BEFORE THE
PUBLIC SERVICE COMMISSION OF UTAH

Questar Gas Company	)	Docket No. 02-057-02

PREPARED DIRECT TESTIMONY OF
BARRIE L. MCKAY
FOR QUESTAR GAS COMPANY

May 3, 2002

Q. Please state your name and business address.

A. My name is Barrie L. McKay. My business address is 180 East 100 South, Salt Lake City, Utah.

Q. By whom are you employed and what is your position?

A. I am employed by Questar Gas Company ("QGC") as Director Regulatory Affairs. I am primarily responsible for state regulatory matters in Utah and Wyoming.

Q. Attached to your written testimony are Exhibits QGC 5.1 through 5.10. Were these prepared by you or under your direction?

A. Yes.

Q. What are your qualifications to testify in this proceeding?

A. I have listed my qualifications in Exhibit QGC 5.1.

Q. What areas will your testimony address?

A. My testimony will address issues that relate to rate allocation and rate design. First, I will address the current status of how customers are added to our system. I will describe what they are currently required to contribute when they are hooked up to the system, and what we believe should be required as an up-front contribution in the future. I will then address the related issue of accounting for such contributions. Next, I will

address the Company's recommendation with regard to the class cost-of-service study presented in this case. Finally, I will discuss proposed tariff changes, including proposed rates for the various rate classes of customers that should be implemented as part of this case.

NEW CUSTOMER CONTRIBUTIONS

Q. By way of background, please describe what investment is generally added to the system rate base when a typical residential customer initiates service for the first time.

A. Each new customer generally requires installation of a service line, plus a meter and regulator. In addition, the extension of a main is also required in some cases.

Q. Please describe these four categories of plant.

A. The main line to serve residential customers is typically plastic pipe of two to three inches in diameter that is laid three feet underground along the side of the streets throughout a community. Typically, pressure for a residential main line is 35 pounds per square inch ("psi"), which allows the Company to serve numerous customers from the same main line. The service line for a residential customer is typically plastic pipe of ½ to 1¼ inches in diameter that also runs 18 inches underground from the main line to the residence. The service line pressure is the same as that for main lines.

The meter is the gray, typically aluminum "box" that is located on the side of the residence and is attached to the end of the service line. The meter measures the amount of gas used by the customer.

The regulator is saucer shaped, typically four to eight inches in diameter and is connected to the meter. The regulator reduces and maintains the pressure of the gas entering the meter.

Q. What is the average cost to add a new customer to the Company's system?

A. As can be seen in page 1 of 4 Exhibit QGC 5.2, column A, line 5, the average cost in 2001 for new main, service line, meter and regulator was $1,806 for each customer.

Q. Is this different from the average cost of serving all existing customers?

A. Yes. As can be seen in column B, line 5, the average cost of an existing customer is approximately $571. This is the depreciated net book value of these plant accounts on a per-customer basis for our entire system. If the incremental cost of adding a new customer equaled $571, then QGC would have no incremental cost concern, and no need for a customer contribution. As it stands, the incremental shortfall is $1235 ($1806 – $571).

Q. Are new customers charged for some of this difference between the average cost of serving existing customers and the average cost of providing new service?

A. Yes. Customers are now required to make contributions for main extensions and service lines, as well as for excess construction costs. These amounts are detailed in Sections 9.01 and 9.02 of QGC's Utah Natural Gas Tariff.

Q. Please describe the contribution required from a customer when extending a main is necessary to provide service to that customer.

A. Section 9.01 of the tariff currently provides that, when an existing main must be extended to serve a new customer, the customer is given a footage allowance based on the type and number of natural gas appliances to be installed by that customer. Any main installation cost required beyond this footage allowance must be contributed by the customer before construction is initiated. These main extension contributions are subject to refund if subsequent additional customers request service from the Company and are served from the already extended main line. As can be seen in column C, line 1, new customers contribute an average of $128 for main extensions.

Q. Please describe the contribution required from a customer for a service-line extension.

A. Again, as summarized in Section 9.02 of the tariff, the Company currently allows a footage allowance based on the appliances to be installed at the location to be served. As with main extensions, the customer is obligated to pay for incremental footage required above and beyond the allowance. There is no provision for refunds. A service line generally serves only one customer. As can be seen in column C, line 2, new customers contribute an average of $135 for each new service line.

