

MICHAEL L. GINSBERG (#4516)
Assistant Attorney General
Division of Public Utilities
MARK L. SHURTLEFF (#4666)
Attorney General
160 East 300 South
P.O. Box 140857
Salt Lake City, Utah 84114-0857
Telephone (801) 366-0353

BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

In the Matter of an Application of
QUESTAR GAS COMPANY for an
Increase in Rates and Charges.

POST HEARING MEMORANDUM

Docket No. 02-057-02

The following is the Post hearing Memorandum of the Division of Public Utilities (DPU) on the issue of the rate of return and capital structure of Questar Gas Company in the above entitled proceeding.

INTRODUCTION

This rate case is significant because it is the first Questar rate case in a number of years where the Company made a concerted effort to change the Commission's test year policy to improve what it viewed as its most serious issue; i.e., growth in customers and a corresponding increase in rate base and the decline in the use of gas per customer. These issues, plus others, caused Questar to argue that it would not have an opportunity to earn its authorized rate of return in the rate effective

period without changes in how the PSC regulated Questar. The stipulation, although not setting precedent, has addressed the Company's issues, satisfactorily removing significant business risks that the Company faced when the Commission established the 11% return on equity in August 2000. These changes, plus others, make this case an important watershed for the Commission. The DPU believes that an important question is whether the Commission will reflect these material changes in risk in the Company's rate of return by reducing the allowed return below the 11% established two years ago. The DPU believes that such a result is justified by not only the DCF results, but by the change in the risk profile of Questar.

PRIOR ORDER OF THE PSC ESTABLISHES CERTAIN PRINCIPALS THAT SHOULD BE APPLIED IN THIS PROCEEDING

The Commission has heard rate of return issues many times and certain principals have been established in prior proceedings that should be applied here. Parties that wish to deviate from those prior practices must show valid reasons why those deviations should occur. Such items as the use of Questar's actual capital structure, the use of both earnings and dividend growth rates to calculate "G" in the DCF formula, the requirement of using comparable companies in creating a sample which does not include Questar, the recognition of Questar's lower financial risk due to its higher equity ratio in its capital structure, the relationship that exists between interest rates and equity costs and the recognition of business risk in determining equity costs have all been established in prior orders that should be followed unless valid reasons are

shown. We do not believe that those reasons have been shown. A review of prior orders will assist the PSC in making decisions in this case.

First, establishing rate of return is a matter of sound judgement for the Commission. The Company is entitled to a return that will allow it to maintain its credit and allow it to attract capital. It should be authorized a return comparable to companies with similar risk. There is a range of reasonableness established by the experts to which PSC judgement must be applied while taking into account business and financial risk, interest rates, the economy and other relevant factors.¹

Second, at least since 1989, the actual capital structure has been used to set rates. However, in the past, the Commission has recognized that when Questar's equity ratio is higher than the sample of companies, the lower financial risk associated with this capital structure should be taken into account in establishing rate of return.² Questar's equity ratio is, once again, higher than the sample companies in this case and, thus, should be taken into account.

The Commission has consistently stated its preference for the DCF model as its preferred tool to assist it in determining rate of return. The 1993 Order went into the greatest detail why the PSC prefers the DCF model and in particular, the constant growth DCF model. This model helps the PSC establish a required return for the Company compared with comparable companies. Some other reasons relevant to this case are: data is readily available for the inputs to the model, and it is easy to determine why the results of the various experts differ.³

¹See 89-057-15 p. 25.

²See for example 99-057-20 Order p. 5 & 10, 89-057-15 p. 32.

³93-057-01 p. 18.

