arizona Commerce Authority, expansions are occurring throughout the state. We're proud to partner with several these new large customers, including semiconductor, battery and electric vehicle manufacturers, as well as expansions among several agricultural and farming customers.

Las Vegas continues to be a prime destination for the sports, entertainment and, hospitality industry and is continuing to drive job growth in the area. Las Vegas hosted a Formula 1 race last November and Super Bowl 58 a couple of weeks ago. 2023 also saw two new casino resort openings, the opening of the sphere and the announcement of a new Oakland A's stadium.

This vast economic activity continues to translate to new customer growth. And this is reiterated by S&P Global' s projection that between 2024 and 2028 population growth in Arizona and Nevada will continue to outpace the national average. Our investments to support this population growth, combined with our investment safety and integrity management programs are the cornerstones of our $2.4 billion three-year capital expenditure program.

These types of investments have translated to double digit rate base growth since 2017, and our current capital investment plan is expected to translate to rate base growth of 6.5% to 7.5% through 2026. There are two primary drivers supporting our expected 10% to 12% utility income growth that Karen mentioned.

First are the need to refresh rates to more closely match the level of O&M expenses we're currently experiencing, and second, to start recovering over $1 billion of capital investments that will be included in our rate case proposals, which we anticipate will result in an increase in our authorized rate base of over 25%.

While we are focused on working collaboratively with our regulators to get rate through for us across each of our regulatory jurisdictions, we are equally focused and committed to continuing to find ways to collaborate with each of our regulators to improve the timeliness of the recovery of our investments. So we can continue to partner with our customers and regulators to support the economic growth in our service areas, but also to ensure the safe and reliable operation of our distribution systems.

Let's talk about some of our pending and upcoming rate cases in more detail. Starting on slide 17. We provide an update on our Nevada rate case filing, which was filed last September. We're pleased to highlight that we reached an agreement with the commission staff and the consumer advocate to settle certain issues as part of a black box statewide revenue requirement increase on and on rate design issues.

The federal revenue requirement of nearly $66 million prior to any adjustments that may be made to the company's proposed cost of capital includes, primarily a reduction in the depreciation rates from what had been proposed in our depreciation study with the reminder being a black box reduction to the company's proposed level of O&M expense.

The proposed settlement includes no reductions to our proposed increase in rate base of nearly $300 million, which reflected the various investments we've made in Nevada since our last rate case. We believe the agreed-upon level of O&M recovery more closely aligns with our current cost of service. The only remaining issues pertain to cost of capital and that hearing was completed Monday, February 26.

We anticipate a final commission decision on the proposed settlement and the cost of capital issues within the next four to six weeks and if approved for new rates to become effective sometime in April.

On slide 18, we provide an overview of our Arizona rate case, which we filed earlier this month. Similar to our Nevada filing, our $126 million request is primarily driven by the need to start recovering on investments we've made to ensure safe and reliable service to our customers, but to also update rates to reflect the recent impact inflation had on our cost structure.

The request is comprised of $40 million for changes in O&M and $36 million for changes in the cost of capital to fund our infrastructure investments. We've also requested to start recovering on more than $650 million of rate base investments we made in Arizona since our last rate case, including close to $230 million of rate base requested in the post test year period through the end of October 2024.

Our filing also includes the requested capital tracker for required safety investments that we're referring to as a system improvement benefit mechanism or SIB business designed to enhance safety, minimize regulatory lag, minimize customer impact through annual rate adjustments and potentially extend the time between general rate case filings.

If approved as filed going forward the proposed sale will allow us to start recovering annually through a surcharge, all non-revenue producing code and regulatory investments that we make each year representing approximately 40% of our Arizona capital budget.

We've been working very closely with key stakeholders over the course of the past year on developing the SIB and we believe this type of capital tracker has an acceptable way to ensure ongoing investment to support the safety and integrity of the system for the benefit of our customers while helping to provide a timely and reasonable return on that investment for our investors.

We are confident in our request, and we are proud of our efforts in Arizona as we partner with all stakeholders to support the demand for our services as economic growth continues to expand throughout the state. We anticipate a procedural schedule to be issued within the next 30 to 60 days, with new rates expected to be in place by spring of 2025.