Q. The tariff also provides for the recovery of excess construction costs. What is this meant to recover?

A. Sometimes construction of a main extension or service line will require some extra expenditures. These include costs of rights-of-way, permit fees, as well as overtime and direct construction costs incurred to install a line through areas of rock, frost and other abnormal conditions. These costs are included in the required contribution from the specific customer in addition to the regular main extension and service-line amounts.

Q. Have there been any recent changes in the contribution required from customers?

A. QGC recently completed a review of its tariff and service practices. We discovered that some tariff provisions have not been uniformly applied, especially in the area of excess construction costs and excess service line contributions. In some cases, not all of the excess costs have been recovered. For example, many municipalities have recently imposed new fees for street and sidewalk excavation. These new fees have not always been consistently tracked and collected as excess costs. The Company is now emphasizing the uniform collection of these contributions, and we expect to recover an additional $25 per main contribution and an additional $62 per service-line contribution because of the uniform collection of all excess costs.

Q. Have these excess construction costs and the costs associated with the recent changes been included in the average contribution costs identified in column C, lines 1 and 2, of Exhibit QGC 5.2?

A. Yes.

Q. Once a new customer has made a contribution and has initiated natural gas service, is that customer's only remaining obligation to pay the usual monthly customer charge and block rates for gas service?

A. No. Since our general rate case in Docket No. 95-057-02, the Company has been authorized to collect a "New Premises Fee." This is an additional monthly charge of $12 for the first 12 months that a new customer receives service. This amount has been included in Exhibit QGC 5.2 as a contribution from customers, page 1, column C, line 4.

Q. What was the rationale behind the New Premises Fee, and how has it been received by customers?

A. The New Premises Fee was instituted to provide a means for new customers to pay a larger share of the up-front costs incurred in adding them to the system. The fee is imposed on customers who actually receive the benefits of gas service, rather than on developers who merely install the facilities. At the time, it was thought that a monthly fee would serve the same purpose as a traditional contribution except that the amount could be collected in installments to ease the burden on the customer. Frankly, this has been a very frustrating point for many customers. When customers have commented on the New Premises Fee, they have typically suggested that this up-front cost should be assessed as a new construction charge, as is typically done with water and sewer hook-up fees. Many customers find it is less of a financial burden to make an additional up-front cost of $144 and include the cost in the financed price of the home, rather than pay an additional $12 per month for the first year of service. Customers are also frustrated at

being informed of the free footage allowance, paying an up-front contribution, and *still* having to pay an additional monthly fee.

Q. What is the Company's recommendation regarding the New Premises Fee?

A. Given the other changes we are proposing for extending service, we believe collecting the New Premises Fee over 12 months may, in fact, be more of a financial burden to new customers than an up-front contribution of an equal amount. Recognizing this, we believe that it would be better if all construction costs were contributed in an up-front amount that can be rolled into the cost of the home.

Q. When all contributions are considered, what does a typical customer contribute when initiating natural gas service?

A. Column C, line 5, of Exhibit QGC 5.2 shows that an average customer will contribute $407 toward the costs of being added to the system.

Q. Does this contribution make up the difference between serving new customers as compared to existing customers?

A. No. This customer contribution of $407 reduces the actual cost of connecting this new customer from $1806 to $1399 ($1806 – $407 = $1399). This still exceeds the average cost of serving our existing customers of $571 by $828 (see column D, line 5). So, even with the current required contribution of $407, a new customer averages an additional $828 investment over that required to serve our existing customers. Said another way, the incremental investment required to serve a new customer far exceeds the average cost of serving our existing customer base. In large part, this is what Mr. Allred refers to when he characterizes QGC as an "increasing-cost" utility. Investor funds must be dedicated to provide service to these new customers.

Q. Do you recommend that new customers pay all of this $828 difference?

A. No. There is a balance that must be struck between encouraging system growth and new revenues, weighed against the cost required to add these customers. Increasing the average customer contribution by the full $828 would be too large of a shock for new customers. However, we do believe that the amount assessed to new customers should increase. Our recommendation in this case is to increase the average customer contribution in aid of construction ("CIAC") by $100 (see column C, line 6) and re-evaluate its impact before any further actions are taken.

