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State of Utah
Department of Commerce
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Executive Director
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Deputy Director
Division of Public Utilities
IRENE REES
Director

M E M O R A N D U M

To: Public Service Commission

From: Division of Public Utilities
Irene Rees, Director
Energy Section
Marlin H. Barrow, Utility Analyst
Artie Powell, Acting Manager

Date: May 31, 2005

Subject: Questar Gas, Account 191 Pass Through, Docket No. 05-057-06.

EXECUTIVE SUMMARY:

Questar Gas Company (QGC) has filed its application for recovery of purchased gas and associated costs in accordance with the pass through provisions of its tariff. Gas commodity prices are market driven and fluctuate with market prices. The pass through provisions allow QGC to apply for rate adjustments that reflect actual changes in gas prices. These gas cost increases or decreases are passed directly to customers on a dollar-for-dollar basis and do not accrue to the company as profits or losses. The costs that are eligible for recovery through a pass through application include costs incurred for Company production, purchases of gas from third party producers, plus the costs

associated with gathering the gas from the wells, transporting the gas to QGC's distribution system and storing the gas for winter usage.

The pass through request represents a 14.4% increase in the commodity portion of gas rates. This large increase in the price of natural gas is due to the imbalance in the U.S. natural gas supply/demand paradigm, increased demand for new electrical generation, which is fueled mostly by natural gas and growth in demand that out paces the development of gas supplies in new or existing fields. Nevertheless, QGC uses a mix of Company owned production and gas purchase strategies to hedge against volatile gas prices. This allows QGC, despite this increase, to deliver to its customers some of the lowest cost gas in the nation.

The Division of Public Utilities (Division) is responsible for auditing and monitoring QGC's pass through account (191 Balancing Account) and for investigating the company's requests for adjustment through this mechanism. The Division has reviewed QGC's filing and has verified that the costs claimed by the company are in line with expected market conditions and are eligible for recovery. Therefore, the Division does not object to QGC's application for adjustment.

ISSUE:

QGC filed on May 6, 2005 with the Public Service Commission (PSC), their semi-annual gas cost pass-through filing. This filing asks for an increase in revenues of $115,402,000 due to an increase of $119,038,000 in the commodity portion of the gas rates, offset by a

$3,636,000 decrease in the supplier non-gas portion of rates. If approved by the PSC, assuming a typical usage of 115 decatherms per year, this will raise the typical residential customer's monthly bill by$10.89 or 14.42% over current rates.

Tariff Provision:

QGC's Tariff for Natural Gas Service in Utah, PSCU 400, §2.10, pp. 2-11 – 2-17, allows the company to recover, on a dollar for dollar basis, purchased gas costs and gas-related costs in accordance with the accounting directives stated in the tariff.

RECOMMENDATION: DIVISION DOES NOT OPPOSE APPROVAL

After a preliminary review of this application and also recognizing the magnitude of this increase, the Division of Public Utilities (Division) does not object that, on an interim basis, the application be approved as filed with the proposed rates becoming effective June 1, 2005. The Division also recommends that QGC be required to provide monthly updates on developments in the gas industry that might affect current and future prices of natural gas and that these updates continue through the upcoming fall and winter seasons.

DISCUSSION:

QGC's current filing (Docket No. 05-057-06), based on expected sales volumes of 101,474 thousand decatherms, for the 12 months ending May 31, 2006, reflects the gas purchases, company owned production, transportation, gathering, storage and royalty costs necessary to meet those projected sales requirements. It should be noted that this current pass through request is the third largest percentage increase requested by QGC in the past twenty years and is the highest dollar amount per decatherm (Dth) that QGC has

ever charged.

Price History Recap:

From 1985 through 1999, the GS-1 commodity gas component rate varied from a high of $2.66/Dth in January 1985 to a low of $1.04 in January 1996. At the beginning of 2000, the commodity gas component of the GS-1 rate was $2.23/Dth. At the same time, First of the Month (FOM) Rocky Mountain[1] gas was selling at $2.15/Dth.

During the year 2000, QGC filed one pass through effective October 1, 2000, which raised the commodity gas component rate to $2.91/Dth. However, QGC's filing came before the summer of 2000 when the price of natural gas rose substantially due to what many think was the effect of the energy crisis in California. The FOM Rocky Mountain price, for example, went from $2.15/Dth, at the beginning of 2000 to $6.14/Dth by the end of the year; and it jumped to $8.58/Dth in January 2001. QGC was caught in this price run up and as a result filed their largest single pass through increase, which became effective Jan 1, 2001. This was an increase in the commodity rate of $1.75 bringing the new GS-1 rate to $4.67/Dth.

