STATE OF NEW HAMPSHIRE

PUBLIC UTILITIES COMMISSION

DG 08-048

In the Matter of:
Unitil Corporation and Northern Utilities, Inc.
Joint Petition for Approval of Stock Acquisition

and

DG 08-079

In the Matter of:
Unitil Corporation and Northern Utilities, Inc.
Petition for Approval to Issue Securities

Direct Testimony

of

Steven E. Mullen
Assistant Director – Electric Division

July 16, 2008

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I. INTRODUCTION AND SUMMARY

Q. Please state your name, position and business address.

A. My name is Steven E. Mullen. I am employed by the New Hampshire Public Utilities Commission as Assistant Director of the Electric Division. My business address is 21 South Fruit Street, Suite 10, Concord, New Hampshire.

Q. Please summarize your educational background and work experience.

A. In 1989, I graduated *magna cum laude* from Plymouth State College with a Bachelor of Science degree in Accounting. I attended the NARUC Annual Regulatory Studies Program at Michigan State University in 1997. In 1999, I attended the Eastern Utility Rate School sponsored by Florida State University. I am a Certified Public Accountant and have obtained numerous continuing education credits in accounting, auditing, tax, finance and utility related courses.

From 1989 through 1996, I was employed as an accountant with Chester C. Raymond, Public Accountant in Manchester, NH. My duties involved preparation of financial statements and tax returns as well as participation in year-end engagements. In 1996, I joined the Commission as a PUC Examiner in the Finance Department. In that capacity I participated in field audits of regulated utilities' books and records in the electric, telecommunications, water, sewer and gas industries. I also performed rate of return analysis, participated in financing dockets and presented oral testimony before the Commission. In 1998, I was promoted to the position of Utility Analyst III and continued to work in all of the regulated industry fields, although the largest part of my time was concentrated on electric and water issues. As part of an internal reorganization of the Commission's Staff in 2001, I became a member of the Electric Division. I was promoted to Utility Analyst IV in 2007 and then Assistant Director of the Electric Division in 2008. Working with the Electric Division Director, I am responsible for the day-to-day management of the Electric Division including decisions on matters of policy. In addition, I evaluate and make recommendations concerning rate, financing, accounting and other general industry filings. I represent Staff in meetings with company officials, outside attorneys, accountants and consultants relative to the Commission's policies, procedures, Uniform System of Accounts, rate case, financing and other industry and regulatory matters.

Q. Have you previously testified before this Commission?

A. Yes. I have testified before the Commission on numerous occasions.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to provide comments and recommendations regarding certain aspects of the proposed acquisition of Northern Utilities (Northern) and Granite State Gas Transmission (Granite) by Unitil Corporation (Unitil). Specifically, I will address three issues: a) Unitil's study of potential synergy savings resulting from the transaction, b) the impact of the transaction on Unitil Energy Systems, Inc. (UES) and its customers, and c) the plan to finance the transaction including the debt financing planned as part of the capitalization of Northern.[1]

Q. Before summarizing your testimony, do you have any general comments?

A. Yes. I want to make it clear at the outset that comments in my testimony reflecting my views on the electric side of the transaction, while important, should not be viewed in

[1] The debt financing was filed on May 30, 2008 and assigned docket number DG 08-079. In accordance with Order No. 24,860 (June 3, 2008) in DG 08-048, the proceeding to consider the financing petition will follow the same

isolation, nor should they be construed as overriding any comments made by other Staff witnesses regarding gas operations and rates. The transaction involves direct and indirect impacts to electric and gas utilities currently operating in New Hampshire, and the impacts to each of those utilities must be separately analyzed.

Q. Please summarize your testimony.

A. As part of its filing, Unitil included an analysis of what it considered to be potential synergy savings arising from the acquisition transaction. While I view Unitil's study as more of a "cost comparison study" than a "synergy study," UES' post-acquisition earnings, should the transaction be approved, must be monitored to determine the earnings impact of any potential cost savings and whether an adjustment to distribution rates may be warranted. In terms of financing the transaction, while Unitil has proposed a plan that is reasonable in structure, the results of that plan, especially regarding Northern's resulting cost of capital, along with other issues discussed in the testimony of Staff witness Stephen P. Frink, cause the transaction to fail the "no net harm" standard, necessitating a recommendation that the Commission deny the joint petition, as filed.

