

UNITIL SERVICE CORP
COMMENTS TO THE ENERGY PLANNING ADVISORY BOARD
STAKEHOLDER FORUM

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Unitil appreciates the opportunity to participate in the Stakeholder forum and to assist the Energy Planning Advisory Board in its efforts to develop and refine the strategic plan for the energy policy of the state of New Hampshire. This is a critical time in energy markets worldwide, and how the state of New Hampshire reacts today may make a significant difference in its long term economic future.

We urge the Board to keep two key principles in mind as it approaches its work. First, the state has a limited, but important, role in energy markets and should focus its efforts on those policy areas where it can be effective and make a difference. Second, energy is a global commodity subject to dynamic market forces. The most effective policy initiatives for the state will be those which use the power of competitive market forces as much as possible to accomplish change.

Given the number of stakeholders expected and the limited time available to the Board, Unitil will limit its presentation to three recommendations, in the following policy areas – electric market structure – needed services to electric customers – supporting infrastructure investments. At the public forum on June 23, Unitil’s comments will be supported by George R. Gantz, Senior Vice President of Customer Services and Communications.

Recommendation #1 – Complete the restructuring of the electric market in New Hampshire as envisioned in RSA 374-F.

In 1996, the state of New Hampshire began an ambitious program to remake the electric utility industry in the state by separating the generation function from the delivery function, and by subjecting generation to competitive market forces. In the following decade this effort gained considerable momentum nationally and in New England. As a consequence, the electric industry today is significantly different than it was ten years ago. In New England, wholesale electricity suppliers are largely subject to competition and no longer operate as protected monopolies.

Initially, the efforts in New Hampshire to implement the restructuring of the electric industry were forestalled by Court challenges. Subsequently, in the face of the California and Enron debacles, the New Hampshire legislature stepped in and delayed the completion of this restructuring for Public Service Company of New Hampshire, who serves the majority of electric consumers in the state. Meanwhile the three smaller companies, Unitil, National Grid and the New Hampshire Electric Coop, proceeded with electric restructuring in their various ways.

As of May, 2006, all of the customers of these three utilities are provided with electric delivery services by their local utility, and a choice of either Default Service procured periodically by the utility from the competitive wholesale market or Competitive Generation Service purchased directly from a retail electricity supplier. Many of the large customers have chosen competitive supply options offered by a number of retail competitors. Competitive offers to smaller business and residential customers are still not available so they remain on utility-supplied Default Service. All customers are exposed to a competitive market price in one form or another.

However, 70% of the electric customers in New Hampshire, those served by PSNH, are provided electricity supply under a hybrid option. Customers are free to choose a competitive retail supply option, but PSNH provides a Default Service based largely on a mix of generating facilities that it continues to own and operate, with additional purchases of generation on the wholesale market as needed to meet customer requirements. Supply service is priced at an average cost of service for PSNH, determined and set in a regulatory investigation on an annual or semi-annual basis. Under the legal framework that exists, however, PSNH is not required to complete the transition to market based generation services, nor are they allowed to alter or expand their portfolio of owned generation resources. Effectively, one foot remains in the old world, and one in the new.

The status quo is not good for the state of New Hampshire. PSNH and its customers are in limbo and cannot move forward or go back. And the competitive market in New Hampshire is only partially open, leaving competitive suppliers less interested in competing for those customers who are in the market. Right now, large customers in Maine and Massachusetts where markets are fully open are getting more competitive bids and lower prices than large customers of the same size in New Hampshire.

Unitil recommends that the state complete the process it has begun, by moving to market based pricing for PSNH generation services and creating a statewide competitive market for generation services. This transition could be accomplished in a variety of ways and over a variety of timeframes. We would recommend that the transition be planned and begun as soon as possible, and that it be based on the following considerations:

- Competitive options for large customers are readily available in New Hampshire, while competitive options for smaller business and residential customers are not.

This fact is reflected in the way Default Service is procured and priced for Unitil's large customers. Unitil procures this Default Service through quarterly competitive wholesale solicitations, and the price for the service varies by month. The fact that large customers have good competitive options should guide the procurement and pricing of Default Service for PSNH's large customers as well.

- Given the lack of competitive retail options for smaller business and residential customers, it is appropriate to provide for some dampening of potential price volatility for these customers, while moving towards more transparent market pricing that provides correct price signals to customers about the impact of their consumption decisions. Unitil does this through a ladder portfolio of power supply procurements.
- A competitive market for electric generation is, in the long run, inconsistent with utility-owned, cost-based electric generation, because the two approaches involve fundamentally different economics and risks. Fair markets require a level playing field where participants face the same sets of incentives and disincentives. And since electric generation is not, fundamentally, a natural monopoly, it should be subject to competition. New generation resources should be funded, built, operated and maintained under the competitive market framework, competing on a level playing field with other generation resources in New England. Utilities or their affiliates should be allowed to build new generation, but should be required to face the same risks as other market competitors.
- Customer choice is, in the long run, inconsistent with utility-owned, cost-based electric generation. Utility ownership of generation involves long term

commitments to specific technology and fuel choices, and establishes a base of fixed costs which cannot be avoided when market conditions change. When competitive market prices drop relative to the utility costs of supply, and customers choose to leave the utility generation option, who will pick up the utility's fixed costs? The remaining ratepayers will – the small business and residential customers who have the fewest competitive options.

