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M E M O R A N D U M

To: Public Service Commission

From: Division of Public Utilities
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Date: June 23, 2008

Subject: Questar Gas, Account 191 Pass Through, Docket No. 08-057-15.

ISSUE:

On June 5, 2008, Questar Gas Company (QGC) filed an application to adjust rates for natural gas with the Public Service Commission (PSC). This filing in Docket No. 08-057-15 asks for approval to increase the supplier non gas cost and commodity portion of the Company's Utah natural gas rates in order to pass-through an expected total increase in gas costs of $379,369,000. This increase is based on projected Utah gas costs of $909,235,034. The commodity portion represents an increase of $365,801,000 in rates while the supplier non-gas rate increase is $13,568,000. However, due to the magnitude of the increase and the current uncertainty that exists in the gas markets, QGC is asking the Commission to implement this pass-through in two phases. The first phase, with an effective date of July 1, 2008, asks for an increase of $195,000,000 to be in effect during the summer months when usage is typically low. The second phase delays implementing an additional $184,000,000, based on current projections, until October 1, 2008. In reading QGC's application, the Division of Public Utilities (Division) assumes QGC is not requesting approval of the second phase at this time. The Division expects QGC will file a new application in September with updated forecasts and other pertinent information in order to request approval of the second phase of this application. The purpose of mentioning the second phase at this time is to bring attention to rapid escalation in gas prices.

If the first phase is approved by the PSC as filed, a typical residential customer, assuming a usage of 80 decatherms per year, will see an average increase in their annual bill of $149.39 or an increase of 22.85% over current rates.

RECOMMEND APPROVAL:

After a preliminary review of this application, the Division recommends, on an interim basis, the first phase of this application be approved as filed with the proposed rates becoming effective July 1, 2008.

DISCUSSION:

This filing (Docket No. 08-057-15) uses a base period of July 1, 2008 through June 30, 2009. QGC expects total system requirements of 118.8 million decatherms. Of this total system requirement, 89% or 105.7 million decatherms is required to meet firm system sales expectations with 96% of the firm system sales requirements or 101.7 million decatherms Utah's firm sales volumes. The remaining 13.1 million decatherms of the total system requirement is for Company's restoration of Btu value after gas processing and fuel use (9.3 million Dth) and to meet planned storage levels (3.8 million decatherms). To supply these system requirements, QGC plans on utilizing 52.9 million decatherms of WEXPRO production at a net cost of $264.1 million (44.5% of total requirements at an average net cost $4.99/Dth) and purchasing from third party producers, during the winter heating season, another 65.9 million decatherms for $626.2 million (55.5 % of total requirements at an average net cost of $9.50/Dth).

As noted in the filing, and as provided in QGC's Tariff for Natural Gas Service in Utah, PSCU 400, §2.10, pp. 2-11-2-17, these gas costs represent a direct pass through of costs. These costs do not impact the operating profit or rate of return of QGC except for $4.7 million as noted on line 13, column (E) of Exhibit 1.5, which is the Utah allocation of the pre-tax return on the working storage gas inventory approved by the PSC in Docket No. 93-057-01 and using the cost of capital approved in QGC's last rate case in Docket No 02-057-02.

Efforts To Mitigate Gas Price Volatility

Natural Gas Spot Prices

This pass-through filing comes at a time when energy costs are increasing almost daily. There appears to be three primary drivers to the national increase in gas prices, namely the rapid rise in oil prices, hurricane weather concerns and commodity speculation.[1] Other commonly cited factors include rising use of natural gas for electricity generation and tight LNG supplies due to rising international demand. There is no consensus on exactly what is the primary driver. In addition to national and international factors, the opening of the Rockies Express pipeline has relieved a regional surplus of gas that had artificially depressed prices in the Rocky Mountain region.

Figure 1 on the next page shows the actual first of month spot prices of gas at Opal, Wyoming from July 2007 through June 2008 along with the projected prices from July 2008 through June 2009 (solid line)[2]. It also shows the forecasted prices that were used in the previous pass through filing in Docket No. 07-057-09 (dotted line). The difference between the two lines gives an indication of how much actual prices have departed from forecast prices since the last pass-through filing.