II. DG 08-048 - SYNERGY STUDY

Q. Please describe in general terms how Unitil calculated the potential synergy savings of the transaction.

A. A detailed description of how the synergy study was performed was included in the testimony of Unitil witness Laurence M. Brock. Briefly, Unitil examined the categories of costs related to labor, overheads, employee benefits and insurance for the existing Unitil companies[2], Northern and Granite both before and after the proposed acquisition.

procedural schedule as DG 08-048. See also secretarial letter dated July 10, 2008 in DG 08-079.
[2] The existing Unitil companies are Unitil Corporation, Unitil Service Corp., Unitil Energy Systems, Inc., Unitil

As part of the transaction, Unitil will be hiring additional employees to replace certain centralized service functions that Northern and Granite currently receive from other NiSource companies. In comparing the before-and-after costs of the to-be-affiliated companies, Unitil projected system-wide savings in 2010 (the first full year of combined operations) of approximately $5.4 million.[3]

Q. As is commonly found in merger or acquisition transactions, are there similar departments at Unitil and Northern/Granite that are being combined and, in effect, synergized?

A. No. To the contrary, as stated earlier, Unitil will actually be hiring additional employees to replace central service functions that Northern and Granite currently receive from other NiSource companies.

Q. How then do the potential cost savings materialize?

A. As discussed in Mr. Brock's testimony, Unitil believes that it can provide centralized management and administrative services to Northern and Granite at lower costs than they currently receive those services from other NiSource companies. It should be noted that in estimating its future labor costs, Unitil used salary range midpoints for purposes of making its cost projections. In that light, future actual labor costs can be expected to vary from the estimated amounts.

As for the existing Unitil companies, including UES, Unitil projected that potential savings could be derived from allocating centralized labor and overhead costs from Unitil Service Corp. over an expanded group of affiliated companies.

Power Corp., Fitchburg Gas and Electric Light Company, Unitil Realty Corp., Unitil Resources, Inc., Usource, Inc. and Usource, LLC.

[3] Subsequent to the initial filing of the petition, Unitil has revised the number of new employees it will need to hire from 42 to 55 and then to 59. Unitil indicated that it would provide an updated synergy study to reflect those

Q. In your view, is Unitil's study one of synergies, or would you term it differently?

A. I see Unitil's study as more of one about potential economies of scale and a straight comparison of before-and-after costs. I would term it more as a "cost comparison study." While that may be simply semantics, I think it better reflects the nature of the transaction.

Q. Does Unitil's cost comparison study encompass all potential cost changes related to the transaction?

A. No. Unitil's approach does not take into account cost changes in other areas, including changes in rate base and the cost of capital. Those issues, however, are specific to Northern and Granite and are discussed in more detail in the testimony of Stephen P. Frink.

III. DG 08-048 - IMPACT OF TRANSACTION ON UNITIL'S ELECTRIC CUSTOMERS IN NEW HAMPSHIRE

Q. To what areas of New Hampshire does Unitil currently provide electric service?

A. Through its regulated electric distribution utility, UES, Unitil provides electric service to customers in Concord and surrounding communities as well as various communities in the seacoast region of New Hampshire.

Q. Did Unitil project any potential cost savings from the transaction to UES?

A. Yes. As detailed on Mr. Brock's Schedule LMB-3, by comparing 2008 budgets with and without Northern and Granite, Unitil estimated savings of $1.4 million to UES, primarily due to certain existing service company costs being spread over an expanded group of companies.

Q. Do you think those savings will materialize?

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changes, but as of the date of this testimony Staff had not been provided with such an update.

A. I think the opportunity is there, but only time will tell whether and to what extent UES experiences any actual cost savings as a result of the acquisition transaction, assuming that it is approved.

Q. Do you expect UES to incur any increased costs as a result of the transaction?

A. No. However, if either as a result of the transaction or due to developments with the gas operations of Northern and/or Granite in the future, Unitil is deemed to be a riskier entity, Unitil's, and therefore UES', cost of capital could increase. I will note, however, that Unitil is currently involved in gas operations through its Massachusetts affiliate, Fitchburg Gas & Electric Light Company. In addition, to this point I have not received any information that Unitil will be deemed a riskier entity due to the transaction. I merely want to point out that the possibility exists.

Q. If UES were to experience the projected $1.4 million of annual savings, how would that affect the rates UES charges to its customers?

A. UES' rates would not be impacted unless and until UES is involved in a proceeding to adjust its rates. While the majority of potential cost savings might fall in the area of costs included in distribution rates, any potential cost savings could also impact costs attributable to UES' other rate components.