Turning to slide 19, you'll see we're also well underway in executing on our plans to file rate cases across our other two regulatory jurisdictions. Within the next week, we plan to file a rate case at FERC fo interstate pipeline affiliate, Great Basin Gas Transmission Company that reflects just under $100 million increase in rate base with the proposed revenue increase of over $16 million and consistent with FERC rate making, we anticipate rates become effective by September, subject to refund.

We also remain on track to file our next California rate case in the third quarter. Where we anticipate a proposed increase to rate base of 60% to 70% of our currently authorized rate base of $435 million. 2024 will be a big year for us on the regulatory front and our team is focused and committed to working collaboratively with our regulators to refresh rates to reflect our current cost of service.

As demonstrated by last year's results, the whole team at the utility is moving forward with a purposeful mission to safely provide reliable, affordable and sustainable energy solutions to our customers and communities while working to improve the returns we're able to deliver to our investors.

I'll now turn the call over to Bill Fehrman, President and CEO of Centuri Group for an update on the utility infrastructure services business.

Bill Fehrman - *Centuri Group, Inc - Chielf Executive Officer & President*

Thanks, Justin, and good morning to all of you on the call. I really appreciate the chance to talk about Century and why I decided to join the company. I've been in this industry for over four decades and for the past 17 years, help lead the growth of Berkshire Hathaway Energy. I retired from BHG in October of 2023 knowing that after a short break, I would really want to dive into a new leadership opportunity.

I learned of the Centuri President and CEO position, and what tipped the scales was the chance to dive into Centuri separation from Southwest Gas and then beyond the ground floor of its new existence as a public company. These leadership opportunities do not come around very often and after meeting with Keren, Rob and members of the Southwest Board I decided to jump in with both feet, and now you see my business experience to position Century for the future.

The BHG were successful because of the operating discipline, focus on customers and cost management that was in our DNA. This is focus I intend to bring the Centuri as we build on an already strong foundation and work to grow the business. I was attracted to Centuri because of its great history, long-standing relationships with blue-chip utility customers and a strong position into take advantage of what I know is significant infrastructure spend in progress and planned in the sector that can drive long-term growth.

As I get started in this role, I'm pleased to have Greg as historic alongside me as our CFO. Greg has been acting CFO, the last several months and prior served as Centuri's Chief Accounting Officer. Greg has a comprehensive understanding of this business knows the numbers better than anybody has significant SEC reporting experience in his background and has a strong passion for what we're trying to do a Centuri. I'm very proud to have Greg as my business partner as we move Centuri forward into the future.

On slide 20, I've provided a high-level overview of the company's strategic framework for 2024. Centuries leadership team has fully embraced this new direction and are committed to achieving our objectives. One of these objectives is to successfully separate the company from Southwest and begin our journey as a stand-alone public company.

Let's focus on the framework, I believe to be a great company in gas and electric power business, you have to be great at safety. Centuri has a solid safety record, but we will continue to relentlessly push for improved performance. My goal is that every one of our employees returns home from work the same way they arrived at the office or jobsite.

Outside of safety were focused on reducing costs across all facets of the business, starting with sales, general and administrative expenses. To that end I have eliminated two corporate leadership levels, which allows me to get very close to our operating businesses.

Each of our business unit presidents now report directly to me. This restructuring will continue as we streamline our cost structure and implement a disciplined accountability model.

I've made it clear that we will allocate capital inside the company both maintenance and growth capital to those businesses that are the most profitable and well run. And we will focus on optimizing our existing contracts while aligning with our customers on their priorities.

Finally, I understand that our stakeholders will look for growth. We are focused on growing revenue and have a number of initiatives underway to grow our electric and gas businesses, while diversifying into complementary service lines.

As listed on slide 21, our core customer base consists of the highest quality electric and gas utilities, which we serve primarily under multiyear master service agreements. The average relationship length with our top 20 customers exceeds 22 years. Our diversified employee pool of more than 12,500 team members provide service in 87 locations across 43 states and 2 provinces of the US and Canada. This broad geographic reach facilitates our work with blue-chip investor-owned utilities and our 100 million customers.

With these resources, Centuri is well positioned to be a standalone strategic utility infrastructure services leader, with the scale and capabilities to meet the evolving needs of utilities and utility holding companies. As we work towards our pending corporate separation, we have the resources, capabilities and business structure to continue delivering on our growth opportunities.

