State of Utah
Department of Commerce
Division of Public Utilities

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Memorandum

TO: Public Service Commission

FROM: Division of Public Utilities
Philip Powlick, Director,
Artie Powell, Energy Manager
Charles Peterson, Technical Consultant
Tatyana Silva, Intern

DATE: March 4, 2008

RE: Questar Gas Dividend Declaration February 12, 2008

I. ISSUE

On February 12, 2008 the Board of Directors of Questar Gas Company declared a quarterly cash dividend of $6,875,000 on the outstanding shares of Questar Gas common stock. The dividend is payable to the Company's sole shareholder on March 17, 2008.

Pursuant to Utah Code Annotated 54-4-27, the Company must notify the Commission of the dividend within five days of its declaration. The Commission has 30 days from the dividend declaration date to investigate whether the payment of such dividend would result in impairment of the capital or to the utility's service to the public, and if it finds that such impairment will or may occur, the Commission may order that the dividend not be paid.

II. RECOMMENDATION (No Action)

Based upon the following analysis, the Division finds no indication that the capital and operations of Questar Gas Company will be impaired pursuant to UCA 54-4-27. Therefore the Division recommends that the Commission take no action.

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III. ANALYSIS

The Division of Public Utilities has investigated the effects of the dividend on the capital and cash flows of the Company using the latest financial information available, the annual financial statements through December 31, 2006 and the quarterly financial report as of September 30, 2007 and reviewed the Company's bond rating though the various bond rating agencies.

In approaching this assignment, the Division understands the terms "impaired" and "impairment" in the statute to mean that (1) the payment of the dividend will result in actions being taken against the Company by creditors, rating agencies, or others due to a reduction in the value of the capital, the violation of loan covenants, or other agreements; (2) the payment of the dividend would result in a reduced ability of the Company to provide service through a lack the working capital or other financial capacity to continue its operations in the same manner it would if the dividend were not paid.

Exhibit 1 sets forth financial results for the years ended December 31, 2000 through 2006 and operating results for the twelve months ended September 30, 2007. Revenues for the year ended December 31, 2006 increased to $1,064 million from $963 million for the same period in 2005, a 10.5 percent gain; over the same period net income increased from almost $36.0 million to 37.0 million, for a 2.8 percent gain. Natural gas sold costs, were up about 14 percent from 2005 to 2006. Natural gas costs are passed through to customers and are the main driver in the revenue increase. Longer term, revenues and operating expenses were all increasing at a 12 to 13 percent annual rate over the 2000 to 2006 time period; however, net income was growing at a more moderate 7.4 percent annually over the same period. Over the 2000 to 2006 period, dividends on common stock have consistently increased by $500,000 each year, or about 2.0 percent annually over the period covered. Questar Gas has continued this policy through 2007, and at the first quarter rate, Questar Gas will increase its dividend payment in 2008 by $500,000 to $27.5 million. Comparing the revenues and income of the rolling twelve month period ended September 30, 2007 with the December 31, 2006 year-end results indicates that Questar Gas' total revenues are declining. The decline is primarily due to the reduced price of natural gas and secondarily to the rate reduction ordered last September.

The Company's net profit margin averaged about 3.9 percent of revenues over the 2000 to 2006 period ranging from 5.4 percent in 2002 to 3.3 percent in 2003; for 2006 it was a below-average 3.5 percent. For the rolling twelve month period ending on September 30, 2007, the net profit margin was about 3.9 percent. Questar Gas's margin (revenues less gas costs) increased $3.3 million in the third quarter of 2007 compared to the third quarter of 2006 and decreased $0.2 million in the first nine months of 2007 compared to the first nine months of 2006 and decreased $6.5 million in the 12 months ended September 30, 2007, compared with the 12-month period ended September 30, 2006. Following is a summary of major changes in Questar Gas's margin

The balance sheet information set forth on pages 3 and 4 indicates some sizable fluctuations in certain accounts over the time period examined. Current assets and current liabilities reflect these fluctuations. As might be expected, gross and net plant in service increased fairly steadily over the 2000 to 2006 period. Net plant averaged a 4.8 percent annual increase over the 2000 to 2006 period. Total assets increased at an average rate of 4.4 percent annually. Beginning in 2006 the Company has increased its annual capital expenditures over levels prevailing during the last few years. The purpose is to keep up with the growth in the number of customers, of course, but more recently the Company determined that it needs to replace older plant at a faster rate than in the recent past. The Company indicates in its 2006 10-K that it plans to spend $116.4 million in 2007 for capital expenditures compared with $86.7 million in 2006.[1]

Long-term debt, including current portion, increased at an average rate of 6.2 percent annually. However, common equity grew at a lower average rate of 3.8 percent due, in part, to the rate of increase in retained earnings of 3.0 percent. Of special note is the notes payable to Questar. This account has varied widely between $36 million and almost $106 million on an annual basis. As of September 30, 2007 the account balance was $19,700,000. It appears that Questar Gas uses its parent company as a "bank" from which it obtains short-term loans according to its need for liquidity. The flip-side is that during the spring and summer, the Company loans funds to the parent as indicated by a note receivable from Questar Corp.

The primary cause of the difference in growth between long-term debt and common equity, compared to total assets is deferred income taxes which steadily grew at a 6.8 percent annual clip and other deferred credits that grew at 44.2 percent. Deferred income taxes are considered, in some contexts, to be part of common equity: here it has represented a cash flow that was available to pay dividends and make other capital or financing payments. Common equity as a percent of total assets declined from 37.7 percent in 2002 to 28.8 percent in 2005 before rebounding a little to 30.7 percent as of December 31, 2006. The Company has no preferred stock.