Q. How often are UES' various rate components adjusted?

A. Default Service charges are adjusted quarterly for UES' large commercial and industrial customers and semiannually for residential and small commercial customers. UES' External Delivery Charge (i.e., transmission and related costs) and Stranded Cost Charge are adjusted annually. Distribution charges are not adjusted on a scheduled basis. Rather, adjustments to distribution rates occur based on a finding by the Commission that an adjustment is necessary to address issues such as over-or under-earnings, accounting changes, law changes or similar such items. A distribution rate case can result from a motion by a utility, another party or the Commission.

Q. Has Unitil proposed a tracking mechanism for potential cost savings arising from the acquisition transaction?

A. No. Rather, Unitil has stated that "[a]t the time of [the] next rate case, the synergy savings will be fully reflected in the cost of service and passed on to Unitil's customers."[4] I find this direct flow-through method to be preferable to trying to track particular savings. Using flow-through, the savings will be whatever they are and they will be reflected 100% in UES' earnings. To the extent such potential savings were to cause UES to be in a position of significant over-earnings for the distribution portion of its business, Staff or another party could request that the Commission open a proceeding to review UES' distribution earnings.

Q. What are UES' current earnings compared to its most recent allowed return on equity?

A. Based on UES' most recent form F-1 filed in accordance with Puc 308.11, for the twelve months ended March 31, 2008, UES reported an overall rate of return of 8.30% which translates to an earned return on equity of 10.27%. The allowed return on equity from UES' most recent distribution rate proceeding is 9.67%. Although those recent results indicate a slight level of over-earning, in my view it is not significant enough to warrant opening a rate proceeding at this time. In addition, the earned return on equity has trended downward as compared to previous quarters.

Q. With that in mind, what do you recommend regarding the impact of potential cost savings arising from the proposed acquisition transaction on UES' distribution

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[4] Prefiled testimony of Mark H. Collin, page 17, lines 10-11.

rates?

A. I recommend that we continue to monitor UES' earnings, as we currently do, via its various periodic filings with the Commission. If UES were to experience a significant level of over-earnings (whether related to this transaction – should it be approved – or not), Staff would request that a rate proceeding be opened. As stated in Unitil's prefiled testimony, the first full year of any potential savings will not occur until 2010. All sorts of different events could occur between now and then that could influence UES' earnings in either direction.

Q. To put the projected savings into context, assume a) the transaction is approved, b) UES does experience the projected $1.4 million of annual savings, and c) all of the savings occur in the area of distribution costs. What would be the impact to UES' distribution earnings and rates?

A. Using information as of the end of March 2008 as a proxy for 2010 and future years, if UES was exactly earning its 9.67% return on equity, its required net operating income would be approximately $9.2 million. Assuming savings of $1.4 million, UES' net operating income would increase to $10.6 million. Such a level of net operating income would result in an earned return on equity of approximately 12.77%. Based on UES' distribution operating revenues for the twelve months ended March 2008 of approximately $36 million and excluding related tax impacts, a 4% decrease to its distribution rates would be warranted.

Q. As part of the perpetual review of UES' earnings, are there other aspects of UES' and Unitil's operations Staff will continue to monitor?

A. Yes. Staff will continue to monitor UES' reliability performance to ensure that sufficient funding is maintained and not shifted to other parts of the organization. In addition, on page 7 of his testimony, Mr. Brock described how Unitil proposed to ensure a fair and reasonable allocation of costs among all post-acquisition companies. While the Audit Staff has previously reviewed the allocation factors used by Unitil, I think it is important that any post-acquisition allocation factors also be reviewed.

Q. Do you have a specific recommendation on this point?

A. Yes. I recommend that, if the acquisition is approved, Unitil be required to submit an analysis of its various post-acquisition allocation factors and how they were determined for Staff and other parties to review, as soon as they are available.

IV. TRANSACTION FINANCING INCLUDING DG 08-079 DEBT FINANCING PLAN

Q. How does Unitil plan to finance the proposed acquisition?

A. In the short term, Unitil has obtained a commitment letter from the Royal Bank of Canada for bridge financing for the entire $160 million stock purchase price.[5] On a permanent basis, as Northern and Granite will be acquired debt-free, Unitil is proposing to capitalize the companies using approximately 50% equity and 50% debt.