During the year of 2001, FOM natural gas prices again fluctuated dramatically, from a high of $8.58/Dth at the beginning of the year to a low of $0.95/Dth by October of 2001, ending the year at $2.02/Dth. QGC followed this trend by reducing the commodity gas cost component of the GS-1 rate from $4.67/Dth to $2.69/Dth, effective January 1, 2002.

Prior to 2003, the price of natural gas in the Rocky Mountain region was lower than the

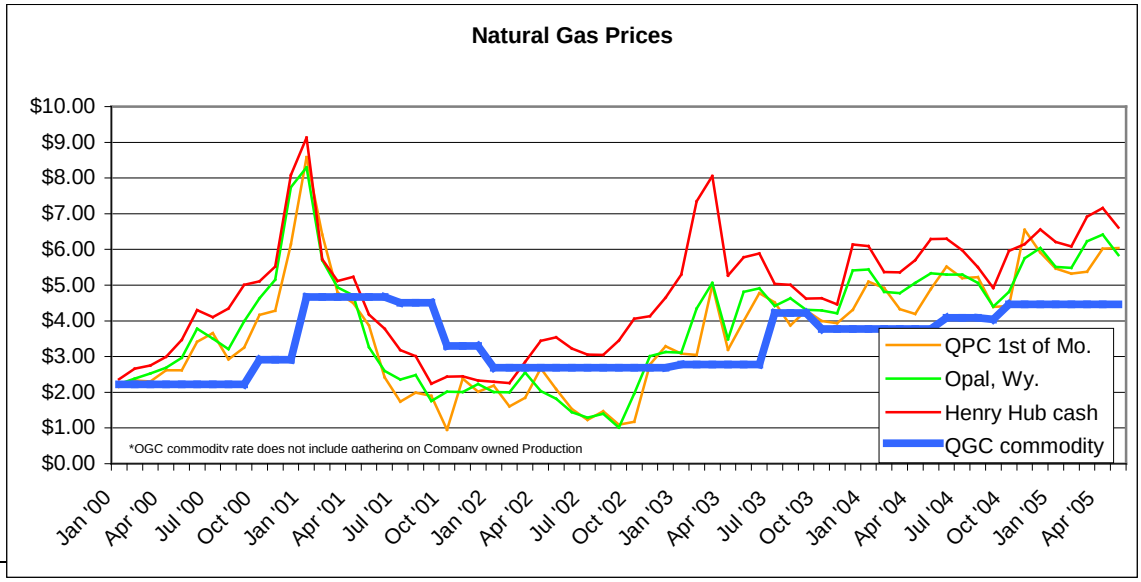
[1] First of month pricing is Questar Pipeline's posted price as reported in "Inside FERC'S Gas Market Report" and is the price monthly gas purchase contracts are settled at.

national market price at Henry Hub by an average of $1.00 plus /Dth. This phenomenon was attributed to a lack of pipeline capacity to move the gas out of the Rockies. However, by the summer of 2003, events occurred, both regional and nationally, which have had a major impact on the price of natural gas. First Kern River Gas completed a major expansion of its pipeline system capacity, allowing more Rocky Mountain gas to reach the gas-starved markets of California. This reduced the average basis between Rocky Mountain gas and the Henry Hub price by an average of $0.50/Dth. Secondly, instead of prices declining during the summer months, they increased to over $4.00/Dth in the Rocky Mountains and moved even higher, apparently due to increased demand for electrical generation to meet air conditioning load and gas storage requirements in the summer months coupled with a national forecast of tighter supplies. Because of these events, QGC filed for a pass through effective July 1, 2003, which increased the commodity gas cost component of the GS-1 rate to $4.22/Dth.

Since July 2003, the price of the FOM Rocky Mountain gas has ranged between a high of $6.55/Dth, reached in November 2004 and a low of $3.87/Dth reached in August 2003. In May of 2005, the FOM price is $6.04/Dth. QGC has filed three pass-through filings since July 2003, excluding the adjustments made for Commission ordered CO2 changes, ranging from $3.77/Dth to $4.75/Dth. The last pass through, which was for $4.75/Dth, was effective October 1, 2004.

