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
Doug Wheelwright, Utility Analyst

DATE: December 1, 2008

RE: Questar Gas Dividend Declaration October 28, 2008

I. ISSUE

On October 28, 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 December 15, 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. This included the annual financial statements through December 31, 2007, the quarterly financial report as of September 30, 2008 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 of 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 2007 and operating results for the twelve months ended September 30, 2008. Revenues for the year ended December 31, 2007 decreased to $932.5 million from $1,064.6 million in 2006, a 14 percent decline. Over the same 2006 to 2007 period, net income increased from $37.0 million to 37.4 million, for a 1 percent gain. Natural gas sold costs were down about 2 percent from 2006 to 2007. Natural gas costs are passed through to customers and are the main driver in the revenue decrease. Longer term, revenues and operating expenses were all increasing at a 8.2 to an 8.6 percent annual rate over the 2000 to 2007 time period; however, net income was growing at a more moderate 6.4 percent annually over the same period. Over the 2000 to 2007 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 2008. Comparing the revenues and income of the rolling twelve month period ended September 30,

2008 with the December 31, 2007 year-end results indicates that Questar Gas' total revenues have increased from $932.5 to $958.2. This increase is due primarily to the recent rate increase. The Company's net profit margin averaged about 3.95 percent of revenues over the 2000 to 2007 period ranging from 5.4 percent in 2002 to 3.3 percent in 2003; for 2007 it was slightly above the historical average at 4.01 percent. For the rolling twelve month period ending on September 30, 2008, the net profit margin was 3.93 percent. Questar Gas's margin (revenues less gas costs) for the rolling 12-months ending September 2008 was $252.6 million, a difference of $7.3 million in comparison to 2007 ending margin.

The balance sheet information set forth on pages 3 and 4 of Exhibit 1 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 2007 period. Net plant averaged a 5.6 percent annual increase over the 2000 to 2007 period. Total assets increased at an average rate of 5.0 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, but the Company also determined that it needs to replace older plant at a faster rate than in the recent past. The Company indicates in its 2007 10-K that it plans to spend $136.4 million in 2008 for capital expenditures compared with $135.9 million in 2007.[1]

Long-term debt increased at an average rate of 2.6 percent annually over 2000 through 2007. However, with a new debt issuance this spring, long-term debt jumped by $100 million to $370 million as of September 2008. Common equity grew at a higher average rate of 3.7 percent due, in part, to a $30 million equity contribution from the parent company. 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, 2008 the account balance was $72.2 million. 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.

[1] Questar Gas Company, SEC Form 10-K, December 31, 2007, p. 12.

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 6.3 percent annual clip and other deferred credits that grew at 39.3 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 to 30.7 percent as of December 31, 2006, but declined again to 29.2 percent as of December 31, 2007. As of September 30, 2008 it amounted to 31.7 percent. 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 year end 2005. However, they became weaker since that time. Most of the long-term solvency ratios were below the average of the 2000 to 2007 period at the end of 2007.

The profitability ratios have remained fairly healthy through the end of 2007. On an SEC financial reporting basis the Company had a return on equity (ROE) of 11.16 percent in 2007, which is virtually identical to the allowed 11.2 percent during the period. Rates are expected to decrease due to the 2006 CET Amortization case and the rate order in Docket No. 07-057-13, where the company's authorized return on equity was reduced to 10.0 percent.

Asset utilization ratios are mostly in line with long-term averages.

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 this year downgraded Questar to A3. Questar Corp. does not issue debt at the parent-company level. The parent instead issues debt at the subsidiary level, primarily to provide capital-structure clarity for

regulatory purposes. [2] 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 of A-2.

The Company's capital has maintained a 48 percent to 52 percent debt and equity, respectively, capital structure since 2000.

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 2008 is that Questar Gas was given a relatively good business profile score of 3.[3] The Division does not know what adjustments the Standard & Poor's analysts might make to Questar Gas financial results, our calculations indicate that QGC's 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 11.16 percent for the twelve months ended December 31, 2007. 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 to 10 percent going forward. The recent volatility in natural gas prices and the likely consumer response may have some long-term negative impact. 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

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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.

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.

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 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. In 2008, the Company obtained new long term debt, and is forecasted to increase their debt as needed up through 2012. Dividends on common stock are assumed to increase by $500,000 per year consistent with the recent trends. After 2008, capital expenditures are forecasted to increase from 2009 through 2012, based on the current trend between 2000 and 2006 (before major plant growth). 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. The Company is projected to maintain a 10 percent return on equity for the first couple of years, but will increase to 11 percent by 2012. Adjustments will be required in the future to maintain the regulated return on equity level.

IV. CURRENT CREDIT ENVIRONMENT

The Division is concerned with the current and ongoing changes in the financial market. The current availability of credit and the ability of Questar to obtain adequate financing for operations should be addressed by the company. As noted above, Questar Corporation does not issue long term debt at the parent-company level. The company issues debt at the subsidiary level, primarily to provide capital-structure clarity for regulatory purposes. With the recent tightening in the credit markets it is even more important to maintain adequate cash balances to fund current and future operational needs.

The dividend payment of Questar Gas to the parent company in prior years has been reviewed in relationship to the other affiliated companies. In 2007 Questar Gas provided 34.2% of total revenue and 7.4% of net income. Questar Gas paid out 73.5% of net income to the parent company provided 32.3% of the Questar Corporation dividend payment. Similar percentages were paid in 2006 and 2005 as illustrated below.

	2007 Questar Corporation	2007 Questar Gas	2006 Questar Corporation	2006 Questar Gas	2005 Questar Corporation	2005 Questar Gas
Revenue	2,726.6	932.5	2,835.6	1,059.1	2,724.5	962.5
Net Income	507.4	37.4	444.1	37.0	325.7	36.0
Dividend	83.7	27.0	79.7	26.5	75.6	26.0
Payout Ratio	16.50%	72.19%	17.95%	71.62%	23.22%	72.22%

This is a large cash requirement from one entity and is a concern in the current credit environment. While there is no indication of Questar Gas Company's debt ratings changing, the Division notes that Standard & Poors has recently placed the industry on credit watch. However, taking into account current market conditions and Questar Gas Company's financial strength, current circumstances indicate that Questar Gas Company should have adequate cash flows to maintain its service obligations and meet its financial needs.

V. CONCLUSION

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.