Q. How does Unitil plan to obtain the equity financing?

A. The equity financing will be obtained through a public offering and issuance of Unitil stock. Unitil plans to have an equity offering of a size that will not only provide funds for the acquisition but will also provide funds for equity contributions for other subsidiaries and other corporate purposes. Unitil has not determined the exact size of the offering, but has stated that the size will depend upon the receipt of regulatory orders supportive of the acquisition as well as market conditions at the time of the offering.

[5] This does not include the working capital portion of the purchase price that Unitil intends to finance using short-term debt under Unitil's Cash Pooling and Loan Agreement.

Q. What are Unitil's plans concerning the debt financing?

A. On May 30, 2008, Unitil filed its debt financing plan with the Commission. In that filing, Unitil and Northern stated that the debt will be issued by Northern as subsidiary level debt. The debt will be unsecured and will be in an aggregate amount of up to $80 million issued in three tranches:

- 10-year final / 9-year average life
- 20-year final / 15.5-year average life
- 30-year final / 25.5 year average life

Q. What are the interest rates for the debt expected to be?

A. In its financing petition, Unitil stated that the fixed annual rates will not exceed 7.5% on an aggregate (weighted average) basis. However, the debt will not be marketed until September 2008 so actual pricing will depend upon capital market conditions at that time.

Q. Did the companies provide current indicative coupon rates for the debt?

A. Yes. At the time of the filing, current estimates of the pricing for the 10-, 20- and 30-year maturities were 6.53%, 7.26% and 7.47%, respectively, which, assuming an equal distribution among the three maturities, would result in a weighted average rate of 7.09%.

Q. You mentioned that the debt is planned to be unsecured rather than secured with first mortgage bonds. What are the implications of an unsecured versus a secured financing?

A. According to Unitil and its investment advisers, RBC Capital Markets (RBC), an unsecured financing will result in lower issuance costs (primarily legal costs) and will provide greater future financial flexibility than would a first mortgage bond issuance.[6] In addition, regarding the perceived additional risk that an unsecured issuance might generally indicate, RBC stated as follows:

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[6] See copies of responses to oral data requests 2-13 and 2-14 included as Attachment SEM-1.

> While investors would generally view the security of a first mortgage bond structure as an enhancement to the credit, given the strong proposed capital position of Northern and the benefit of its association with Unitil, we view the value of providing first mortgage security as being minimal. Our experience in privately placing long term debt for Unitil's Fitchburg (unsecured) and UES (first mortgage) subsidiaries indicated virtually no difference in pricing between the two.[7]

Q. Having reviewed the petition for approval of the stock acquisition and the financing petition, what is your impression of the overall financing plan, including the details of the proposed debt?

A. Overall, the plan to capitalize Northern/Granite with 50% debt and 50% equity appears reasonable. In terms of the planned equity issuance, although an issuance of Unitil Corporation stock does not require Commission approval, I do have a couple of comments. First, Unitil will be increasing its authorized number of shares of common stock from 8 million to 16 million. Such an increase has the potential to dilute the value of currently outstanding common shares, thereby decreasing the value of the currently outstanding shares. It is possible Unitil is planning to offset the potential dilution through other measures, but Staff has not yet been provided with the proxy for this planned issuance (which would provide more details). Also, as Unitil plans to use some of the proceeds from the equity issuance to infuse equity to its existing subsidiaries, the amount and timing of any equity infusions to UES could materially impact UES' capital structure and overall cost of capital. Such impacts will have to be closely monitored.

Regarding the planned debt issuance for Northern, while the proposal to issue the debt in three tranches of different maturities is reasonable, an issue arises relative to the resulting debt cost and, therefore, Northern's overall cost of capital after the acquisition. This

[7] Attachment SEM-1, page 3 of 4.

issue stems from the fact that Northern's existing debt, which matures in 2013, carries a cost rate of 4.8%, while the planned debt could go as high as 7.5%. This, in turn, will raise Northern's overall cost of capital and Northern's resulting revenue requirements. So, although the structure of the debt financing plan may be reasonable, the results of that plan may not be reasonable. This issue is explored in more detail in the testimony of Stephen P. Frink.

Q. Do you have any concluding comments regarding the acquisition transaction as a whole?

A. Yes. While there is nothing particularly troubling on the electric side of the transaction, there are issues on the gas side, as discussed by Mr. Frink, that would appear to cause the transaction to fail the "no net harm" test. Therefore, the Commission should deny the petition, as filed. If the acquisition petition is not approved, then there is no need for Unitil and Northern to proceed with the debt financing petition.

