CONTENTS

I. INTRODUCTION AND SUMMARY 1

II. CAPITAL STRUCTURE 7

III. COST OF DEBT 9

IV. COST OF COMMON EQUITY 10

A. Summary and Conclusions 10

B. An Overview of Cost of Common Equity Models 11

C. Comparable (Proxy) Companies 22

D. Application of Cost of Equity Models 23

1. Single-Stage DCF Models 23
2. Two-Stage DCF Models 26
3. CAPM Results 27
4. Risk Premium Results 30

V. MODELS AT THE UTAH STATE TAX COMMISSION 31

VI. COMMENTS ON MR. HEVERT'S COST OF EQUITY RESULTS 32

VII. COMMENTS ON JOHN REED'S ANALYSIS AND CHOOSING A COST OF EQUITY AT THE HIGH END OF THE RANGE_ 39

VIII. CONCLUSIONS AND RECOMMENDATIONS 43

RMP Cross 1
EXHIBIT NO. ~~07-035~~
Case 07-035-93
Date May 30, 2008
Witness Charles E Petersen
Reporter Kelly Wilburn

Cross Exhibit
RMP ___ (RoR)

Testimony of Charles E. Peterson

I. INTRODUCTION AND SUMMARY

Q: Please state your name, business address and title.

A: My name is Charles E. Peterson; my business address is 160 East 300 South, Salt Lake City, Utah 84114; I am a Technical Consultant in the Division of Public Utilities (Division).

Q: On whose behalf are you testifying?

A: The Division.

Q: Please summarize your educational and professional experience.

A: I attended the University of Utah and earned a B.A. in mathematics in 1978 and a Master of Statistics (M.Stat.) through the Graduate School of Business in 1980. In 1990 I earned an M.S. in economics, also from the University of Utah.

Between 1980 and 1991 I worked as an economic and financial consultant and business appraiser for several local firms or local offices of national firms. My work frequently involved litigation support, consulting and I have testified as an expert witness in both federal and state courts.

In 1991, I joined the Property Tax Division of the Utah State Tax Commission. In 1992, I was promoted to manager over the Centrally Assessed Utility Valuation Section. I provided expert testimony regarding valuation, economic and cost of capital issues, both in deposition and formal hearing before the Utah State Tax Commission.

I joined the Division in January 2005 as a Utility Analyst; in May 2006 I was promoted to Technical Consultant. I have worked primarily in the energy section of the Division. In 2007, I earned the Certified Rate of Return Analyst (CRRA) certificate from the Society of Utility and Regulatory Financial Analysts (SURFA).

My current resume is attached as DPU Exhibit 2.1.

Q: Please outline the projects you have worked on since coming to the Division.

A: I was involved in evaluating cost of capital issues in the 2004 PacifiCorp rate case that was settled in February 2005. I subsequently co-authored a paper regarding the Capital Asset Pricing Model (CAPM) published in the *The NRRI Journal of Applied Regulation.*[1] I have recently co-authored an article related to ring-fencing that was published in *Public Utilities Fortnightly.*[2] In 2006 I provided written and oral testimony on cost equity supporting the stipulation that settled most issues in the previous PacifiCorp general rate case (Docket No. 06-035-21).

I have worked on DSM, HELP, and service quality and customer guarantees involving PacifiCorp. I was the Division lead on an internal research project regarding ring-fencing that resulted in a report to the Utah Public Service Commission (Commission). I was the lead of

[1] The NRRI Journal of Applied Research, vol. 3, December 2005, Ohio State University, Columbus, OH, pp. 57-70.
[2] Public Utilities Fortnightly, Vol. 146, No. 2, February 2008, pp. 32-35, 66.

the economics and finance group within the Division assigned to evaluate the proposed acquisition (the Acquisition) of PacifiCorp (the "Company") by MidAmerican Energy Holdings Company ("MEHC"). Please see Docket No. 05-035-54. I have been the lead on a number of Qualified Facilities (QF) contract cases.

Q: Have you previously provided testimony to the Commission?

A: Yes. I first filed testimony in the Uinta Basin Telephone case (Docket No. 05-053-01) regarding ring-fencing issues. I subsequently filed testimony in the PacifiCorp Acquisition matter (Docket No. 05-035-54). I provided testimony in support of the stipulation regarding cost of equity in the last PacifiCorp general rate case Docket No. 06-035-21. I have testified before the Commission on a number of smaller matters, including special and QF contracts, without pre-filing formal testimony.

Q: What is the purpose of your testimony in this matter?

A: My testimony discusses issues related to the cost of capital of the Company. Cost of capital includes capital structure, cost of common equity, cost of debt and cost of preferred stock. Cost of equity and overall cost of capital are important parts of the revenue requirement of a regulated utility. I will provide testimony supporting the Division's belief that the appropriate cost of equity for Questar Gas Company is 9.25 percent. As discussed briefly below, the Division has no significant disagreement with the Company's requested capital structure of 51.38 percent common equity and 48.62 percent long-term debt. The Company informed the Division on March 26, 2008, that it has successfully issued new debt. The debt issuance includes \$50 million in a ten-year loan at 6.30 percent interest and a \$100 million amount for a term of 30 years at 7.20 percent. Based on the conclusion of this debt issuance the Division does not believe at this time there is a basis for adjusting the Company's cost of debt and accepts the 6.72 percent figure recommended by the Questar Gas.

