Memorandum

TO: Public Service Commission

FROM: Division of Public Utilities
Chris Parker, Director,
Artie Powell, Energy Manager
Charles Peterson, Technical Consultant
Doug Wheelwright, Technical Consultant

DATE: March 10, 2016

RE: Questar Gas Dividend Declaration February 16, 2016

I. 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.

II. ISSUE

On February 16, 2016, the Board of Directors of Questar Gas Company (QGC) declared a quarterly cash dividend of $10.0 million. The dividend is payable to the Company's sole shareholder, Questar Corporation, on March 21, 2016.

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.

III. ANALYSIS

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 as it would if the dividend were not paid.

The Division of Public Utilities 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, 2015, Questar Corporation News Release dated February 17, 2016, and a review of the Company’s bond rating from the various bond rating agencies. The financial characteristics of Questar Gas generally indicate a profitable and stable utility company.

Exhibit 1 is a summary of the financial results for the periods ending December 31, 2010 through December 31, 2015. Effective March 1, 2014, Questar Gas received approval to increase rates as a result of a general rate case. For the 12 months ending December 31, 2015, total revenue saw a decrease of 4.51% from $960.9 million to $917.6 million. The decrease in total revenue is primarily due to a decrease in the total volume due to warmer than normal weather conditions and a decrease in the market price of the natural gas commodity. During calendar year 2015, the calculation of heating degree days[1] was 19% warmer than normal. From a longer term perspective, total revenue has increased slightly from 2010 through 2015 with an average annual increase of 0.32%.

Earnings from Operations increased 12.1% from $109.4 million in 2014 to $122.6 million in 2015. During the same period, net income increased 16.5% from $55.2 million to $64.3 million. Net Income as a percentage of total revenue (Net Margin) increased to 7.01% in 2015 compared

[1] The number of degrees that the average temperature for the day is below 65° Fahrenheit.

to the five year average of 5.67%. The weather, as measured in heating degree days, was 19% warmer than normal in 2015.

During 2015, the Company experienced a 2.9% increase in the number of customers from 962,000 to 990,000. A portion of the growth in total customers is due to the purchase of the Eagle Mountain service area. The customer growth rate without the Eagle Mountain acquisition was 2.3%. While the number of customers increased, the temperature adjusted usage per customer decreased from 108.9 Dth in 2014 to 103.3 Dth in 2015.

Natural Gas supplies were provided by a combination of cost-of-service production and from market purchases. Cost-of-service natural gas provided by Wexpro represented approximately 59% of the natural gas supply in 2015 compared to 62% in 2014. With the lower market price of natural gas, Wexpro drilling has been slowed compared to previous years. The reduction in the drilling of new wells has reduced the total production. Wexpro produced 57.7 Bcf of Cost-of-Service gas in 2015 compared to 63.5 Bcf in 2014. Market purchases total 39.6 Bcf in 2015 compared to 38.8 Bcf in 2014. [2]

The balance sheet information on page 2 of Exhibit 1 identifies an increase in accounts receivable from Affiliates from $45.2 to $69.2 million due to the allocation of qualified plan and postretirement benefits to the operating entities. Accounts receivable and unbilled gas accounts receivable showed little change over the reporting periods. For comparison, the net plant and equipment has increased steadily from 2010 through 2015 with a 9.91% average annual increase compared to a 9.25% average annual increase in total assets. Capital expenditures have increased from $108.6 million in 2010 to $217.4 million in 2015 primarily due to the ongoing feeder line replacement program.

Page 4 of Exhibit 1 calculates the financial ratios for the periods under review. Short-term liquidity ratios for 2015 were lower than historical averages with the current ratio at 0.82 and the quick ratio at 0.49 compared to the average of 0.86 and 0.55. The long-term solvency ratios are

[2] Exhibit 1, page 6.

also slightly lower than historical averages with Net Worth / Total Debt at 0.40 and Net Worth / Fixed Assets at 0.36 compared to the average of 0.43 and 0.37.

The profitability ratios are changing due to the increase in capital expenditures in recent years. Return on Total Assets shows a slight decrease in 2015 to 3.97% compared to the historical average of 4.04%. Return on Total Capital was 7.22% in 2015, down slightly from average of 7.33%. On an SEC financial reporting basis, the Company had a Return on Equity (ROE) of 10.53% for 2015. The Company's authorized return on equity is 9.85% and is calculated based on slightly different regulatory guidelines. The calculation for the regulatory ROE includes a number of adjustments and has historically been lower than the SEC calculated amount. The adjusted regulatory ROE will be provided by the Company with the Results of Operation filed in March. Based on the preliminary calculations, the Company does not appear to be earning more than the Commission authorized rate of return. The Division will continue to monitor the regulatory ROE calculations and will report any findings to the Commission.