Q. How does the Company propose to implement this new main and service-line extension policy?

A. As can be seen in Exhibit QGC 5.2, page 1, column B, line 7, the average existing investment of $571 and the proposed reduced investment shortfall in column D, line 7, of $728 total approximately $1,300. This $1,300 would become the typical dollar allowance for new customers. Using the column A total cost of new mains and new service lines as the allocation factors, this $1,300 would be allocated $730 to mains and $570 to service lines. These dollar allowances would replace the current footage allowances in the tariff. When determining what a new customer should contribute, these allowances will be deducted from actual construction costs. Any difference would be required as an up-front contribution from the customer at the time of construction.

Q. Would the New Premises Fee still be collected from new customers?

A. No. Our recommendation, as explained earlier in my testimony, is to do away with this fee.

Q. Is the Company proposing new tariff sheets describing this policy?

A. Yes. Attached as Exhibit QGC 5.3 are the proposed changes to Sections 9.01 and 9.02 in legislative format.

ACCOUNTING FOR CONTRIBUTIONS IN AID OF CONSTRUCTION (CIAC)

Q. Earlier in your testimony, you described the main extension charges and service-line fees as contributions. Please describe the accounting for these amounts on the Company's books.

A. CIAC includes monies contributed from customers. Currently, QGC records these contributions as revenue when they are received.

Q. Are these amounts also reflected as a reduction to the Company's rate base?

A. No. The current accounting treatment for these contributions is to include them in revenue in the year they are received, with no impact on rate base.

Q. How did this come about historically?

A. The Tax Reform Act of 1986 required utilities to pay income taxes on amounts they received as contributions in aid of construction. Matching the tax-accounting treatment for book purposes avoided the need to record deferred taxes. This deferred-tax balance would have recognized that taxes had been paid currently for tax purposes, but would be paid in the future for book purposes. Such deferred-tax entries increase rate base. At the Company's request, in Docket No. 87-057-13, QGC was allowed to record CIAC as revenues. At the time, we thought this might be a practice that would be followed by other utility companies in the United States. This has not proved to be the case. I know of no other local distribution company that has instituted this accounting practice in the past 15 years for either accounting or ratemaking purposes.

Q. Why has this practice not been followed by others in the industry?

A. I believe there are several reasons. First, accounting for contributions as revenues results in a mismatch. When contributions are recorded as revenues within the year of receipt, they are not matched with the plant that they helped fund and construct. This creates a mismatch of having all benefits recognized up-front while the plant is typically used over a 30-year period. Second, this practice misrepresents the operating revenue of a company. QGC is in the business of providing and distributing natural gas. It should record revenue related to providing that service rather than recording "revenue" that has been contributed for building plant. In addition, because main CIAC's are refundable, some portion of what is recorded as revenue in one period is refunded to customers in a future period. About 40% of main-extension contributions are eventually refunded. This requires the Company to record revenues in one year and then "unrecord" them in a future year. For these reasons, the Company's auditors have encouraged QGC to terminate the practice of recording CIAC as revenues.

Finally, this practice distorts year-to-year comparability. A wide fluctuation can occur in earnings arising from this accounting practice, which has nothing to do with normal utility operations. In a sense, QGC's earnings are now partially dependent on the construction cycle. QGC experienced this phenomenon last year. While there had been no significant change in any of the costs the Company had incurred for doing business, its revenue and net income were skewed by the practice of booking CIAC as revenue.

Q. Do you propose a change in how contributions are accounted for by the Company?

A. Yes. The accepted practice nationwide is for regulated utilities to record customer contributions as a reduction to rate base. Doing this allows a utility to recognize the benefit of these contributions over the life of the plant.

Q. What then is the Company's recommendation in this case?

A. We recommend that the Commission approve the discontinuance of treating CIAC as revenue and, instead, require these monies to be recorded as a reduction in rate base, which is then accrued as a customer benefit over the life of the plant.

Q. Will this effect the revenue requirement of the Company in this filing?

A. No. This has no effect on the Company's revenue requirement of $241,000,000. In addition, in future cases it will result in slower growth in rate base.