Probably the most important difference between the Company's DCF calculations and those of the DPU/CCS is that the Company failed to use dividend growth rates along with its earnings growth rates to arrive at an estimate of the dividend growth rate to include in the DCF model. This issue alone would have lowered Dr. Williamson's average DCF results to 10.89% -- well within the range of the other experts.⁴ Dr. Williamson is well aware of how the PSC has ruled on this issue. He was the Company's witness in the 1989 rate case and used only earnings to estimate the dividend growth rate of the DCF model. In that order the PSC held:

We can only accept Dr. Williamson's DCF results in part . . . reliance upon earnings growth rate forecasts to estimate the dividend growth rate also imparts an upward bias. A cost of equity estimate near those of the other two witnesses is obtained when corresponding adjustments are made.⁵

The use of both earnings and dividend growth rates to assist in coming up with a growth rate for the model has been re-established in both Questar's 1993 and 1999 rate cases.⁶ Other utility decisions have also addressed this issue. In a US West case, the Commission ruled:

The upshot is that we remain convinced that we should use as much relevant information as is available, and that means both earnings and dividend information. The record shows that using only the earnings growth forecasts . . . produces the highest DCF estimates for the return requirements for the proxy companies . . . We also find reasonable agreement that several sources of information should be used to estimate the growth variable "G."⁷

⁴Cross examination ex. 9.

⁵89-057-15 p. 29, in that case as in this, the DPU witness used both earnings and dividend growth rate estimates to determine the dividend growth rate in the DCF model.

⁶The 1995 rate case was settled.

⁷DPU ex. 6.0 SR, p. 4 quoting 95-049-05.

We see no reason why prior practices of the PSC should be abandoned in this case by ignoring dividend growth rates in calculating “G.” The Company clearly has not met its burden to show why the PSC should so deviate.⁸

SIGNIFICANT CHANGES IN BUSINESS RISK FACING THE COMPANY SINCE THE 11% RATE OF RETURN WAS ESTABLISHED IN 2000 JUSTIFY THE PSC LOWERING THE RATE OF RETURN BELOW 11%

Independent of the DCF results, there have been significant changes in the risks facing the Company today that justifies lowering the 11% return authorized a little over two years ago. These changes were recognized by the Company when, at the end of the hearings, it reduced its return request from 12.6% to 11.75%. The Company recognizes that it is in a better position today than it was at the beginning of the rate case or when the last order came out. This lowering of its requested return was solely due to the significantly lower business and financial risk facing the Company today and not due to a lowering of the DCF calculations by its rate of return witness. Although the DPU appreciates the Company’s recognition of the lower risk it faces, it seems that the reason the Company changed its rate of return request at the last minute, was that it recognized that it had failed to meet its burden to show that a rate of return of 12.6% is justified. The Commission, like Questar, should recognize the change in risk the Company faces but measure that change off of what the Commission determined to be reasonable in the last rate

⁸DCF theory calls for dividends growing over an infinite horizon into the future. The corresponding growth rate is, according to DCF theory, the appropriate input into the model. However, no one knows what that rate is. The earnings forecast by IBES and Value Line are 3 to 5 years in the future. The dividend rate forecast in Value Line is also for a limited time period. Earnings deviate wildly from one year to another. Dividends tend to be constant over

case; i.e., 11%. These significant changes recognized by the Company should result in a lowering of the return authorized by the Commission two years ago and not an increase in that authorized return as suggested by the Company.

A review of changes since the last rate case will demonstrate why the Commission should lower the return below that authorized in 2000.

The first and most obvious change since the last rate case is the use of a end of year 2002 test year with the usage per customer as current as possible. Growth in rate base due to increases in customers and decline in the usage per customer were the major reasons why the company filed this rate case.⁹ Although the test year change is in a stipulation and may not be the policy of the Commission in the future, the Company recognizes the value of a future test year to the Company's business risk profile and, therefore, should be recognized by the Commission in setting an allowed rate of return.

Other major changes since the last rate case have also occurred that should be taken into account by the Commission.

Recovery of bad debt in the 191 account

This is the first rate case where only the non-gas portion of bad debt will be recovered in general rates. Bad debt associated with gas costs (about 1/2 of the bad debt expense) will be recovered dollar for dollar in the 191 account. The Company indicated that they have

time. A combination of both has been accepted as a valid way of determining the growth rate to be used in the model.

