STATE OF NEW HAMPSHIRE

PUBLIC UTITITIES COMMISSION

DG 08-048

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

Direct Testimony

of

Stephen P. Frink
Assistant Director – Gas & Water Division

July 16, 2008

New Hampshire Public Utilities Commission

Unitil Corporation &
Northern Utilities, Inc.

Joint Petition for Approval of Stock Acquisition

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Stephen P. Frink

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

A. My name is Stephen P. Frink and I am employed by the New Hampshire Public Utilities Commission (Commission) as Assistant Director of the Gas & Water Division. My business address is 21 S. Fruit Street, Suite 10, Concord, New Hampshire 03301.

Q. Please summarize your educational and professional experience.

A. See ***Attachment SPF-1***.

Q. What is the purpose of your testimony in this proceeding?

A. The purpose of my testimony is to summarize Staff's concerns regarding the proposed acquisition of Northern Utilities, Inc. (Northern) by Unitil Corporation (Unitil) (collectively, Unitil and Northern are sometimes referred to as the Joint Petitioners) and explain how the proposed acquisition as filed does not meet the 'no net harm' standard. In addition, my testimony will explain Staff's concerns regarding the proposed acquisition of Granite State Gas Transmission, Inc. (Granite) by Unitil. Granite is an interstate pipeline whose rates are regulated by the Federal Energy Regulatory Commission (FERC). Granite is owned by NiSource, Inc. (NiSource). While the Joint Petitioners have not requested Commission approval of Granite's acquisition, Granite does appear to be an owner and operator of a "pipeline, including pumping stations . . . and other facilities, for the transportation . . . or sale of gas" as set forth on the face of RSA 362:2 (definition of "public utility"). In addition, Granite's pipeline is important to the operation of Northern and Northern's ratepayers are the primary source of funding for Granite's investments and operations.

Q. Please summarize the acquisition proposal contained in the Joint Petition.

A. The petition seeks approval for the acquisition of Northern by Unitil through Unitil's purchase of 100 percent of the common stock of Northern from Bay State Gas Company (Bay State), a subsidiary of NiSource. In addition, Unitil seeks approval to defer and amortize transaction and transition costs over 10 years.1

The purchase price to be paid for Northern and Granite is $160,000,000, subject to a working capital adjustment which is estimated at $37,300,000, bringing the total purchase price to $197.3 million. Northern and Granite will continue to operate as stand-alone subsidiaries with their own assets, liabilities, accounting records and corporate identities. The purchase price will be financed through equal parts debt and equity with Unitil to issue common equity and Northern to issue long term debt.2 On May 30, 2008, Unitil and Northern filed for Commission approval for Northern to sell unsecured promissory notes in an aggregate amount not to exceed $80,000,000 (Docket No. 08-079).

Unitil will retain all of Northern's approximately 78 current employees and add more than 40 new positions following the acquisition of Northern, primarily in the areas of gas engineering, operations and customer service. Despite adding personnel, Unitil expects the

1 Transaction costs are defined as investment banking, advisory and legal fess incurred by Unitil to achieve the Northern transaction. Transition costs are defined as the costs to be paid to Nisource affiliates for the continuation of administrative and management services to Northern after the close of the transaction pending full integration of Northern into Unitil.
2 The long-term debt will refinance or replace NiSource inter-company debt currently included in the capital structure of Northern. The proceeds from the private issuance will provide cash to fund the acquisition.

acquisition to produce integration savings of $5.4 million annually, with Northern's share being approximately $2.3 million per year, exclusive of the costs to achieve the savings. The savings are said to be derived from efficiencies associated with the provision of shared utility services and adoption of best practices.

There is no acquisition premium associated with the transaction and Unitil will not seek recovery of transaction and transition costs, although Unitil will seek to recover the financing and integration costs incurred in connection with the Northern transaction. See ***Attachment SPF-2***. Unitil promises that there will be no change in Northern's rates, terms or conditions of service for at least one year from the closing of the transaction.

Q. What areas of potential concerns has Staff examined in detail?

A. Concerns include customer service, gas control and contracting, hedging, public safety, integration savings, financing and rate impact. Also, while Unitil has experience in operating a natural gas utility, albeit a much smaller, simpler system than Northern, it has no experience in operating a natural gas interstate pipeline.