Q. Will this effect customers' rates in this filing?

A. Yes, removing these contributions from revenues will require that an equivalent amount be included in block rates.

Q. Do you recommend adjusting the existing plant and accumulated depreciation accounts to recognize this change?

A. No. Customers have benefitted with lower block rates as contributions have counted as revenues in past years. This benefit has equaled the long-term impact of the higher rate base that has been included in rates. Thus, the adjustment should be made on a prospective basis.

CLASS COST OF SERVICE

Q. The second topic you identified is the Company's cost-of-service study. Referring to Exhibit QGC 5.4, "Explanation of Cost-of-Service Terminology," please describe this exhibit.

A. This three-page exhibit presents an explanation and description of the allocation bases and cost-causation factors used in this case. These are the same allocation methodologies approved by the Commission in the last several QGC general rate cases.

Q. Please explain Exhibit QGC 5.5, "Functionalized Cost-of-Service by Rate Classification."

A. Exhibit QGC 5.5, page 1, is a summary sheet showing the distribution non-gas ("DNG") cost of service by rate classification, summarized by the two primary functions used in previous cases: production and distribution. The total cost of service for each rate classification is shown on line 5, with test-year sales for each rate classification expressed in decatherms, as shown on line 6. The credit shown on line 4 reflects the non-gas revenue from natural gas sales for natural gas vehicles ("NGV"), NGV leases, firm transportation and Accounts 487 and 488 revenues. The revenues collected in the test year for firm transportation, municipal transportation and NGV sales and leases have been adjusted upward to reflect the proposed rate increase for these classes of service. Exhibit QGC 5.6 shows the calculation of these credits. The DNG cost per decatherm by rate class is shown on line 7, page 1, of Exhibit QGC 5.5.

Q. Please describe the major cost elements of the cost-of-service study.

A. This cost study allocates costs such as on-premises customer service, meter-reading expense, network costs, gathering of Company-owned production, large-diameter main costs and feeder-line costs to each customer class. Exhibit QGC 5.4 contains an explanation of the terminology and allocation bases used in this study.

In each cost category, the allocation bases or factors are used to allocate costs to each rate class. For each rate class, the total cost of service is shown on line 19 of Exhibit QGC 5.5, page 2. Then, page 4 of Exhibit QGC 5.5 shows the calculation of allocation factors described in Exhibit QGC 5.4.

Q. What volumes are used in the development of the allocation factors?

A. The test-year volumes used have been temperature-adjusted to reflect average temperatures for the 30 years ended 2001, as identified in Gary L. Robinson's Exhibit 4.6, page 3A, column E.

Q. How does the Company propose to allocate the annual Utah deficiency of $23,017,000 shown on Mr. Robinson's Exhibit 4.5, page 1, among customer classes?

A. The results of this class cost-of-service study are consistent with the class cost-of-service study used in QGC's last three general rate cases. In the previous three cases, in order to provide stability and minimize change, the Company has proposed that DNG revenue for all sales, transportation and lease classes be percentage increased. Exhibit QGC 5.7, column D, shows a summary of the revenues by class that will result from a uniform percentage increase. Column F of the Exhibit also shows the cost of service for the GS, F-1, F-3, FT-2, I-Sales and I-Transportation classes.

Column H of Exhibit QGC 5.7 shows the difference between a percentage increase for the various classes and an allocation that uses the cost-of-service factors. The variances shown in this column are similar to the variances that existed in the rate designs approved in Docket Nos. 93-057-01, 95-057-02 and 99-057-20, except for the I-Transportation class.

To bring this class more in line with previously approved rate designs, the Company proposes to reduce the class differences shown in column G by one-third. The resulting costs assigned to each class are shown in column E. The resulting variances by class are shown in column H. By comparing columns G and H, it can be seen that the difference between a percentage increase and the class cost-of-service study has been reduced by the desired one-third. This brings all rate classes to where levels of assigned costs are consistent with rate designs approved in the last three general rate cases.

Q. Why doesn't the Company propose to shift entirely to the increases by class indicated in the class cost-of-service study?

A. On a percentage basis, this would result in a 34% increase to the I-T class. In our judgment, this type of rate shock would be inadvisable and inconsistent with the regulatory principal of gradualism. Many of these customers have competitive

alternatives to the service provided by QGC. These include bypassing the QGC system and taking service directly from an interstate pipeline. The revenue contribution that would be lost from bypass would ultimately have to be shouldered by the remaining customers. The proposed rate design decreases the likelihood of substantial bypass.