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[1] Inside FERC'S Gas Market Report, June 13, 2008; "Petroleum gains help Drive NYMEX", page 1, "Hurricane threat to Gulf still valid",page 1, "Industry struggles to pin down impact of index speculators", page 4.

[2] Arithmetic average of GI, CERA and PIRA forecast from July 2008 to June 2009 used in pass-through application Docket No. 08-057-15.

Figure 1

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Like the previous pass-through filing this filing by QGC is based on an average of future price projections by three different forecasting entities. Those three entities are Global Insight (GI), Cambridge Energy Research Associates, Inc. (CERA) and the PIRA Energy Group (PIRA). The twelve month arithmetic average spot price of these three entities for July 2008 –June 2009 is $9.03/Dth. There is a divergence of opinions within the three forecasting services used by QGC as to the prediction of the future spot prices. This is displayed in Figure 2 on the next page.

Figure 2

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Because of this disparity and the volatility that exists in the gas markets today, QGC has opted to use a phased-in approach to the increased gas cost by limiting the request in this filing to $195.0 million. Before October 1, 2008, QGC will revisit the future price forecast and make an amended filing which will reflect market conditions at that time.

Phased In Approach Pros and Cons

As previously mentioned, QGC has requested a two phase implementation approach in this filing. The Division sees both pros and cons to this approach. Some pros for using a two phase approach are; (1) For those customers, such as commercial and industrial users, whose usage is higher in the summer than a typical residential customer, it reduces the cost to them during the summer months which is more reflective of expected actual summer gas costs. (2) It provides an opportunity to further analyze current market conditions in hopes that prices will moderate in the next few months as some of the current market drivers become less relevant. (3) The amount of the phase two increase is more reflective of actual expected winter costs and is passed on at that time. (4) It helps keep the over (under) collection in the 191 account balance more in line with current costs.

Some of the cons for using a two phase approach are; (1) The total amount of the potential increase is public knowledge now and if prices do moderate and drop, QGC will still be seeking a rate increase when the news media may be reporting price decreases. (2) If prices do not moderate, but actually increase in the Fall, QGC could ask for an even greater increase its next pass-through filing than currently anticipated in phase-two. (3) Other than customers on budget billing, most customers will not see a major impact on their bills until the winter heating season and may not be as encouraged to engage in DSM programs and opportunities. (4) If prices rise more than expected before October, an even higher second-phased price adjustment may be necessary in order to amortize the under-collection between July and October.

In reviewing the above pros and cons, the Division recommends implementing this pass-through in two phases because it does help distinguish the actual costs of gas between summer and winter usage since gas is purchased on the spot market for winter usage while the lower cost WEXPRO production is the primary source for the summer usage.

Pricing Sensitivity

As shown in Figure 2, of the three forecasting entities, PIRA is currently forecasting the highest spot prices while CERA is forecasting the lowest prices for the 12 months ending June 2009. Assuming PIRA or the highest price forecast is more reflective of the actual spot market price over the next 12 months, a typical customer, with no phase-in as currently proposed, could expect to see an increase in their annual bill of $334 compared to $300 using the average of the three forecasts. If the lower price projection were the actual spot market price over the next 12 months, a typical customer would see an increase of $256 in their annual bill compared to $300.

Using the current phase-in approach as suggested in this application, the PIRA forecast would require an additional increase of $230 million in October instead of the current projection of $184 million while with the CERA or lower price scenario, customers could expect to see an additional increase of $132 million. This represents a potential band of $98 million dollars between the highest and lowest forecasts for the second phase of this pass-through application.

Pricing Hedges

The WEXPRO production and QGC's storage practices play an important role in QGC's plan to "hedge" against natural gas price volatility while meeting their overall supply plan. These practices allow QGC to keep WEXPRO production flowing during the summer months to meet summer demand and to inject into storage. The Company can then withdraw the lower cost company production in the winter months, which minimizes the need to purchase gas in the winter.