The Company paid four quarterly dividends in 2015 for a total payment of $38.0 million. This amount represents a 5.5% increase from the $36.0 million in dividends paid in 2014. The annual dividend payment amount represents a 59.1% payout ratio of the total net income. The 2015 payout ratio is lower than the five year average of 65.5%. The payout ratio is calculated by dividing the annual dividend payment by the net income.

Included in the Other Financial Indicators section are four calculations used by Moody's as part of their bond rating guidelines. These include the EBIT / Interest, Debt / Book Capitalization, Retained Cash Flow / Debt and a Simple ROE calculation. All of these ratios are within the guidelines specified by the rating agencies as of year-end 2015. On January 31, 2014, Moody's Investor Services upgraded Questar Gas and Questar Corporation from A3 to A2.[3] The upgrade was due to the following rationale:

> The regulatory environment has been constructive for Questar Gas. The company has obtained rate mechanisms that stabilize its credit metrics and accelerate the

[3] Moody's Investor Service, US utility sector upgrades driven by stable and transparent regulatory frameworks, February 3, 2014.

> recovery of its investments. For example, its recent rate order indefinitely extended an existing decoupling mechanism and implemented an infrastructure cost-tracking mechanism that allows Questar Gas to place into rate base almost immediately upon project completion capital expenditures associated with a multi-year high-pressure natural gas feeder-line replacement program. We expect this replacement program to continue to keep Questar Gas' capital expenditures elevated for several years, so this cost tracking mechanism will help accelerate the recovery of this investment. The company has also had a weather normalization adjustment mechanism for some time. [4]

On February 1, 2016, Moody's placed Questar Corporation on review for downgrade but affirmed the outlook for Questar Gas and Questar Pipeline as stable. The review for downgrade was prompted by the announced acquisition of Questar Corporation by Dominion Resources.

The Company's regulatory capital structure is currently 46.1% debt and 53.9% equity, which is close to the five year average of 46.8% debt and 53.2% equity. Total Common Equity grew at an average rate of 8.5% for the periods under review and included a $20 million equity contribution from the parent company in 2011 and a $90 million equity contribution from the parent company in 2013.

Long-term debt is currently $534.5 million. In December 2012 the Company issued $150.0 million in private placement notes and an additional $150.0 million was issued in December 2013. The 2012 debt was issued as 12 and 15 year notes at an average rate of 3.2%. Proceeds from these issues replaced $133.5 million in maturing debt with an average rate of 6.06%. The 2013 debt was issued as 30 and 35 year notes at an average rate of 4.8%. Proceeds from these issues were used to repay existing indebtedness and general corporate purposes. Questar Corp. normally 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.[5]

Of special mention is the note payable to Questar Corporation of $273.3 million. Short term notes payable to the parent company have varied widely during the periods under review. The

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[4] Moody's Investor Service, Rating Action: Questar Corporation and Questar Gas, January 31, 2014.
[5] Questar Comments on Moody's Rating,, http://prnwire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/11-12-2002/0001839749&EDATE= > < Accessed June 9, 2010.

note to Questar Corp reached the lowest point at $17.7 million as of December 2013, increased to $119.3 in 2014 and has increased further to the current historical high of $273.3 million. It appears that Questar Gas continues to use its parent company as a “bank” from which it obtains short-term loans according to its need for liquidity. The Company has indicated that it will be issuing additional long-term debt to reduce the note payable to Questar Corp. The additional debt issuance has been postponed due to the pending merger of Questar Corp with Dominion Resources. Short term intercompany loans charge an interest rate based on the method determined in Docket 85-057-09. As of December 2015, the interest rate on the intercompany loan was 0.25%

Page 5 of Exhibit 1 includes the operating statistics and looks at the revenue by customer class along with the natural gas costs per dekatherm (Dth) for each year under review. Residential, commercial and industrial sales provided 94.9% of the total revenue dollars but represented 55.8% of the total volume in 2015. The volume of gas for transportation customers has increased from 30.7% in 2011 to 44.2% in 2015. The increase in the volume for transportation customers is likely due to the low commodity price which has created an incentive for large volume customers to move to the transportation class. System natural gas cost were down 15.6% to $5.05 per Dth compared to $5.98 per Dth in 2014.