Current Situation:

Since QGC's last filing, which was effective October 1, 2004, the price of natural gas has continued to increase. The increase was larger than what was anticipated in the October 2004 filing. That filing assumed a weighted average purchase price of $5.45/Dth for the period October 2004 through September 2005. The average FOM Rocky Mountain price for October 2004 through May 2005 is $5.64/Dth; the NYMEX forward price curve for the upcoming summer and into the winter months is expected to range from about $7.50/Dth to $8.75/Dth[2]. Similarly, a recent Questar Corporation news release indicated "the company's guidance … assumes an average price for gas of $7.10 per MMBtu for April through December 2005."[3] With QGC's current filing, QGC's weighted average purchase price is $6.65/Dth. A graphical history of these prices follows.



[2] Based on information from FERC's Office of Market Oversight & Investigations derived from Platts Gas Daily, which was based on data current through 04/05/05.

[3] Questar Corporation News Release, April 27, 2005.

The price QGC customers pay for natural gas is lower than other parts of the country due in large part to QGC's WEXPRO agreement for Company owned production, which is a great benefit to those customers. Without this company production, instead of looking at a commodity gas component price of $5.92/Dth, the price could be $7.59/Dth, or approximately a 35% increase instead of the 14% increase requested in this filing.

On a national basis, one of the concerns of industry experts is that the rise in natural gas prices is being over looked due to the current price of a barrel of oil. This was recently expressed in a meeting of the American Petroleum Institute held in Houston, Texas in April of 2005[4]. According to some experts, there seems to be a lack of interest or unwillingness on the part of the nation's political leaders to address the problem of rising energy prices by blocking efforts for more exploration for these resources to begin in undeveloped areas. As one of the speakers at that conference stated, "*the U.S. needs to develop 'a more balanced energy portfolio.' The U.S. policy has been 'schizophrenic' in that it promotes the use of gas as a clean-burning alternative while restricting access to some of the country's most gas-rich areas.*"[5]

Yet, despite this run-up in natural gas prices, when natural gas is compared to a gallon of gasoline on an equivalent Btu basis, a gallon of gasoline at the gas pump costs more than twice as much as what a delivered Decatherm of natural gas does. (See Exhibit 1 at end of memo for calculations)

[4] Platts Inside FERC, May 9, 2005, "Blinded by the cost of Gasoline, U.S. Public said not to be Focusing on Impact of Gas Prices."
[5] Ibid

Efforts To Mitigate Gas Price Volatility:

QGC must purchase about half of its annual requirements from third party suppliers to meet its customers' needs. However, due to its customers' load shape (i.e. residential heating), a much greater portion must be purchased from third parties during the heating season (October-May) when gas prices historically are higher. As a result customers are potentially exposed to market volatility.

Current purchased gas prices are, historically speaking, high and volatile. QGC attempts to manage gas price volatility, and thereby mitigate customers' exposure to that volatility, through a planned purchase program or "hedging". QGC develops a winter gas-purchase portfolio made up of fixed price contracts for approximately one-third of the portfolio, contracts with a price cap for about one-third and buying the other third under index price contracts. QGC uses various purchase contracts to achieve this mix but may use financial hedge contracts if necessary. The WEXPRO gas and QGC's storage practices play an important role in the overall plan by allowing QGC to keep Company production flowing during the summer months to inject into storage and then withdraw the lower cost company production in the winter months which minimizes the need to purchase as much gas in winter when prices are historically higher.

This plan, known as QGC's Integrated Resource Plan (IRP), was developed in consultation with the Division, Committee of Consumer Services (CCS) and PSC and has been presented to regulators over the past few years and approved tacitly by regulators as a policy for QGC to pursue in gas procurement. QGC meets periodically with regulators to explain market conditions and provide the opportunity for regulators to provide input

on the decisions QGC is making in developing its purchased gas portfolio. As the plan year progresses, QGC files quarterly variance reports with the PSC explaining why actual gas purchase results differ from planned IRP projections. The latest report filed with the PSC shows actual year-to-date gas purchases May 2004 -October 2004 are lower than planned by 17% while Company owned production is higher than planned by 8%. This is due to a combination of warmer than normal weather conditions and more company production being available than anticipated. However, the cost per decatherm of the purchased gas has been higher than what was filed in QGC last pass-through filing in Docket 04-057-11.

Unfortunately, in the environment of today's energy markets, the opportunity for QGC to obtain gas supply contracts for periods greater than one year has not been offered at acceptable prices or terms. At times of high price volatility, the market imbeds a high volatility premium for fixed price contracts and other options. In today's market, due to the price of gas, financial hedges are very expensive and may be unattractive as a hedging tool, even though there is $2,000,000 set aside in this filing for such purposes.