On slide 22, we detail Centuri's proven track record of strong financial performance. As Karen and Rob mentioned Centuri achieved excellent revenue and adjusted EBITDA results in 2023, driven by continued strong project execution on contract awards from long-tenured client engagements. The $55 million growth in adjusted EBITDA represents a 24% annual increase, as we successfully manage through the inflationary pressures that we faced during 2022.

We are continuing to deliver growth across our operations, both through expanding our core electric and gas operations. While realizing more utility focused work in support of system modernization, and energy transition. As illustrated in the business mix charts, we continue to diversify our portfolio have a balance between electric and gas utility infrastructure service.

We also remain diversified geographically with no one reporting [or] representing more than 14% of revenue. We continuing to make significant progress on the corporate separation, and I'm very excited to be leading Centuri during this historic time of change and opportunities for the company.

With that, I'll turn it back over to Karen.

Karen Haller - *Southwest Gas Holdings Inc - President & Chief Executive Officer*

Thanks, Bill. Our 2023 results are evidence of the progress we continue to make executing our strategy and we are enthusiastic about 2024. On slide 24, we are initiating our 2024 Southwest net income guidance to be in the range of $228 million to $238 million. We are confident that strong regional economic outlook in our service territories will drive 2024 results within these guidance ranges.

Recall that Rob indicated, we had more than $15 million of benefits to 2023 in net income that are not expected to recur in 2024, which you can see on the bottom of slide 24. We expect to lose approximately $30 million in pre-tax interest income largely associated with the PGA balances as well as $6 million of COLI earnings at the midpoint of the range.

We are not expecting any further property write-downs in 2024 like the $5 million we saw associated with the sale of our old corporate headquarters in 2023. Additionally, as Rob also pointed out, we saw an $8 million out period adjustment early last year, related to net cost of gas sold that benefited 2023 earnings and is not expected to recur.

Higher expected average utility plant and service balances, along with higher amortization of regulatory assets is expected to drive higher depreciation and amortization expense, in 2024 and we expect higher pension expenses largely driven by the assumed discount rate change and slightly higher O&M. Other changes assumed are higher income from equity AFUDC driven by higher expected construction spending, and higher overall income and other general taxes.

As you can see on the slide, we expect a significant increase in gross margin driven by forecasted customer growth and a rate increase in Nevada, and all we expect these changes will provide for strong utility earnings in 2024. Partly due to expected customer growth at the utility, we are expecting 2024 utility CapEx to be approximately $830 million, which would be an increase over 2023 actuals of about $70 million.

While nearly 50% of our forecasted capital spending relates to maintaining a safe and reliable system for the benefit of all of our customers. Some of this increased 2024 CapEx, is a result of the responsibility we have to invest in our infrastructure, to meet the better-than-expected customer growth and favorable new business trends across our service territories, combined with the required investments we need to make to enhance the safety and integrity of the system.

And part of the increase is driven by our continuous improvement initiatives, which we expect to lead to future cost savings at the utility.

Looking further out, we are also providing you with our expected compounded annual growth rate for net income of 10% to 12% from 2024 through 2026. While the impact of the regulatory cycle is expected to result in somewhat lumpy net income growth over that period, our regulatory strategy and our plan to achieve a flat O&M per customer trend over the same period, are expected to be important components of our growth story. Additionally, you can find the 2024 to 2026 drivers in the appendix of our presentation on slide 30.

As Justin mentioned, our rate base compounded annual growth rate has increased to now be in the range of 6.5% to 7.5% over the same 2024 to 2026 period and we expect to invest about $2.4 billion in total of CapEx over the next three years. Due to restrictions related to the IPO process, we are not providing any Centuri guidance.

Before we open the call up to Q&A, I want to point to slide 25, and emphasize that our teams are focused on executing our strategic priorities, delivering strong financial results and providing exceptional service to our customers.

At Southwest Gas Holdings, we are confident in our path forward as a premier pure-play natural gas utility. We plan to continue delivering steady organic rate base growth through strong regional demand dynamics, as well as earnings growth through financial discipline, operational excellence and constructive regulatory relationships.