Page 6 of Exhibit 1 includes a breakdown of the cost of sales for Questar Gas. The majority of this information is taken from Note 1-F included in the SEC 10-K report. Of particular note is the Operator Service Fee (OSF) paid to Wexpro. While the total cost of gas sold has decreased at an annual average rate of 1.18% for the periods under review, the OSF has increased at an average annual rate of 5.86% and represents the largest individual line item in the total cost of gas. The OSF grew from $240.0 million in 2010, increased to $349.7 million in 2014 and has decreased to $319.0 million in 2015. In contrast to the growth in the cost of the OSF, the volume (Bcf) of the cost of service gas production from Wexpro has increased at an average annual rate of 2.82%. During the same time period, the volume of purchased gas decreased at an average annual rate of 8.01% and the cost decreased at an average annual rate of 19.59%. The Division is currently reviewing the individual components of the OSF in prior years and will provide any findings to the Commission.

On May 1, 2012, Questar Gas Company filed a legal action against QEP Field Services Company, a subsidiary of QEP Resources, Inc. Questar Gas believes certain charges of QEP Field Services Company for gathering services exceed the amounts contemplated under a Gas Gathering Agreement, effective September 1, 1993, pertaining to certain gas produced by Wexpro Company under the Wexpro Agreement. Questar Gas is alleging breach of contract by QEP Field Services Company and is seeking an accounting, damages and a declaratory judgment relating to the services and charges under the Gas Gathering Agreement. In an agreement dated October 19, 2014, QEP Field Services and Tesoro Logistics (Tesoro) entered into a membership purchase agreement to transfer interest and related assets and liabilities to Tesoro including control of this legal action. Tesoro closed on the transaction for QEP's midstream business on December 2, 2014.

On December 2, 2014, the court issued a memorandum decision granting for partial summary judgment for breach of contract filed by Questar Gas. The court found that QEP breached the Gas Gathering Agreement by overcharging Questar Gas in its gathering rates. The court also denied two motions for partial summary judgment filed by QEP to reduce or limit contract damages. The court also denied cross-motions for partial summary judgment by both parties relating to another claim of breach of contract. The issues raised by the cross-motions, QEP counterclaim and damages on all claims are currently reserved for trial. Trial has been scheduled for April 2016. While Questar intends to vigorously pursue its legal rights, the claims and counterclaims involve complex legal issues and uncertainties that make it difficult to predict the outcome and therefore, management cannot determine whether this litigation may have a material adverse effect on its financial position, results of operations or cash flows.[6]

In a separate legal issue, in February 2015, a trial was held in the case of Rocky Mountain Resources and Robert N. Floyd v. QEP Energy Company and Wexpro Company.[7] Plaintiffs

[6] Questar 2015 Form 10-K, Note 10 – Contingencies, p. 86.
[7] Ninth Judicial District, County of Sublette, State of Wyoming, Case No. 2011-7816.

allege they are entitled to a 4% overriding royalty interest (ORRI) in a state oil and gas lease assigned to Wexpro and QEP in the Pinedale Field. On February 13, 2015, a jury decision was reached that awarded the Plaintiffs $14.1 million from Wexpro and $16.2 million from QEP. Wexpro and QEP plan to file an appeal of the case to the Wyoming Supreme Court. Wexpro has accrued its estimate of additional royalties in the case. Any additional payments from this case could potentially be expected to be recovered from Questar Gas customers.[8]

On January 31, 2016, Questar Corporation, the parent company of Questar Gas, entered into a merger agreement with Dominion Resources, Inc. a Virginia corporation. The merger is subject to the approval from Questar shareholders and regulatory agencies and is expected to be completed by the end of 2016. The Merger Agreement includes certain termination rights for both companies. Under certain circumstances, Questar could be required to pay termination fee of $99.0 million. In addition, upon termination in certain specified circumstances, Questar would be required to reimburse certain expenses in an amount not to exceed $5.0 million. Dominion may also be required to pay a termination fee of $154.0 million to Questar under certain circumstances.[9] The Division is currently reviewing the proposed merger agreement and specific dates for a Commission decision have not been determined.

Questar Corporation owns 100% of the stock in Questar Gas; therefore, the entire dividend payment of $10.0 million will be paid to Questar Corporation. The dividend payment represents a significant cash requirement for the Company and could become an issue if there is a downward trend in the overall profitability. At the present time, Questar Gas has adequate cash flow to maintain its debt service obligations and meet its financial needs. The Company is projected to maintain profitability levels similar to historical results and the Division will continue to monitor the actual results and the regulated return on equity.

[8] Questar 2015 Form 10-K, Note 10 – Contingencies, p. 87
[9] Questar 2015 Form 10-K, Note 2 – Proposed Merger with Dominion Resources, p. 75

IV. CONCLUSION

The Division concludes that the payment of a $10.0 million common stock dividend 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 or the services rendered by the Company.

cc: Barrie McKay – Questar Gas
Michele Beck – Office of Consumer Services