In hindsight, one could ask the question "Why didn't QGC lock in more gas when prices were lower?" By reviewing a little history, we may be able to answer that question. In the early 90's QGC (Mountain Fuel Supply) was brought before the PSC[6] because they had long-term contracts for gas supplies in the $3.20/Dth range. Because the then current spot market prices were lower, QGC's failure to terminate these long-term supply

[6] Docket Nos. 91-057-11 & 91-057-17.

contracts was deemed imprudent by some parties, although the Commission eventually ruled in QGC's favor.

Again as late as the spring of 2002, the opportunity to lock up long term gas prices in the range of $3.50/Dth presented itself, but with spot market prices in the $2.00/Dth area, some parties question whether that would have been a good decision to make at that time? In order to obtain longer-term gas supplies, a premium above the current market prices is required in order to lay off the risk of price volatility. To lock up prices in the $3.50/Dth range, QGC would had to have entered into "take-or-pay" contracts requiring QGC to take or pay on a daily or monthly basis, a certain volume of gas. By entering into such an agreement, QGC would have forgone the opportunity to obtain the less expensive "spot" gas. The taking of this "spot" gas would enable QGC to reduce its take of Company owned production (WEXPRO gas), which is a limited resource and preserve it to offset higher prices in the future. This is precisely what QGC has done. As shown in the analysis of the IRP mentioned above, as prices have increased, QGC has increased its takes of Company owned production to mitigate the cost to its customers. It should also be kept in mind that in 2002, long-term meant a contract of two to three years in length. As such, these contracts would now be expiring and would provide no protection against today's market, where as Company owned production does.

QGC has asked in meetings with the PSC, DPU and CCS whether or not it should pay these premiums to obtain long-term supplies and the response has, in general, been to hold off paying most of those premiums because they have been deemed to expensive when measured against current market conditions. The same question remains today, should QGC pay $7.40/Dth today to hedge against the possibility of avoiding $10.00/Dth

for future winter seasons when current prices are in the range of $5.50 to $6.00/Dth. Perfect hindsight gives us the answers; unfortunately natural gas can't be purchased with hindsight.

Possibly in the future, if there is more stability in the market, QGC may be able to obtain multi-year term purchase agreements with acceptable terms and conditions with producers or even perhaps with Questar Market Resources as a means of providing more stability to QGC customers. Inherently, when long-term fixed price contracts are entered into, the purchaser of those contracts runs the risk that those fixed price contracts will be "out of the money" when compared to current market prices. In QGC's situation, when such an event occurs, history has shown, QGC is criticized for being imprudent.
QGC must compete in the gas market with all the other LDCs in the country, with the only variables being pipeline capacity and nearness of supply. Fortunately, as discussed above, QGC does have one of the best hedges of any LDC in the country. The company owned production developed under the WEXPRO agreement provides almost half the gas used by sales customers. The cost of this gas, which is based on cost-of-service pricing, is about half the current purchase price and plays an important role in reducing the overall price of gas for customers. Additionally the Company uses its storage capacity to provide price stability. Company owned production and lower priced summertime purchased gas are injected into storage in the summer months and then used in the winter in place of higher cost purchases. The combination of company owned production, storage and fixed price contracts provided price stability on about 70% of the gas supplies for QGC sales customers last winter.

Comparative Analysis Docket No. 05-057-06 to Docket No. 04-057-11

Comparing the commodity gas cost component of the GS-1 rate in this filing with the commodity gas cost component rate in Docket No. 04-057-11, shows an increase from $4.746/Dth to $5.919/Dth, or a $1.173/Dth rate increase. This $1.173/Dth rate increase, when applied against the projected firm sales volumes of 99.6 million decatherms, collects $116.8 million of the requested $119.0 million increase in commodity gas costs. (Line 8 of Summary Table)

Of the $116.8 million collected from the firm sales volumes, gas related costs, which consist of company owned production, gas purchases and gathering, transportation and storage costs, total $112.2 million. (Line 4 of Summary Table) Included in this $112.2 million is $2.0 million for gas stabilization costs as well as a reduction of $1.6 million for projected capacity release credits. QGC also continues to manage the heat content of the gas supply at an estimated annual cost of $5.7 million for CO2 processing. The costs for this process are not included in this filing but have been deferred pending resolution of Docket #05-057-01 as have all CO2 processing costs dating back to December 2002.