We continue to advance towards the planned separation of Centuri to create a more attractive value proposition for stockholders and delever the business organically, with healthy cash flow generation.

With that, I'd like to open the call for questions. As a reminder, we are not in a position to answer specific questions about the IPO process.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Richard Sunderland, JPMorgan. .

Richard Sunderland - *JP Morgan Securities LLC - Analyst*

Hi. Good morning. Can you hear me?

Karen Haller - *Southwest Gas Holdings Inc - President & Chief Executive Officer*

Yes, we can. Good morning, Rich.

Richard Sunderland - *JP Morgan Securities LLC - Analyst*

Great. Thank you. I appreciate all the utility detail here. I'd like to start with the cost efforts relative to this new utility outlook. How do you think about sustainability of earned returns after the current rate case cycle with this new flat O&M per customer target? And then similarly what would the SIB be worth to that earned return outlook if you're able to secure it in the rate case?

Robert Stefani - *Southwest Gas Holdings Inc - Chief Financial Officer, Senior Vice President*

Yeah Rich. So, yeah, it's a great question. Obviously, we're looking to implement rates here in 2024 for Nevada and then looking to Arizona in 2025. Given that rates will come in, in Arizona in 2025, we build to more of that run rate ROE in 2025 and beyond.

So, as Karen and I had highlighted on the call, we had an extensive amount of PGA related interest income that obviously helped with the ROE. That was the anticipated and we'll see the rate structure in Nevada and Arizona in '24 and '25 really bring us to those run rate levels of ROE.

With respect to the SIB program, I think it's obviously that was just included in the rate case and we'll have to navigate that with the commission and regulators over the course of this coming year. And we'll obviously, we'll update you and investors as we progress on that front.

Karen Haller - *Southwest Gas Holdings Inc - President & Chief Executive Officer*

And the optimization initiatives that we've talked about will help keep O&M flat and I think that will help us as well on that ROE and maintaining that as it goes forward. So, that's worked into our plan moving forward is to continue to execute on those optimization initiatives and keep O&M on a flat trend.

Richard Sunderland - *JP Morgan Securities LLC - Analyst*

Okay. Got it. And I know this goes back a little bit, but maybe a year or two years ago, you had highlighted an 8% earned ROE or being above 8% as one of the metrics in focus. Is that still where you're focused when you say run rate ROE? Or has that thinking evolved at all?

Robert Stefani - *Southwest Gas Holdings Inc - Chief Financial Officer, Senior Vice President*

Yeah. I think that certainly achieving 8% and beyond 8% we're laser focused on that between cost optimization between pursuits of regulatory strategy including that SIB tracker program. That would obviously reduce flag and benefit ROEs.

But what I think you're seeing as far as unfolding the regulatory strategy in Nevada, the cadence of the filing in Arizona, the cadence of the filing and the tracker, our focus on cost optimization efforts which will benefit ROEs in the near-term, but will also benefit customer bill in the longer term.

But all of those should lead to the continued ROE recovery at and above that 8% level. Although, we're not providing specific guidance, I think that where you're heading with your question is certainly our focus.

Richard Sunderland - *JP Morgan Securities LLC - Analyst*

Got it. Very helpful. And then for my second question, just digging into this new mechanism a little bit further. It sounds like there's been some early engagement on this process I mean in advance of the application. Could you speak a little bit more to that engagement? How this aligns with local goals around safety, any other considerations around the request and the application?

Justin Brown - *Southwest Gas Corporation - President*

Yeah. Rich, it's Justin. How are you doing? Yeah. We spent a concerted amount of time working with the Pipeline Safety division at the Arizona Corporation Commission bringing them out, sharing information regarding our system, doing demonstrations that are off centers, just educating them on the challenges we have with our system, right and focused on specific pipe types and that kind of evolved to really kind of just all code and regulatory.

And so, I think it's been a very collaborative process, where we've tried to solicit their feedback on things that they might be comfortable with, based on things they've approved for water companies years ago versus some of the things they've done more recently on some of the electric generation mechanism. So again, we're just -- we're trying to work with them collaboratively on ways to minimize regulatory lag.

And we're somewhat indifferent on what that looks like as much as trying to find a path forward to make some incremental improvement. We think this mechanism really strikes that balance.