⁹On a regulatory bases for the year 2001 using an average rate base the company essentially earned its authorized rate of return. It is the growth in customers from that average and the continued decline in usage per customer that drove this rate case.

experienced a significant increase in bad debt and that allowing recovery in the 191 account was a significant positive financial factor for the Company.¹⁰

Contributions in Aid of Construction

One of the main causes of this rate case is the growth in customers and the continued need to provide capital expenditures for those new customers. In this case a significant change in accounting is taking place, and a significant increase in up front contributions will be made by new customers. Both of these are positive financially for the Company. Cash flow will improve between \$9 and \$11 million, decreasing capital requirements about 10%. Mr. Allred acknowledged that this change is significant and positive.¹¹ A second positive change is that the amount a customer will pay up front will increase \$250 per customer.¹² This proposal will produce about \$2.25 million not included in the revenue requirement in the rate case. The money will reduce rate base additions, thus reducing the need for future rate increases.

¹⁰TR 133. Mr. Allred did not know if the sample of companies collect a portion of bad debt in the 191 account but did indicate that he believed that all gas distribution companies are looking for better way to recovery bad debt expenses.

¹¹TR 134-35.

¹²TR 135. The Company only proposed to increase the contribution by \$100. In the stipulation the amount will actually go up \$250, reducing rate base and Company contributions even more than the Company asked for when they filed this rate case.

Interest rates and inflation

Both the level of inflation in the economy and interest rates have declined since the last rate case. A review of Cross Exhibit 1 and Mr. Allred's comments can be found at TR 141. He indicated that both inflation and interest rates are at record low levels.

Gas costs

Mr. Allred indicated that the high gas costs in the winter of 2000 were negative for the Company even though it has a 191 account.¹³ Today's gas costs have come down significantly since the last rate case.

Questar stock price

A review of Cross Ex. 2 and 3 show that, even though there have been significant market declines, Questar's stock has performed well compared to the market or utility averages. Mr. Allred indicated that based on these exhibits he would believe Questar's stock is a positive stock to invest.¹⁴

Supreme Court decision

Although not directly related to the economy, Questar was successful in its CO2 appeal which has provided a one-time benefit to the company.

¹³TR 141-42.

¹⁴TR 144.

Summary

A little over two years ago the Commission determined that an 11% return on equity was reasonable. An 11% return would allow the Company to attract capital, maintain its credit and earn a return comparable to others with similar risks. Significant changes in the Company's risk profile have occurred since that decision. The DPU believes these factors should not be ignored but instead should be a basis for a reduction in the return below 11%. This we believe is particularly true when the cost of equity determined through a DCF model is also under 11%.

ALL WITNESSES RETURN ON EQUITY ARE UNDER 11% WHEN APPROPRIATE ADJUSTMENTS ARE MADE TO DR. WILLIAMSON'S DCF RESULTS

Even though the Company has dropped its requested return on equity to about 11.75%, when its witness' DCF calculation is properly modified, a return under 11% is justified. A return under 11% would be more in line with the estimates of Dr. Powell and Mr. Parcell. Their proposed returns on equity are both under 11%.¹⁵ This section will focus on modifications necessary to bring Dr. Williamson's DCF calculations in line both with prior Commission orders and a reasonable way to calculate central tendencies.¹⁶

¹⁵Dr. Powell's return on equity is 10.5%. Mr. Parcell's return on equity for gas distribution companies is 9.5% to 11%. Because of a variety of risk related reasons for Questar, his recommendation is 9.5% to 10.5% with a point estimate of 10%. For all practical purposes the DPU and CCS recommendations are similar. When corrected, Dr. Williamson's DCF calculations are within this range.