A reduction in the credits for the I-2, IS-2, I-4 and IS-4 schedules from the previous filing account for a $.7 million increase (Line 5 of the Summary Table). The Supplier Non-Gas Costs, which are backed out of the commodity rate and recorded as a separate SNG component of the total rate, account for a $.2 million increase. (Line 6 of Summary Table)

An increase of $3.7 million in costs is due to the amortization of the $34.2 million under collected balance in the 191-Account Balance. (Line 7 of Summary Table)

SUMMARY TABLE

Line		Inc (dec) Rate from prev filing (/Dth)	Inc (dec) Costs from prev filing (millions)
	GS-1 Current filed gas commodity	$4.746	
1	Production	$0.023	$2.3
2	Gas Purchases	$1.319	131.3
3	Gath,transp and Storage	($0.215)	(21.4)
4	Total Gas Related Costs	$1.127	112.2
5	Reduced credits	$0.007	0.7
6	SNG adjustment	$0.002	0.2
7	191 amortization	$0.037	3.7
8	Total Commodity	$1.173	116.8
9	IS-4,I-4 est commodity adj.		2.3
10	Total Commodity Increase	$1.173	$119.0
	GS-1 Proposed gas commodity rat	$5.919	

A detail reconciliation of the above table is attached as Exhibit 2.

The Division also notes that beginning October 1, 2005, the PSC-Ordered Gas Processing Refund credit of ($0.28567) will be removed from the current tariffs, adding an additional $2.74 monthly charge to a typical customer using 115 decatherms per year. This event will cause QGC to file an updated pass-through filing and at that time an updated forecast of prices based on existing market conditions.

SUMMARY AND CONCLUSION:

In summary, this is a major increase in natural gas costs and comes at a time when gas costs are high due to reported imbalances in the gas market supply and demand model. This raises several concerns the Division has with this pass through filing:

The **first** is, QGC's customers may mistakenly conclude that Questar Gas Company will profit from this increase. Some of this confusion probably arises from Questar's

Corporate press releases on earnings which are being driven by Questar's Market Resources benefiting from these high prices The Division wishes to emphasize to the Commission, that other than the carrying costs on the inventories in the storage gas, QGC is only passing on the costs they incur from gas producers in providing the gas supply necessary to meet demand and, therefore, QGC does not profit from these increases. The Division feels that this fact is sometimes lost in press releases to the public as well as the fact that the impact of this increase is less than half of what the impact could have been if QGC didn't have the benefit of the WEXPRO production to meet about 40% of its supply needs.

The **second** concern is, because this is a major increase, the effect of which may not be felt by most customers until the winter heating season begins, there will naturally be an effort on many to reduce usage. This may impair QGC in their ability to recover their fixed costs due to current rate designs, which recover those costs through volumetric sales. Because of this, the Division will continue to closely monitor the price of Rocky Mountain natural gas as compared to the prices in this filing and will make appropriate recommendations to adjust rates if necessary. The Division also will work with QGC to explore ways to mitigate the effect declining usage has on the Company so that conservation measures maybe more fully undertaken as a joint effort on the part of QGC and their customers.

The **third** concern is the impact these prices may have, not only on residential users but also on the Utah economy as they impact industrial and commercial entities. The Division recognizes the pressure this places on entities to remain competitive and profitable while not becoming inflationary. Despite these concerns, and after reviewing

QGC's application, the Division doesn't object to the Commission approving this application on an interim basis in order to allow Questar Gas Company to continue to provide the required gas service during this period of high gas prices. The Division also recommends that QGC be required to provide monthly updates on developments in the gas industry that might affect current and future prices of natural gas and that these updates continue through the upcoming fall and winter seasons.

As always, the Division will continue to monitor the published monthly index prices[7] and compare them to the prices used in this pass-through filing to see if any trend develops which may warrant an out of period filing by QGC to reduce the commodity gas cost rate.

Cc: Questar Gas Company
Committee of Consumer Services
Rea Petersen, Division of Public Utilities
Russell Skousen, Department of Commerce

[7] Published monthly in Platts "Inside FERC's Gas Market Report."

EXHIBIT 1

Gallon gasoline to Decatherm conversion:

1 gallon of gasoline equals approximately 112,750[8] Btus.
1 decatherm equals 1,000,000 Btus.
1 decatherm equals 8.7 gallons of gas.
1 gallon of gas at the pump costs $2.25
1 decatherm delivered to house costs $7.89 in summer and $8.79 in winter. (Per proposed GS-1 rate schedule effective June 1, 2005.)
8.7 gallons x $2.25 equals $19.58
$19.58 for 8.7 gallons of gas compared to $7.89 or $8.79 for one decatherm of natural gas.