Richard Sunderland - *JP Morgan Securities LLC - Analyst*

Got it. Appreciate the color. And thanks for the time today.

Robert Stefani - *Southwest Gas Holdings Inc - Chief Financial Officer, Senior Vice President*

Thanks, Rich.

Operator

Julien Dumoulin-Smith, Bank of America.

Julien Dumoulin-Smith - *Bank of America - Analyst*

Hey, good morning, congrats Bill on joining here. Maybe just following up on the last question a little bit, just to start on that front. I mean, I hear you guys on the SIB effort I'd be curious, how do you think about the efforts to foot driven by the commission around forward-looking mechanisms here?

I get it's not quite the same thing, gets at the broader subject of rate lag. How do you think about that pairing up, maybe not necessarily in the current instance because as you think about future efforts, maybe how -- what is reflected ultimately as you think about this 10% to 12% CAGR in terms of earned returns across jurisdictions in the '26 timeframe? But really emphasis on the ACC efforts on reducing lag via perhaps other forward-looking mechanisms.

Justin Brown - *Southwest Gas Corporation - President*

Yeah, Julien, it's Justin. And we've talked a lot about this over the last year and some of the commentary coming from the ACC and their sincere commitment to try to make improvements in that regard. Obviously, last year Commissioner Myers opened a docket to look at that. I think just recently they announced a workshop that will happen next month.

So again, I think that's great progress. But to your point, the timing of which we've got a rate case pending right now. We need to find a way to kind of bridge those two. And so, that's how we look at this mechanism as a way to kind of help.

And then we'll continue to participate and work with them on around education efforts different ideas about things that we can do structurally in Arizona to help whether that be through future test year, constructs, whether it be through a formula rate making. I think there's a lot of different opportunities.

And again, we're somewhat agnostic to the types of mechanisms or the structure as much as, hey let's work together on making incremental improvement because I think there's a lot of opportunity.

Julien Dumoulin-Smith - *Bank of America - Analyst*

Yeah. But maybe the punch line is given the time line of the hearings and the present case I mean even for '26 that might be a little ambitious to really have that the full extent of those benefits reflected, right? But maybe it'd be '27 onwards by the time you actually get a rate case.

Justin Brown - *Southwest Gas Corporation - President*

Yeah, correct. You're exactly right.

Julien Dumoulin-Smith - *Bank of America - Analyst*

Excellent. And just clarifying a little bit further, earned returns by jurisdiction or as much commentary you can provide? I mean, obviously, the 10% to 12% net income CAGR is better than the updated and improved rate base CAGR of roughly 7%. How do you think about just what's reflected in this, call it medium-term 2026 target, if you can speak a little bit to that, and obviously kudos on progress outside of Arizona including Nevada here?

Robert Stefani - *Southwest Gas Holdings Inc - Chief Financial Officer, Senior Vice President*

Yeah, Julien great question. The differential between net income growth and the rate base growth clearly driven by regulatory outcomes. I think you're seeing us get in for rate cases within that period so that's why the net income growth associated off of the 2024 base year net income is outpacing the rate base growth.

Obviously these are always significantly impacted in those interim periods. But by 2026 we've got the run rates bill impacts and whatnot associated with Nevada and Arizona filings and having been fully settled by them.

Julien Dumoulin-Smith - *Bank of America - Analyst*

Excellent. And lastly if I can, I mean, Bill I know a new role for you and obviously great precedent that you're coming from and having engaged with some of the large utilities in the country here. How do you think about the strategy and any enhanced elements that you could bring to the Centuri business?

Again I get that this is a little difficult to comment too much. But as best you can opine on how you think about expanding the scope and or improving the efforts underway already. I'd love to hear.

Bill Fehrman - *Centuri Group, Inc - Chielf Executive Officer & President*

Sure. Well, clearly I have a lot of relationships across the industry and we'll use those to reach out to those companies and look for opportunities to grow. And then with just the various amounts of infrastructure improvements that are going to go on across the country there's very clear opportunity there for us to engage and really go much further than that probably isn't possible right now.

But I think if anyone looks at the landscape, it's very clear that there's massive amounts of infrastructure spending that's going to go on and we're going to try very hard to take a good share of that.