Q: Are you asking the Commission to modify its view of the use of different methodologies?

A: Yes. The Commission last adjudicated cost of capital issues in the most recent previous Questar Gas Company general rate case (Docket No. 02-057-02). In that case, which follows the line of reasoning in earlier decisions, the Commission expressed justified skepticism about the CAPM model. The Commission appeared to largely reject consideration of the CAPM. However, the CAPM continues to be one of the most widely taught and used models to estimate the cost of equity capital. Additionally, it is appropriate for rate of return witnesses to consider more than one model in their testimony in order to, hopefully, have increased confidence in and to refine their estimates. For these reasons I recommend that the Commission recognize and consider this model as part of the decision-making process in arriving at an appropriate authorized rate of return for a utility.[3]

Q: Please outline the scope of your testimony.

A: First I will review and comment on the basis of the Company's capital structure request. Then I will review and comment on the Company's requests for cost of long-term debt

[3] By extension the Commission may want to consider other models as they are from time to time offered and supported by testimony.

Then I will describe the methods, data, and analyses that I used to arrive at the Division's recommendation for cost of equity including the selection of comparable companies.

I will review and comment on those areas in which I agree and disagree with testimony of the Company's cost of equity witness, Mr. Robert Hevert. I will also briefly comment on the testimony of Mr. John. J. Reed, a colleague of Mr. Robert Hevert, who has offered a study of efficiency measures in support of Questar Gas Company's request (through Mr. Hevert) that its allowed return on equity be awarded at or near the top of Mr. Hevert's range.

In order to prepare testimony, I set a cut-off of March 14, 2008 for stock prices and debt yields. If there are significant changes in the financial markets before the hearing on this matter in May, related to the gas utilities, I will update my analysis accordingly.

Q: Please briefly summarize the work and investigations that you have performed in this matter.

A: I have reviewed and analyzed the testimonies of Questar Gas witnesses David M. Curtis, the Company's Vice President and Controller, and Robert B. Hevert, an outside cost of equity witness along with the supporting testimony offered by Mr. Hevert's colleague John Reed. Mr. Curtis provided testimony regarding cost of debt and capital structure. Mr. Hevert filed testimony on cost of equity. I have also performed my own independent estimation of cost of capital, particularly with respect to cost of equity.

Q: What was the Company's original filed position regarding cost of capital?

A: When the Company originally filed for a June 30, 2009 test year, the Company asked for the following cost of capital rates of return:[4]

Component	Structure	Cost
Long-Term Debt	47.71%	6.56%
Common Stock	52.29%	11.25%
WACC	100.00%	9.01%

Subsequently the Commission ordered a test year 12-months ending December 31, 2008, causing the Company to file revised testimony. Finally last week, based upon the actually issuance of the anticipated new debt, Mr. Curtis revised the Company's cost of capital request to the following:[5]

Component	Structure	Cost
Long-Term Debt	48.62%	6.72%
Common Stock	51.38%	11.25%
WACC	100.00%	9.05%

Q: With respect to the Company's filed testimony, what have you concluded?

A: As outlined above, I determined that the capital structure and the cost of long-term debt are reasonable. I believe that the cost of equity point estimate recommendation by Mr. Hevert is too high and lies far outside what I would consider a reasonable range for Questar Gas Company.

[4] Direct Testimony of Bruce N. Williams, December 2007, p. 3.
[5] Direct Testimony (Updated) of David M. Curtis, Exhibit QGC 5.21U, p. 3 of 3.

Division Exhibit 2.2 summarizes the capital structure and cost of capital point estimates supported by the Division, and depicts the Division's final weighted average cost of capital is 8.02 percent. The following table summarizes the capital structure and cost of capital point estimates supported by the Division as set forth on Exhibit 2.2.

Component	Structure	Cost
Long-Term Debt	48.62%	6.72%
Common Stock	51.38%	9.25%
WACC	100.00%	8.02%

There is a caveat with this recommended cost of capital. The recommended cost of equity may be perceived by Wall Street as too low relative to Questar Gas' peers. The result may be a reduction in the Company's debt rating, which would generally result in a higher cost of capital. I will discuss this in more detail later in my testimony.

II. CAPITAL STRUCTURE

Q: What is Questar Gas' current capital structure?

A: I examined the latest actual capital structure of the Company that was set forth in the Company's SEC Form 10-K as of December 31, 2007. At that date, the Company's capital structure was 52.1 percent common equity, 47.9 percent long-term debt. These figures are almost identical to the Company's 2000 to 2007 average of 52.0 percent common equity and 48.0 percent long-term debt.

Q. Did you compare Questar Gas' capital structure with the capital structure of the other companies in the electric utility industry?