[8] Weighting of Btu/gal factors for pentanes, hexane and heptane (gasoline liquid componets found in natural gas streams) from GPA publication 2145-93.

EXHIBIT 2

DETAIL OF SUMMARY TABLE

		UTAH		
		05-057-06	04-57-11	Difference
3	Questar gas production	$ 176,041,820	$ 159,559,132	
4	Other Revenues credit	$ (25,541,345)	$ (13,959,730)	
5	Net QGC Production costs	$ 150,500,476	$ 145,599,401	
6	Gathering	$ 1,885,133	$ 2,438,112	
7	Total Cost of Questar Production	$ 152,385,608	$ 148,037,513	$ 4,348,095
8				
9	Questar Gas Contract Gas	$ 436,651,006	$ 301,080,550	$ 135,570,456
10				
11	Storage adjustment	$ (22,276,546)	$ 770,225	$ (23,046,771)
12				
13	Transportation	$ 63,915,938	$ 62,502,609	$ 1,413,329
14				
15	Storage & Working Gas	$ 18,184,122	$ 16,821,808	$ 1,362,313
16				
17	Utah Allocation of Questar Gas-Related Gas Costs	$ 648,860,128	$ 529,212,705	$ 119,647,422
18	Less:			
19	F-3 Demand Commod Credit	$ (32,339)	$ (46,428)	$ 14,089
20	I-2, IS-2 & t-1 Class Commod Credit	$ -	$ -	$ -
21	I-4 IS-4 Class Commod Credit	$ (12,446,605)	$ (12,923,862)	$ 477,257
22				
23	Net Utah Gas Costs (For Firm Sales)	$ 636,381,183	$ 516,242,415	$ 120,138,768
24				
25	Supplier Non-Gas Costs	$ (79,152,962)	$ (78,276,999)	$ (875,962)
26				
27	Commodity Portion of Test-Year Gas Costs	$ 557,228,222	$ 437,965,416	$ 119,262,806
28				
29	191 Account Amortization	$ 32,075,148	$ 28,023,676	$ 4,051,472
30				
31				
32				
33				
34	Test Year Sales			Inc (dec)
35	Utah (Firm)	99,564,742	98,186,656	Cost Comp (000)
36				
37		Col A	Col B	Col C / Col D
38	Questar gas production	$ 1.768	$ 1.625	
39	Other Revenues credit	$ (0.257)	$ (0.142)	
40	Net QGC Production costs	$ 1.512	$ 1.483	
41	Gathering	$ 0.019	$ 0.025	
42	Total Cost of Questar Production	$ 1.531	$ 1.508	$ 0.023 / $2,270
43				
44	Questar Gas Contract Gas	$ 4.386	$ 3.066	$ 1.319 / $131,345
45				
46	Storage adjustment	$ (0.224)	$ 0.008	$ (0.232) / -$23,058
47				
48	Transportation	$ 0.642	$ 0.637	$ 0.005 / $536
49				
50	Storage & Working Gas	$ 0.183	$ 0.171	$ 0.011 / $1,126
51				
52	Utah Allocation of Questar Gas-Related Gas Costs	$ 6.517	$ 5.390	$ 1.127 / $112,220
53	Less:			
54	F-3 Demand Commod Credit	$ (0.000)	$ (0.000)	$ 0.000 / $15
55	I-2, IS2 & t-1 Class Commod Credit	$ -	$ -	$ - / $0
56	I-4 IS-4 Class Commod Credit	$ (0.125)	$ (0.132)	$ 0.007 / $659
57				
58	Net Utah Gas Costs (For Firm Sales)	$ 6.392	$ 5.258	$ 1.134 / $112,893
59				
60	Supplier Non-Gas Costs	$ (0.795)	$ (0.797)	$ 0.002 / $223
61				
62	Commodity Portion of Test-Year Gas Costs	$ 5.597	$ 4.461	$ 1.136 / $113,116
63				
64	191 Account	$ 0.32215	$ 0.28541	$ 0.037 / $3,658
65				
66	I-4 Adjustments			$2,264
67				
68				1.17 / 119,038.00

Col A & B line 38-64 rates are line 35 divided into repective lines 3 -29.
Col C is Col A less Col B
Col D is Col C x line 35 Col A