Julien Dumoulin-Smith - *Bank of America - Analyst*

Got it. I'll leave it there. Look forward to chatting more. All the best guys.

Bill Fehrman - *Centuri Group, Inc - Chielf Executive Officer & President*

Thanks Julien.

Operator

Ryan Levine, Citi.

Ryan Levine - *Citigroup, Inc - Analyst*

Good morning. I appreciate the added guidance in terms of longer-term earnings outlook for the core utility recognizing there's ongoing rate proceedings in your jurisdictions. Maybe could you speak to where -- what would put you towards the higher and lower end of the ranges outside of maybe cost of capital and rates of that?

Robert Stefani - *Southwest Gas Holdings Inc - Chief Financial Officer, Senior Vice President*

Yeah. So I think obviously we've got, just starting with some of the easier ones. The -- we've modeled a market discount rate on the pension. And obviously that contributed to about a $6 million decline from 2023. So certain assumptions like the impact of the interest rate environment on the pension.

With that I will call your attention to the 10-K which we highlight changes we've made to the pension fund over this past year of going to a 50, 50 allocation and putting a 90% overlay in place there to help dampened some impacts of potential forward interest rate movement.

But something like where interest rates ultimately had obviously there could be upside or downside from their rate case outcomes clearly. Although in Nevada we have settled kind of everything but the cost of capital which we can put a bandwidth around that could drive us upward in the range. The clearly, we obviously model in a baseline on taxes if there were to be a tax change that could impact.

And then as we've discussed we are laser-focused on the cost management and we've modeled in a certain level of cost savings that obviously allows us to continue to achieve a flat O&M per customer growth rate over the forecast period. To the extent that we're able to accelerate more cost savings into the front couple of years of the forecast then that could clearly help on the CAGR as far as what we achieved by 2026.

And then overall just we do provide and obviously, I think, our cap structure is I think well understood this point. But to a certain extent the other thing that can clearly impact is just the interest rate assumptions like how quickly the [Fed] moves on rates and while we don't have a lot of financing requirements, but we also generate some interest income from the cash certainly that were collected to the PGA this year. And so obviously, we've made assumptions around kind of the dot plot and whatnot around setting our guidance with respect to interest income.

Does that help, Ryan?

Ryan Levine - *Citigroup, Inc - Analyst*

Yeah. I appreciate the color. On Centuri, recognizing the sensitivity around providing forecasts but to date, since the management change there was highlighted a number of operational initiatives underway around contracts and staff. Is there any way of quantifying what impact the recent changes have been to maybe the cost structure or some type of operating metrics? And to date, has there been -- is this part of a 100-day plan that the company has underway?

Bill Fehrman - *Centuri Group, Inc - Chielf Executive Officer & President*

So as I noted in my comments, one of the first things that we did was removed two layers of management that was between me and the operating company Presidents and the purpose of that was so that I can get much more into the details of these businesses, understand the opportunities for growth. And as you can imagine, I've been in the role for about a month.

So that work is just now beginning and will be more clearly articulated as we go through the IPO process here in a few weeks. And so there isn't a quote specific 100-day plan. This is the direction of the organization and will be the DNA of the organization, which is to be a very efficient and effective deployer of infrastructure services and I'm excited to continue to move that forward. But again, as we move into the IPO process, this will be much more articulated in that information.

Ryan Levine - *Citigroup, Inc - Analyst*

Great. Thanks for taking my questions.

Operator

Thank you. This concludes our question and answer session. I would now like to turn the call back over to Justin Forsberg for closing remarks.

Justin Forsberg - *Southwest Gas Holdings Inc - Vice President, Investor Relations*

Thanks again, Rocco, and thanks, everyone, for joining the call today and for your questions. This concludes our conference call, and we look forward to seeing many of you soon as we participate in conference activities next week in New York, such as the Bank of America Power & Utilities, Clean Energy Conference, followed by the West Coast Utilities Conference hosted right here in Las Vegas by Siebert Williams Shank later in March, among other events.

Slide 26 continues to include my contact information. As always, feel free to reach out at any time. Thank you for your interest in Southwest Gas Holdings. Have a good day.

Operator

This concludes today's Southwest Gas Holdings, fourth quarter and full year 2023 earnings call and webcast. You may now disconnect your line at this time, and have a wonderful day.