In this filing, WEXPRO production accounts for 44.5% of the gas supply mix at a weighted cost of $4.99/Dth ($4.63/Dth for net QGC production costs and $0.36/Dth for costs associated with gathering the WEXPRO production). The weighted cost of the WEXPRO production has increased 21.9% since the last filing. This increase is the result of increased royalties, which are based on the increase in current market prices, and an increase in the WEXPRO operator fee. The increase in operator fee is attributed to the increased drilling costs necessary to find gas to maintain production levels as older wells begin to decline in production rates. Even though the cost of the WEXPRO production is increasing, the value this production brings to the customers of QGC cannot be over looked. If these volumes were purchased using the current prices forecasted in this filing, a typical residential customer, assuming a usage of 80 decatherms per year and the phased in approach, would see an increase of $334 a year over current rates instead of an increase in their annual bill of $149. This equates to a savings of $185 per year ($334-$149=$185).

QGC further attempts to manage gas price volatility, and thereby “hedge” or mitigate customers’ exposure to that volatility, by continuing its planned purchase program. For this filing, QGC has developed a winter gas-purchase portfolio (October through March) of 65.9 million decatherms. This portfolio will be made up of fixed price contracts for approximately one-third of the portfolio (approximately 22 million decatherms). QGC plans that the remaining two- thirds of the projected 65.9 million decatherms of the purchase gas requirement will be priced under first of month index price contracts. An additional $2,000,000 is included in this filing to allow QGC to purchase price-capped supply contracts. However, the price of such caps is currently too high to be cost-effective. However, the extra $2,000,000 provides the company with the option to act if and when capped contracts prices move downward. These approaches were developed through continued meetings with regulators to provide updated information regarding this planned “hedging” program and current expectations in the gas market. Currently, at the time of this filing, 1.4 million decatherms of the anticipated 22 million decatherms have been converted to fixed price contracts at an average cost $9.01/Dth.

Amortization of existing 191 Balance

Experience has shown that the price forecast used by QGC will not exactly match the actual prices as they unfold with time. This fact is clearly demonstrated by following the monthly balances of the 191 account. At the time of QGC’s last filing in October 2007, this balance was forecasted to be over collected by $56 million ($30 million was the commodity portion and $0.305/Dth credit was applied to the commodity rate to begin amortizing this balance). By October 2007 the actual balance was $46 million over collected. By December 2007 this over collected balance was at $57 million. By May 2008, the account had reversed and was under collected by $5.5 million due to the rapid increase in actual costs. This filing forecasts the June 2008 commodity balance to be under collected by $40 million since these new rates will not be effective, pending

Commission approval, until July 1st. A $0.402/Dth (rounded up) charge rate has been included in the commodity gas rate to amortize the $40 million under collection over the next 12 months. This represents a net increase of $0.707/Dth in the 191 amortization rate.

SUMMARY AND CONCLUSION:

This filing represents a projected dramatic increase in natural gas prices reminiscent of levels seen in 2005. However, the current volatility and uncertainty that still remains in the natural gas markets as demonstrated by the variability in future price forecasts may lead to further rate instability in the future. The potential price swings and the uncertainty this situation creates is of concern to the Division and emphasizes the need for customers to become even more energy efficient. The current DSM programs offered by QGC through the ThermWise campaign is an excellent opportunity for customers to begin becoming more energy efficient now during the summer months when usage in low. The Division urges Questar to use its customer education and DSM funds to educate consumers on how they can reduce their gas usage on an ongoing basis in order to mitigate this and any future price increases.

The Division recommends that the pass-through application and the requested rate increase as proposed by the Company in phase-one be approved on an interim basis until the 2008 audit of the 191 account is completed. Currently, the Division is in the process of beginning the audit of the 191 account for 2007.

As always the Division will continue to monitor the published monthly index prices[3] 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.

[3] Published monthly in Platts “Inside FERC’s Gas Market Report.”

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