Yes. I compiled the capital structures of publicly traded proxy or comparable companies.[6] The data are derived from the SEC Form 10-K filed by each company. Division Exhibit 2.3 summarizes the capital structures of the comparable companies for both the most recent fiscal year and a multi-year average. These comparable companies have bond ratings from the principal rating agencies that are similar to Questar Gas' bond ratings.

The equity percentage in the capital structures of these comparable companies varied from about 42 percent to 65 percent. The average equity percentage is 52.8 percent, which is only slightly higher than Questar Gas' capital structure equity percentage. As can be readily seen from DPU Exhibit 2.3, Questar Gas Company's capital structure is very close to the middle of the range of these comparable companies.

Q: Did the Division consider the capital structure effects on the Company's debt ratings?

A: Yes. Standard & Poor's published criteria indicated that among other factors, a company with Questar Gas' risk profile[7] needs to have an equity (common and preferred) percentage of 50 percent, or higher, to maintain its current bond rating. Because Standard & Poor's includes short-term debt the result is the regulatory capital structure needs to be higher than 50 percent equity in order to satisfy this particular rating agency criterion. However, as suggested by the data in Division Exhibit 2.3, some variation in the capital structure relative

[6] The selection of the comparable companies will be described in detail in the cost of equity section of my testimony.

[7] Standard & Poor's gives a utility a risk profile grade between 1 and 10 (1 is best), based on its evaluation of the company's business and regulatory environment. Questar Gas Company has a risk rating of 3, an above average (low risk) profile.

to a rating agency guideline does not necessarily result in a change in the debt rating. However, the Company's efforts to date to maintain or increase somewhat its equity capital percentage are reasonable in light of this rating agency criterion, especially given the increase in capital expenditures envisioned by the Company.

Q. What is your conclusion regarding capital structure?

A. Questar Gas' request for a capital structure of 51.6 percent common stock and 48.4 percent long-term debt is reasonable.

III. COST OF DEBT

Q: What did you do with respect to the cost of debt?

A: I reviewed the testimony and related exhibits of Company witness David M. Curtis. Mr. Curtis requested 6.72 percent for cost of debt in his updated direct testimony. This debt rate is higher than the original request which was 6.56 percent. This change was due to the noticeably higher rate on the 30-year debt issuance at 7.20 percent announced March 26, 2008. Originally the Company forecasted that the debt could be issued for 6.50 percent. This higher rate surprised me. Mr. Curtis verbally explained to me that the current turmoil in the credit markets made it difficult to find investors willing to go out 30 years. According to Mr. Curtis, the Company did not want to issue all of the debt for 10 years, for which better rates are available because the Company already has a lot of debt maturing 10 years from now and it did not want to take the risk of having to refinance such a large portion of debt.[8]

[8] David Curtis on a telephone conference call that included Barrie McKay, March 27, 2008.

Q: What did you conclude regarding the cost of long-term debt?

A: The cost of long-term debt appears to be reasonable. The current difficulties in the credit markets are well publicized, so it seems likely that the Company would have difficulties in issuing debt at more favorable interest rates.

Q: Is there an issue here that remains open?

A: Yes. The question is did the Company need to act now, i.e. the end of March 2008, to issue the debt or could it have waited a few months to see if market conditions improved? Given the apparent unlikelihood of significant interest rate increases in the near-term, waiting might have been prudent if the Company's cash flow or short-term borrowings could have satisfied the Company's needs. Given the late date that this debt issuance occurred relative to the due date of testimony, I am reserving comment on this issue until a possible later supplement to my direct testimony.

IV. COST OF COMMON EQUITY

A. SUMMARY AND CONCLUSIONS

Q: Please summarize your cost of equity calculations and conclusion.

A: First I identified comparable (proxy) companies that I would use to estimate the cost of equity for Questar Gas. These comparable companies are summarized on Division Exhibit 2.4. I will explain the selection process for the comparable companies later in my testimony. Using data from public sources related to the comparable companies, I calculated several variations of the standard single-stage discounted cash flow (DCF) model and the two-stage

DCF model. In calculating these models, I used both the closing (spot) price of the common stock of these companies as of March 14, 2008 and the 30-day average closing stock price. I considered several variations of the capital asset pricing model (CAPM) using different historical periods to estimate the market risk premium, different sources of beta, and the 20-year U.S. Treasury bond and the 90-day U.S. Treasury Bill rates as estimates of the risk-free rate. Finally, I constructed estimates using a risk-premium model based upon Value Line financial strength ratings. This last Value Line-based model is considered here primarily as a "reasonableness test." I am not asking the Commission to endorse this model.

Division Exhibit 2.5 sets forth the results of the models and calculations that I have made. As indicated at the bottom of Exhibit 2.5, I recommend a point estimate of 9.25 percent as the cost of common equity applicable to Questar Gas Company at this point in time.

B. AN OVERVIEW OF COST OF COMMON EQUITY MODELS

Q: What methods did you look at in order to estimate the current market cost of equity for Questar Gas?

A: I used standard discounted cash flow models (DCF) coupled with two types of risk premium models to support and complement the DCF analyses. Regarding the DCF models I considered both the simple or single stage model and two-stage DCF models. Within each model I considered variations of different growth rates.