Q. What are the customer service concerns?

A. Customers are currently being provided a wide range of services and are accustomed to a certain level of service. The concern is that current services may not continue or be fully supported following the change in ownership. Staff witness Amanda Noonan addresses the customer service issues in her testimony.

Q. What are the gas control, contracting and hedging concerns?

A. Unitil currently operates a natural gas utility, Fitchburg Gas and Electric Light Company serving approximately 15,000 gas customers in Massachusetts, with ample peaking facilities relative to its size. Northern serves approximately 52,000 customers in both Maine and New

Hampshire, has very limited on-system peaking facilities, generates a large amount of revenue from off-system sales, has effectively and efficiently executed a somewhat complicated hedging policy, provided marketer and aggregator services under rules that vary between Maine and New Hampshire, has intervened in FERC proceedings to protect its interests and prepared and filed integrated resource plans with both the Maine and New Hampshire commissions. Staff witness Robert Wyatt addresses gas control, contracting and hedging issues in his testimony.

Q. What are the gas safety concerns?

A. Northern has been aggressive in replacing cast iron and bare steel mains and services and has been responsive to service calls. The petition does not address whether Unitil will continue to invest in cast iron/bare steel main and service replacement at the current rate or whether Unitil will maintain or exceed the current emergency response times. The emergency response times are of particular concern in respect to a section of southern New Hampshire that is currently served by the Bay State operations center located in Lowell, Massachusetts under an affiliate agreement with Northern. Staff witness Randall Knepper addresses safety concerns in his testimony.

Q. What concerns are there regarding integration savings?

A. Unlike the majority of merger related costs, such as transaction and integration costs, which occur early in the process and are readily identifiable, merger savings occur over time and are less predictable. There is always the risk that forecasted savings will not be fully realized, are lower than anticipated, or that the merger may actually result in greater costs. In this instance, the forecasted savings are less obvious than those associated with prior mergers that have come before the Commission. Typically, a larger company acquires a smaller company and is able to eliminate redundant positions, whereas Unitil is not only taking on all of Northern's employees, but is actually adding close to 60 new positions. The savings are based primarily on forecasted service company costs to be billed Northern by Unitil that are lower than those currently being billed Northern by NiSource and its affiliates.

The preliminary estimated annual savings contained in the filing is $5.4 million, $2.3 million of which will accrue to Northern. That estimate is based on approximately 78 existing Northern employees becoming Unitil employees and Unitil hiring 42 new employees to replace management and centralized services currently provided by Bay State or NiSource. Unitil has not yet updated the savings estimate although it has increased the number of new employees it intends to hire from 42 to 59.

Q. What are the financing concerns?

A. Although the Unitil/Northern financing proposal appears reasonable the cost of the financing is a concern. Staff witness Steven E. Mullen addresses financing concerns in his testimony, as well as how the acquisition may impact Unitil's New Hampshire electric utility, Unitil Energy Systems, Inc.

Rate Impact

Q. What is Staff's concern regarding rates?

A. The primary concern is that Northern's ratepayers will experience higher rates than would otherwise be the case without the change in ownership. Based on Staff's review of the filing and discovery responses, that appears be the case and thus the acquisition as filed would not satisfy the "no net harm" standard.

Q. Please describe the "no net harm" standard.

A. RSA 369:8, II (b)(1) provides for Commission approval of an acquisition involving the parent company of a public utility whereby approval is contingent upon the transaction having no adverse effect on rates, terms, service, or operation of the public utility within the state. The Commission has stated that this inquiry is the same one it has historically made under RSA 374:33, to which the Commission has applied what has come to be known as the "no net harm" test. See New England Electric System, Order No. 23,308 (1999). In that order, the Commission explained that "[i]n essence, the 'no net harm' test requires approval of a transaction if the public interest is not adversely affected . . . . [The Commission] must assess the benefits and risks of the proposed merger and determine what the overall effect on the public interest will be, giving the transaction [the Commission's]approval if the effect is at worst neutral from the public-interest perspective."