Q. With respect to individual rate classes, please describe the Company's recommendations.

A. For the Municipal Transportation or MT service, the Company is recommending a percentage increase. At the time this new service schedule was approved in Docket 99-057-20, no customers qualified for this rate schedule. Currently, we have one customer on this rate schedule. The test-year volumes for this customer are 1,628 Dth. We believe the theory upon which the rate was developed in1999 was correct and accurate and is a good estimation of costs incurred to serve this class. However, it is still very difficult to accurately allocate costs to this customer class when only one customer is receiving service under this schedule. For this reason, we recommend keeping the current rate structure and assessing a percentage increase to this class for its share of the deficiency. In the future, if additional customers subscribe to this rate schedule, we will have a more accurate reflection of costs to design a rate for this class.

Q. Does the Company recommend any further adjustments to its General Service rate schedule?

A. Yes. The Company is recommending that the current meter-based customer charge be revised. First of all, we believe the description of the charge is confusing and has become a source of complaint for many customers. This is not a charge for any particular customer service and should not be described as such. As can be seen in my attached Exhibit QGC No. 5.8, page 1, this cost has been renamed as a "Basic Service Fee."

Q. What have you calculated the current GS-1, Category I, Basic Service Fee to be?

A. I have applied the methodology proposed by the Division of Public Utilities and approved by the Commission in Docket Nos. 93-057-01, 95-057-02, and 99-057-20 to calculate the Basic Service Fee. The Company continues to have reservations about this approach. Page 1 of Exhibit QGC 6.7, "Utah GS-1 Basic Service Fee," shows the amounts associated with each of the applicable costs in Utah. Line 14 shows the annual total customer cost. This monthly fee is shown on Line 15 as $6.29. Page 2 of the exhibit is a line-by-line explanation of each component. In light of these results, the Company proposes to increase the Basic Service Fee to $6.00.

Q. Please explain the Basic Service Fees for larger customers.

A. Different basic service fees are charged to GS-1 customers with larger meters and all customers in the firm and interruptible rate classifications except GSS rates. These Basic Service Fees reflect the higher plant costs associated with higher-volume customers. The size of the fees vary with the size and the pressure of the customer's meter set.

Q. What Basic Service Fees have you calculated?

A. In an effort to minimize rate-design issues in this case, I have used the methodology approved by the Commission in Docket Nos. 95-057-02 and 99-057-20 to calculate the Class II, III and IV Basic Service Fees. Exhibit QGC 5.8, pages 3 and 5, shows the calculation of the Basic Service Fee for each category for the firm and interruptible customer classes, respectively. The Company is proposing to update the firm Basic Service Fees to the levels shown on lines 17 and 18 of page 3 to account for current costs. The proposed changes to the interruptible Basic Service Fees are shown on lines 20 and 21 of page 5.

PROPOSED RATES

Q. Please identify the tariff sheets in Exhibit QGC 5.9.

A. These are the proposed tariff rate schedules in final formats containing the rates that will recover the test-year costs from the various customer classes. The rates were derived from the test-year data and information found in the Prepared Direct Testimony and exhibits of Mr. Robinson and the rate-design and cost-allocation methods I have just described. In addition, the various tariff language changes are shown in legislative format.

Q. Please indicate language changes that are particularly noteworthy.

A. On pages 20 and 21 of the tariff describing interruptible service, the words "during the winter season" have been removed. This recognizes that the need for interruption may occur at any time during the year, not just in the winter season. Additionally, in the "Multiple Rates" paragraph of Section 8.01, page 63, language has been added to clearly identify current practice regarding the rate blocks used when billing a customer that has received service under different rate schedules, through the same meter, during the month.

Q. Have you calculated the impact of these rates on the typical GS-1 customer?

A. Yes, I have. Exhibit 5.10 shows the impact of this proposed rate increase on a GS-1 customer in Utah that uses 115 Dth annually. The current annual costs of $681 will be increased to $719, for an increase of $38 or 5.65%.

Q. Does this conclude your testimony?

A. Yes it does.