¹⁶The last time Dr. Williamson testified in a state Questar proceeding was the 1989 case. Dr. Moyer has been the Company's witness generally since that date. His method of calculating DCF results were not followed in this case. For example, Dr. Moyer did not include Questar and National Fuel in his sample last case. Dr. Moyer utilized the mean and not the median to determine the central tendency of his various DCF results. The only important consistency is

Questar and National Fuel should be excluded from the sample

In the 1993 rate case, the Commission recognized that Questar should not be included in the sample of companies. The Commission stated:

Each witness indirectly measures equity costs for Mountain Fuel by applying the DCF to a set of comparable companies. These are selected on the basis of risk and other important characteristics. Companies comparable to Mountain Fuel are used rather than Mountain Fuel itself or its parent Questar Corporation. We find this to be reasonable because Mountain Fuel does not issue equity securities and Questar Corporation, which does, differs too much from Mountain Fuel to be used, uncritically, as a proxy.¹⁷

This practice was followed by Dr. Moyer in the last rate case. Here Dr. Williamson includes both Questar and National Fuel, two diversified companies, in the sample. The inclusion of those two companies bias upward his DCF results. In his original testimony, Dr. Williamson's average DCF results drop from 12.61% to 12.18% when Questar and National Fuel are removed from the sample.¹⁸ Clearly the Company has not demonstrated why the Commission's practice of excluding companies like Questar from the sample should be changed in this case. Dr. Williamson recognized the problem of including diversified companies in the sample when he prepared his exhibits. His results are calculated with and without Questar. The same reason he made those calculations for Questar should also have applied to National Fuel.

Dividend growth estimates should be taken into account when calculating "G" in the DCF model

that neither Dr. Moyer nor Dr. Williamson included any dividend growth rates in their calculation of G for the DCF formula.

¹⁷93-057-01 p. 23.

¹⁸DPU Cross 9. Using the Value Line earnings estimate National Fuel produces the highest DCF results. Using the IBES earnings estimate Questar has the highest growth rate and return of the sample. Inclusion of those two companies moves Dr. Williamson's DCF calculation above what they would have been if Dr. Moyer was still the Company's witness.

The most significant failure of the Company to address past Commission orders, was its failure to include dividend growth rates in calculating “G” in the DCF formula. When Dr. Williamson testified in the 1989 rate case he also failed to use dividend growth rates in his calculation of “G.” In accepting only his DCF results in part, the Commission criticized his failure to take into account dividend growth rates. As was stated earlier this issue constantly comes up and the Commission has consistently rejected exclusive reliance on earnings growth in the DCF model. The Commission has held that earnings and dividend growth rates should be considered in the determination of “G.”

DCF theory is a cash flow model where “G” is to represent the payment of dividends in the infinite future. We do not know what “G” is. Experts look to published earnings forecast, history, dividend growth rates and other types of data to estimate what “G” should be. The IBES and Value Line earnings forecast and the Value Line dividend growth rates are all for a 3 to 5 year future period not an infinite horizon as the model suggests. It is unreasonable to not rely on relevant data available to all investors in determining the proper dividend growth rate for the model. Questar certainly has not demonstrated why the Commission should deviate from a policy that has existed for Questar at least since 1989.

Dividend paying stocks and dividend growth rates are important to investors, particularly in today’s market where value stocks like Questar offer stability. The high flying days of the 90's are being replaced by investor interest in stability. Cross Exhibit 2 shows that since the last rate case Questar stock is up 15% while the S&P 500 is down 60%. It seems obvious which stock an investor would prefer in today’s market.

In determining why dividends should be included, the Commission should review Cross Exhibits 11 and 12. Cross Exhibit 11 shows that earnings fluctuate widely from one year to another. Dividends, on the other hand, have generally a steady and constant growth rate. Cross Exhibit 12 are the Value Line reports for the Williamson's sample companies. It shows that for these companies, earnings fluctuate widely while dividend growth rates are steady. A combination of both earnings and dividends gives us the best chance of not over or under estimating "G." Taking into account both is exactly what the DPU has done. If Questar had also taken into account dividend growth rates, the differences between the DPU/CCS and the Company would be minimal.