Q. Why does Staff expect Northern rates to increase under Unitil?

A. Three factors will negatively impact rates, depending on the timing of a rate case: 1) Unitil exercising a tax election that has the immediate effect of eliminating Northern's deferred taxes; 2) a higher cost of debt; and 3) integration costs of $3 million for which Unitil intends to seek recovery.

Q. Please explain the tax election Unitil has chosen to take.

A. Unitil and NiSource have agreed to make a section 338(h)(10) election under the Internal Revenue Code with respect to the tax treatment of the transaction. As a result, Unitil will receive the benefit of a "stepped up" depreciable tax basis in the assets of Northern. Essentially, Unitil is allowed to write up the tax basis of the assets it is purchasing and recognize greater depreciation for tax purposes, thereby reducing its future tax obligations.

Q. How does the tax election increase customer rates?

A. Currently Northern's books reflect a deferred tax credit which is deducted from rate base when calculating the revenue requirement. The existing tax liability is a result of Northern having collected for federal income taxes from customers in advance of actually paying those taxes. Post acquisition, the deferred credit will be eliminated and Northern's books will reflect a deferred tax liability which is an addition to rate base.

Q. What is the amount of the increase on the revenue requirement due to the tax election?

A. Based on an estimated December 31, 2009 rate base and rate of return at the post acquisition cost of capital, the increase in the revenue requirement due to the tax election would be $1,876,471. See ***Attachment SPF-3***.

Q. Please explain the increase in the post-acquisition cost of debt.

Northern's long-term debt makes up 44 percent of Northern's capital structure and is comprised almost entirely of a $60 million loan from NiSource at a fixed interest rate of 4.80 percent and a maturity date of June 2, 2013. The remainder of the capital structure (56%) is equity. Under the proposed acquisition the debt would be 'refinanced' and is expected to have a weighted average fixed interest rate of 7.09 percent. Although the increased cost of debt is somewhat offset by replacing a portion of higher cost equity, the overall weighted cost of capital is expected to increase from 7.57 percent to 8.38 percent. See ***Attachment SPF-4***. Unitil expects to include the debt issuance costs and the higher cost of debt as a component of the rate of return on rate base for Northern at the time of its next rate case. Unitil's proposal to seek recovery of the higher debt costs would result in higher rates, at least through June 2, 2013.

Q. What is the increase to the revenue requirement due to the higher cost of debt?

A. The amount of the increase is reflected in the calculation of the increase in the revenue requirement calculation for the tax election described above. Replacing the post acquisition cost of capital (8.38%) with the pre acquisition cost of capital (7.57%) indicates the amount of the increase in the revenue requirement related to the increase in the cost of debt is $218,905 of the $1,876,471 cited above. See ***Attachment SPF-5***. However, the impact is likely to be higher as the above calculation does not reflect any increases in net plant following the acquisition, to which the higher rate of return would also be applied.

Q. Please explain how integration costs would increase rates.

A. Unitil estimates integration costs of $3 million and characterizes those costs as expenditures which occur in the normal course of business as Northern replaces and upgrades systems and facilities necessary to serve customers. Therefore, Unitil intends to include those costs in Northern's rate base at the time of its next rate case. To the best of Staff's knowledge, Northern has no immediate plans to update its systems and facilities and it is highly unlikely the $3 million investment would take place absent the proposed acquisition. Under Unitil's proposal, the $3 million investment necessary to accomplish the transition from the Northern to Unitil systems will create additional depreciation expenses and earn a rate of return, resulting in higher rates.

Q. What is the estimated revenue requirement increase due to integration costs?

A. Applying a rate of return at the post acquisition cost of capital to the projected integration cost of $3,000,000 results in an increase to the revenue requirement of $350,234. Applying the Northern deprecation rate of 12.5 percent for information systems results in an annual depreciation expense of $375,000. The combined return and depreciation indicates an increase in the revenue requirement of $725,234 due to the integration costs for which Unitil intends to seek recovery. See ***Attachment SPF-6.***

Q. What is the cumulative impact on the revenue requirement for the three factors cited above?

A. The cumulative impact is an increase in the revenue requirement of approximately $2.6 million.

Q. How does that compare to the expected integration savings?

A. The increase in the revenue requirement exceeds the estimated integration savings to Northern of $2.3 million contained in the initial filing. Unitil has not yet updated the estimated savings. In any event, the savings are not guaranteed and there is no assurance that they will be achieved.