Q. Does this conclude your testimony?

A. Yes, it does.

State of New Hampshire
Public Utilities Commission

Unitil Corporation
Docket No. DG 08-048
Response to Oral Data Requests from Technical Session on 6-18-08

Oral Data Request 2-13: Please describe the differences in the costs for an unsecured financing versus a first mortgage bond.

Response:
There would be no difference in placement fees between a FMB and unsecured financing. However, the costs for legal services are higher for a first mortgage bond financing. Additional legal time is required to research real estate matters, including running registry checks and reviewing recorded documents related to the property owned by the utility to ensure that there are no deed or other recorded documents affecting utility property interests that might violate the terms of the indenture. Following the initial offering, any subsequent property acquisitions, dispositions, liens or conveyances must be reviewed for compliance with the terms of the indenture, and, in the case of many mortgage indentures (including Unitil's existing indenture) annual legal opinions must be filed with the trustee to confirm that the all terms and conditions of the indenture have been complied with and that the indenture continues to confer a first mortgage lien on the utility property. In the case of an existing indenture, a new first mortgage bond offering prompts a supplemental indenture, and the property reviews are built upon the work performed for the previous supplemental indenture. In the case of a debt-free acquisition, the legal work required to review property matters to create a new indenture could be extensive, depending on the property holdings of the utility and when that property was acquired. In addition, the services of a trustee are typically required for a first mortgage bond issue, and there are both legal fees for trustee counsel at the time the bonds are issued as well as ongoing annual fees associated with trustee services. These same types of increased costs are applicable to subsequent issues of first mortgage bonds compared to unsecured financings.

Person Responsible: Mark H. Collin **Date:** June 26, 2008

State of New Hampshire
Public Utilities Commission

Unitil Corporation
Docket No. DG 08-048
Response to Oral Data Requests from Technical Session on 6-18-08

Oral Data Request 2-14: Provide a letter from Unitil's investment advisors regarding the market's acceptance and pricing of an unsecured financing.

Response:
Please refer to Oral Data Request 2-14, Attachment 1, for the requested letter from RBC Capital Markets.

Person Responsible: Mark H. Collin **Date:** June 26, 2008

RBC Capital Markets

Three World Trade Center
200 Vesey Street
9th Floor
New York, NY 10281-8098

DG 08-048
Oral Data Request 2-14
Attachment 1
Page 1 of 2

June 25, 2008

Unitil Corporation
6 Liberty Lane West
Hampton, NH 03842

Attn: Mark Collin
Senior Vice President, Chief Financial Officer and Treasurer

RE: Northern Utilities Long Term Debt Financing

Dear Mark:

As you know, we have provided Unitil Corporation ("Unitil") with indications on pricing and other terms for the issuance of approximately $80 million of long term debt securities (the "Notes") by Northern Utilities ("Northern") which is likely to occur in September. We understand that pro-forma the issuance of the Notes and takedown of an additional $80 million of equity from Unitil, Northern will have a funded debt to capitalization ratio of approximately 50%.

We have indicated that our strategy would be to have Northern issue the Notes on an unsecured basis and without obtaining advance ratings. With respect to these proposed features we would note the following:

- We are strongly of the view that private placement investors will view the Notes as equivalent credit quality to an NAIC 2 or mid to low BBB rating.
- Unitil currently has NAIC 2 ratings for its existing unsecured holding company notes, unsecured notes issued by its subsidiary Fitchburg Gas and Electric and first mortgage bonds issued by Unitil Energy Systems. Our view that Northern would receive NAIC 2 ratings is supported by an analysis of the capital structure of these companies (funded debt to capital of 61.6%, 63.5% and 62.3% respectively for the three entities at the time of issuance).
- The unsecured structure we are proposing would have an extensive negative pledge covenant which would protect bondholders from structural subordination in the event Northern issued first mortgage bonds in the future.
- While investors would generally view the security of a first mortgage bond structure as an enhancement to the credit, given the strong proposed capital position of Northern and the benefit of its association with Unitil, we view the value of providing first mortgage security as being minimal. Our experience in privately placing long term debt for Unitil's Fitchburg (unsecured) and UES (first mortgage) subsidiaries indicated virtually no difference in pricing between the two.

- Issuance of first mortgage bonds would result in higher cost of issuance (primarily legal fees to effect the security filings) and reduced financial flexibility in the future.

We continue to recommend Northern offer its long term debt on an unsecured basis and see little to no cost advantage to utilizing a first mortgage bond format for the issuance.

Very truly yours,

Bard Cook

Bard Cook
Managing Director