The importance of this issue can be seen in Cross Ex. 9. If one were to recalculate Dr. Williamson's numbers with dividend growth rates included, his original testimony would decline from 12.61% to 11.04%. Dr. Williamson's revised estimates would change from 12.47% to 10.89%. In the 1989 rate case, the Commission noted that when adjustments are made to Dr. Williamson's DCF calculation, his numbers are near those of the other two witnesses.¹⁹ That observation applies also in this case.

¹⁹89-057-15 p.29.

The Mean v. the Median issue

In this case Dr. Williamson uses a median to calculate or represent the central tendency of his sample of companies. He then averages the set of medians to arrive at a final rate of return recommendation. Dr. Powell uses a mean to represent the central tendency of the sample of companies and bases his final recommendation on the average of these mean results. Dr. Williamson criticizes Dr. Powell for using the mean to represent central tendency, and argues that Dr. Powell used a median in the last case and therefore is being inconsistent.

The Commission's order in the last case explains why the median was used by Dr. Powell. First, in the last case, the company witness used the mean for both calculations so if anybody is inconsistent it is the company. In the last case at least one company in the sample of companies was an outlier. Two choices existed. The outliers could have been eliminated or the median could have been used instead of the mean to determine central tendency. Dr. Powell chose to use the median to reduce the effect of the outlier instead of eliminating the outlier. In this case the sample of companies had no outlier and, therefore, the mean is the appropriate statistic to represent central tendency.²⁰

The impact of the mean versus the median can be seen on Cross Ex. 9. In both the original and updated exhibits of Dr. Williamson the use of a median increases his results about 40 basis points.

THE RETURNS AUTHORIZED IN OTHER STATES PROVIDES LITTLE CREDIBLE EVIDENCE AS TO WHAT RETURN THIS COMMISSION SHOULD AUTHORIZE FOR QUESTAR

²⁰Interestingly, when Dr. Williamson testified in the 1989 case he used a capitalization weighted mean to determine central tendency of his sample of companies.

Much has been submitted in this case to show what authorized returns are in other states. The Company has submitted a late filed exhibit that compares authorized returns in other states with earned rates of return. One should avoid the tendency to add up the authorized returns above and below 11% or look at the late filed exhibit and try and conclude that a state that gives a higher or lower authorized return will lead to a higher or lower earned return. Nor should one attempt to draw any definitive conclusion as to what direction states are authorizing returns. Some on the list are above 11% and some are below.²¹

What is clear is that insufficient information exists as to what the specifics are in any individual state. For example, we do not know the capital structure selected. An 11% return on a capital structure that excluded short term debt will be different than an 11% return on a capital structure that includes short term debt. Nor do we know if the state we are looking at uses the actual capital structure of the company or a hypothetical capital structure. We do not know the type of regulation that exists in the state.²² We do not know all of the business risk and financial risk characteristics of the companies. In this case we do know that two years ago this Commission authorized Questar an 11% return. Since that time the business and financial risk of the Company has changed materially, justifying a lower authorized return on that basis alone. However, independent of those facts the DCF calculations of the experts justify a return under 11% for companies, which all agree are comparable to Questar.

²¹The article submitted as Cross Ex 5 claims the trend is toward lower returns. This article is dated December, 2001.

²²For example, Alabama has a rate plan where the company cannot file for a general rate case for a number of years.

The results of returns in other states may provide some warm fuzzy feeling but certainly do not provide competent evidence as to what the authorized return should be for this Company.

CAPITAL STRUCTURE

The DPU supported the use of the actual capital structure of Questar. Mr. Parsell has introduced the inclusion of short term debt in the capital structure. As far as the DPU can tell the Commission has not included short term debt in Questar's capital structure in the past. To justify deviation from this past practice, sufficient evidence would have to be presented to justify the change in policy. Dr. Powell did not believe that evidence had been presented. Short term debt appears to fluctuate widely during the year. For example, it appears that today short term debt is zero while at the end of 2001 it was a significant amount. Questar attempted to explain what short term debt is used for and why it fluctuates during the year. In essence, we believe an insufficient record exists to move away from past practice.