<u>Granite</u>

Q. Please provide a brief history of Granite.

A. At one time Granite was part of the Northern distribution system but was reconfigured to allow natural gas to move between two states (to serve Northern's New Hampshire and Maine Divisions), at which time Granite petitioned the Federal Power Commission, FERC's predecessor, to become an interstate pipeline. The petition was approved October 15, 1965. For a brief history of Granite please see ***Attachment SPF-7***.

Q. What is the capacity of the Granite pipeline and by whom is it held?

A. From when Granite first became an interstate pipeline until 1999, the maximum daily capacity was approximately 50,000 dekatherms (Dth) per day. In 1999, the maximum capacity increased to 67,000 and in 2002, when the Portland Pipeline and Maritimes joint facilities went into service, Granite's estimated peak day capacity increased to 150,196 Dth per day. See ***Attachment SPF-8***. Of the total available, 42,888 is unsubscribed and 107,308 is subscribed, with Northern holding 100,000 Dth and three marketers holding the remaining 7,308 Dth. See ***Attachment SPF-9***.

Q. Does Granite serve any other customers other than the four capacity holders?

A. Yes, Granite also generates revenue from off-system sales to Bay State, an affiliated company.

From 2000 through 2006 Bay State sales have generated from 67 to 86 percent of Granite's annual revenue and in 2007 Bay State off-system sales accounted for 37 percent of Granite's total revenues. See ***Attachment SPF-10***.

Q. Please explain Northern's relationship with Granite.

A. As stated earlier, Granite was originally part of Northern's distribution system and still serves as the backbone of the Northern system. Northern is made of many isolated distribution segments that are served by Granite and essentially all of Northern's gas supplies flow through Granite's pipeline. Northern and Granite are affiliates and Northern is also the largest capacity holder on Granite (93 percent of the subscribed capacity). Granite is such an integral part of the operation of Northern's pipelines that Unitil has stated that the acquisition would not occur without the Granite component.

Q. Does Northern have any pipeline supply options other than Granite?

A. No. The cost to construct the facilities necessary to bypass Granite and interconnect the Northern distribution system would be prohibitive.

Q. Do other customers taking service on Granite have alternative pipeline supply options?

A. Bay State has other options. The three marketers with capacity on Granite may have other pipeline supply options, but even if not, if the cost to receive service from Granite became prohibitive, they could discontinue service to their customers and those customers could request service from Northern.

Q. Why might customers choose Granite?

A. The deciding factor would most likely be economics. If supply alternatives exist and other factors are equal, a rational customer will choose the least cost alternative. In the case of affiliate companies, the corporate bottom line may also weigh into the decision. For instance, if

Bay State has the choice between two equally attractive pipeline options, one of which is an affiliate company, the logical choice would be to choose the affiliate company in order to improve overall corporate earnings. Post acquisition, Bay State will no longer have a vested interest in using Granite's services.

Q. What is the rate Granite charges Northern for capacity?

A. Northern pays $1.2639 per Dth for 100,000 Dth of daily firm capacity on Granite, according to the terms of five year special contract that expires October 31, 2008. The annual cost of the contract is $1,516,680. Prior to the special contract Northern was paying Granite the maximum tariff rate of $1.666 per Dth, set by the FERC in 1997.

Q. What were some of the factors behind the special contract?

A. In 2002, when PNGTS and the Maritimes joint facilities went into service, Granite's peak day capacity increased from 67,000 Dth per day to 150,196 Dth. At that time Northern filed an amendment to the affiliate agreement between Northern and Granite to increase Northern's capacity on Granite. In testimony filed with the Maine Commission, Northern stated that although the additional capacity would not be needed for five years, Northern was entering into the contract to ensure at that it would have the capacity when needed, rather than risk having some other entity contracting for that capacity and the capacity not being available to Northern when needed.