Page 7 of Exhibit 1 sets forth financial ratios and other information for the period under consideration. Short-term liquidity ratios, which had been softening somewhat in the prior couple of years, were stronger by yearend 2005, but were back below the 2000 to 2006 averages by the end of 2006. Most of the long-term solvency ratios were below the average of the 2000 to 2006 period at the end of 2006.

The profitability ratios have remained fairly healthy through the end of 2006. On an SEC financial reporting basis the Company had a return on equity (ROE) of 11.42 percent in 2006, 22 basis points above its regulatory allowed rate of return in Utah. The PSC approved a rate reduction in June 2006 that will likely bring the Company's ROE down somewhat as is indicated by the 11.23 percent ROE for the 12 months ended September 30, 2007.

Asset utilization ratios have shown some improvement in the last year or two; however this is partly or perhaps entirely, due to the increase in the price of natural gas, which is a pass-through for the Company. It is unclear at this time whether the asset utilization ratios would show deterioration absent the run-up in natural gas prices.

[1] Questar Gas Company, SEC Form 10-K, December 31, 2006, p. 12.

Questar Gas has apparently not had a published ratings update by Standard & Poor's since April 1, 2005, when the Company's debt was rated A- with a stable outlook. Moody's gives Questar gas its A2, based in part on low (9%) Questar return on equity [at the time]. Questar Corp. does not issue debt at the parent-company level. The company issues debt at the subsidiary level, primarily to provide capital-structure clarity for regulatory purposes. [2] Moody's rating is slightly higher than S&P's A- rating, but the rating was apparently last updated in 2002. Both Standard & Poor's and Moody's ratings of Questar Gas are investment grade ratings. There is no apparent indication from the rating agencies that they have particular concern for Questar Gas that would have an effect on the debt rating in the short term. Questar Gas' parent, Questar Corporation has a current bond rating that is also A-.

The Company's capital structure has drifted downward since 2000 when it was about 46 percent debt and 54 percent equity. Currently it is about 50-50 debt and equity.

Exhibit 2 sets forth a comparison of Questar Gas results with standards set by Standard & Poor's for "A"-rated debt and business profiles 3, 4, and 5. The most recent information we have, as of February 2007 Questar Gas was given a relatively good business profile score of 3.[3] While the Division does not know what adjustments the Standard & Poor's analysts might make to Questar's financial results, our calculations indicate that while the FFO Interest Coverage ratio is in good shape, likewise the FFO to Total Debt ratio has significantly improved over the past year. The Debt to Capital ratio remains a bit low for "A"-rated debt with a "3" business profile. This is consistent with the Company's A- rating by Standard & Poor's.

The financial characteristics of Questar Gas generally indicate a profitable and stable utility company. The return on equity calculated on an SEC reporting basis indicates a return of 11.4 percent for the twelve months ended December 31, 2006. This compares with the Company's authorized return—on a regulatory adjusted basis—of 11.2 percent. As mentioned above, the recent reduction in rates ordered by the Commission will likely reduce the ROE somewhat going forward. The recent volatility in natural gas prices and the likely consumer response may have some long-term negative impact. However, for now at least, the natural gas commodity prices have significantly declined from their peaks of a year ago and appear to have fallen into a less volatile, more predictable, pattern. The growth in common equity has been slower than the growth of the company generally. The dividend policy of the Company is, of course, contributing to that slower growth in equity vis-à-vis the other accounts. If this trend continues at some point the capital structure of the Company would be negatively impacted, which could result in a rating downgrade. However, the Company would be expected to act long before such an eventuality resulted in a negative impact.

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[2] Questar Comments on Moody's Rating,, http://prnwire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/11-12-2002/0001839749&EDATE= > < Accessed December 4, 2007

[3] A business profile score ranges from 1 (very good) to 10 (very poor) with 5 being average. The score rates the risk of the business environment, including regulation, which the company operates in.

The Division has made its own *pro forma* analysis and forecast of the financial results of Questar Gas. The analysis assumes a level of profitability consistent with the recent past including an adjustment for the June 2006 rate reduction. The forecast has also attempted to account for an increase in capital expenditures relative to the historical period, but assumes that other expenses and accounts are kept in line with the historical period. New debt is issued as needed. Dividends on common stock are assumed to increase by $500,000 per year consistent with the recent trends. Capital expenditures are forecast to increase to the $130 million range for 2008 through 2010, based on indications from the Company's rate case filing. While this analysis is based upon a number of assumptions that appear reasonable at this time, actual results will undoubtedly vary, perhaps widely. With this caveat in mind, the Division concludes that there is no indication that the assumed level of dividends, capital expenditures and additional debt will materially and negatively impact the financial health of Questar Gas. Return on equity drops below 10.0 percent in the forecast after 2009 and drops to 9.60 percent in 2011. The Division intends to monitor the financial results of Questar Gas as future quarterly and annual financial statements become available. Exhibit 3 sets forth the forecast financial statements prepared by the Division for calendar years 2007 through 2011.

The Division concludes that the payment of a $6,875,000 common dividend as declared by Questar Gas's Board of Directors is within the discretion of the Company and it appears that there will be no impairment of the capital and the services rendered by the Company because of this dividend payment.