CONCLUSIONS

Questar argues that if the Commission drops the rate of return below 11%, it will send the wrong message to investors. In this case, if the Commission doesn't lower the rate of return below 11% it sends the wrong message to the public. In this case it is uncontested that the business risk of the Company has significantly changed since an 11% return was authorized. The Commission should reflect that change in business risk in its decision. In addition to the change in business risk of the Company, the DCF calculations of all experts when adjusted to past Commission practices are all below 11%. We believe there is no justification on this record to raise the rate of return and there is justification to lower the rate of return. All of the changes

made in this rate case should improve the financial condition of the Company. The Company should believe that it will have a greater opportunity to earn its authorized rate of return in 2003. It is the financial improvements that should result from this rate order that will impress the investment community not the authorized rate of return.

Submitted this _____ day of November, 2002.

MICHAEL GINSBERG
Assistant Attorney General

CERTIFICATE OF SERVICE

I hereby certify that copies of the **POST HEARING MEMORANDUM** in Docket Number 02-057-02 were mailed or hand delivered on the _____ day of November, 2002 to the following:

Reed Warnick
Assistant Attorney General
State of Utah
Committee of Consumer Services
Heber Wells Building Suite 500
160 East 300 South
Salt Lake City UT 84111

Steven F. Alder
Attorney for the Utah Energy Office
Natural Resources
1594 West North Temple 3610
PO Box 146480
Salt Lake City, Utah 84114-6480

Alan Allred
Questar Gas Company
180 East 100 South
PO Box 45360
Salt Lake City UT 84145-0360

Lee R. Brown
U. S. Magnesium LLC
238 N 2200 W
Salt Lake City, Utah 84116

Jeff Burks
Utah Energy Office
1594 West North Temple 3610
PO Box 146480
Salt Lake City, Utah 84114-6480

Steven J. Christensen
Parr Waddoups Brown Gee Loveless
185 South State St 300
Salt Lake City, Utah 84111

Capt Robert C. Cottrell Jr
AFLSA / ULT
Utility Litigation Team
139 Barnes Dr 1
Tyndell AFB FL 32402-5319

Charles M. Darling
Desert Power LP
5847 San Felipe 2900
Houston TX 77057

Gary Dodge
Hatch James & Dodge
10 W Broadway 400
Salt Lake City, Utah 84101

Jonathan Duke
Questar Gas Company
180 East 100 South
PO Box 45433
Salt Lake City UT 84145-0433

William J. Evans
Parsons Behle & Latimer
One Utah Center 1800
201 S Main St
PO Box 45898
Salt Lake City, Utah 84145-1234

Kevin Higgins
Energy Strategies
39 Market St 200
Salt Lake City, Utah 84101

Capt Kristine Hoffman
00-ALC/JAN
6026 Cedar Lane Bldg 1278
HILL AFB UT 84056

Dr. Charles E. Johnson
1338 Foothill Blvd PMB 134
Salt Lake City, Utah 84108

Barrie McKay
Questar Gas Company
180 East 100 South
PO Box 45360
Salt Lake City UT 84145-0360

Terry Naylor
WECCO
10622 W 6400 N
PO Box 629
Cedar City UT 84720

Bruce Plenk
16 East 13th St
Lawrence KS 66044

F. Robert Reeder
Parsons Behle & Latimer
One Utah Center
201 S Main St
PO Box 45898
Salt Lake City, Utah 84145-1234

Gary G. Sackett
Jones Waldo Holbrook & McDonough
170 South Main Street Suite1500
PO Box 45444
Salt Lake City UT 84145

Evelyn Zimmerman
Questar Gas Company
180 East 100 South
PO Box 45360
Salt Lake City UT 84145-0360