The terms of the contract were the result of negotiations between the Maine and New Hampshire Commission Staffs and Public Advocates, Economic & Technical Consultants, Inc. ("ETC" acting on behalf of the Commissions), Northern and Granite. The special contract rate was based in part on an updated revenue requirement which reflected the fact that the Granite pipeline was almost fully depreciated.

Q. Has Granite's rate base changed since the special contract was entered into?

A. Yes. The Pipeline Safety Improvement Act of 2002 introduced several new requirements for Pipeline Operators including those specifically addressing Pipeline Integrity Management (PIM). To comply with the new pipeline integrity requirements, Granite has invested approximately $7.5 million and expects spend another $6.7 million through 2012. See *Attachment SPF-11*.

Q. Has the increase in rate base impacted Granite's rates?

A. Not yet, as Granite has not filed for an increase. Granite has calculated a substantial revenue deficiency for each of the past two years and once the acquisition proceeding is complete, Granite expects to file for a rate increase.

Q. Could Granite have avoided the PIM requirements and still provide safe and reliable service?

A. Possibly, as explained in more detail by Staff witness Randall Knepper. If Granite were not under FERC jurisdiction as an interstate pipeline and was reclassified from a transmission to a distribution line, it would fall under different PIM requirements.

Q. Is such an outcome possible?

A. It appears so, possibly depending on changes being made to the corporate structure of Northern and Granite and the system engineering. Exceptions to federal jurisdiction over interstate pipelines exist. For example, the Hinshaw amendment, section 1(c) of the Natural Gas Act, 15 USCA 717(c) provides an exemption to federal jurisdiction to the extent it applies. As another example, FERC has authority to make service area determinations which would allow transportation to ultimate consumers in the service area by the holder of the service area determination, even if across State lines, see section 7(f) of the Natural Gas Act, 15 USCA

717f(f). Granite would also need approval to reclassify its pipelines, which would also require federal approval.

Q. Is such an outcome desirable?

A. More analysis and review is required before such a determination can be made. If Granite is able to avoid substantial investments in plant while still providing safe and reliable service, that will serve to keep rates down. In addition, if Granite became part of Northern, that would give Northern control of that capacity and eliminate the risk that an outside entity might contract for capacity that Northern may eventually need. Yet another advantage is that regulatory expenses may be reduced, as FERC reporting and filing requirements would no longer apply. A further advantage is that Unitil, which has no experience operating an interstate pipeline, would avoid having to do so. And perhaps most significant, State regulation would likely improve safety oversight, as explained in the testimony of Staff witness Randall Knepper.

Q. Are there any projected integration savings for Granite?

A. No, Granite's operating costs are expected to increase by approximately $200,000 as a result of the acquisition.

Q. Does the Granite issue need to be resolved in this proceeding?

A. The Granite issue needs to be resolved as soon as possible, whether in this proceeding or some other proceeding. Granite expects to make substantial capital investments over the next five years to satisfy its PIM requirements, investments that could possibly be avoided. Granite also expects to file for a rate increase at the FERC in the near future. A substantial increase in rates could change the economics so that customers would leave the system, leaving Northern as the sole source of funding for Granite. If Granite only serves Northern, which for all practical purposes seems to be the case, then it is logical that Granite should be subject to State regulation as is Northern. From both a safety and financial perspective, State regulation appears to be in the public interest.

Q. Do you have any other comments regarding the acquisition?

A. Yes. From the beginning the procedural schedule in this docket has been very aggressive and analysis and review has been fast paced. Unitil has done a good job in responding to Staff's requests and developing and implementing its business integration plans to date. Nonetheless, there are still critical issues for which information is lacking. Responses from Granite and Northern have lagged and although all data requests have been answered, the Granite analysis and review is not complete. Integration savings need to be updated and Unitil's proxy statement has not yet been submitted.

Q. Please summarize your recommendations.

A. Staff recommends that the Commission deny Unitil's petition to acquire Northern as filed, since the proposed financing and accounting of the transaction will ultimately result in higher rates than Northern ratepayers would experience without the acquisition.

Q. Does that conclude your testimony?

A. Yes.