Recommendation #2 – Continue to support energy efficiency and low income programs for electric customers.

The System Benefits Charge (SBC), instituted as part of electric restructuring, provides funding for two important public purposes – promoting energy efficiency, and providing supplemental support for low income customers. Neither of these purposes can be adequately addressed by reliance only on competitive market forces. Until argues that both deserve to continue receiving support through a charge in rates which applies to all customers.

Arguably, consumer choices with respect to their utilization of electricity involve tradeoffs between the price of electricity and the value a customer receives. This is an economic equation that only the customer can make. However, decades of experience have demonstrated that significant market barriers exist that prevent consumers from making optimal energy choices. Some of these barriers are informational, some relate to the market availability of efficient products or services, and some are financial, such as the high upfront costs of technologies that reduce life-cycle costs. It should be the goal of the state of New Hampshire to support and fund programs that help break down these market barriers.

The SBC funding, and the Energy Efficiency Working Group operating under the oversight of the Public Utilities Commission, seeks to do exactly that. Unitil believes the programs that it offers to its customers under this framework have been very valuable and highly cost-effective. It also believes the funding has been at an appropriate level. However, we do expect that the specific funding priorities will evolve and programs will change based on changes in the market and the success in reducing or eliminating barriers. A good example of how this can work is found in lighting in new commercial buildings. In the past, the “energy efficiency” standard for lighting used to be the T-8 technology. T-8 technology is now generally accepted as a baseline in new commercial construction and is no longer supported with rebates, and the T-12 technology is now the energy efficiency standard.

If there is a weakness in the state’s approach to energy efficiency, it is that the incentive programs offered by the utilities and funded through the SBC are not sufficiently backed up by enforcement of local energy efficiency codes. A useful analogy here is that we continue to pour water into the top of the bucket, providing incentives for improved energy efficiency in a limited number of new buildings, while water is leaking out of the bottom of the bucket due to inadequate code enforcement.

The current challenges to the state’s Electric Assistance Program for low-income customers are known and are being addressed in a proceeding at the Public Utilities Commission. For Unitil, we believe current funding is at an adequate level, but we believe the benefit levels and funding priorities need to be reviewed in order to insure that the greatest number of those in need receive at least an adequate level of assistance.

Recommendation #3 – The state needs to support investments in electric delivery infrastructure.

The restructuring of the electric industry in New Hampshire is at least partially based on the concept that companies focused on the transmission and delivery function, and no longer involved in electric generation, will do a better job in providing transmission and distribution services to customers. In the restructured industry, transmission and delivery continue to be regulated monopoly services. They are subject to cost of service ratemaking subject to the review and approval of federal or state regulators, and they impose specific obligations on the utilities to provide electric service to all customers, to maintain appropriate reliability and to assure adequate customer service.

Regulation of transmission prices and services is now predominately a function of federal regulation under the Federal Energy Regulatory Commission. Delivery prices and services continue to be regulated by state Public Utility Commissions. In the ratemaking process, these regulators must provide adequate financial resources to the utilities to enable them to meet their obligations. Specifically, this involves a process of determining the appropriate return on the investments in the required distribution or transmission facilities, plus recovery of an appropriate level of operating and maintenance expenses. Rates need to be high enough to meet these revenue requirements while not being excessive. The determinations involved in such proceedings are based on the informed judgments of the Commissioners and a careful balancing of investor and consumer interests.

Utilities today are in an increasing cost environment. Not only have the costs of goods and materials, and the costs of borrowing, continued to increase, but some costs, including the costs of employee benefit programs, have skyrocketed. At the same time, customer peak

demands during hot summer weather have jumped as the saturation of air-conditioning rises, pushing utilities like Unitil to invest in new and expanded facilities at record levels. In the face of these rising costs, all utilities including Unitil, have taken steps to control costs – given the high escalation of labor related costs, these steps have included and will continue to include reductions in the number of employees.

At the same time, the revenues from existing rates for delivery service, have not kept pace with rising costs. Revenues change with increases or decreases in the number of customers, and with increases or decreases in the average usage by those customers. Slow regional economic growth means lackluster or declining industrial sales and modest increases in the number of customers. Higher prices, and effective energy conservation programs, means lower growth or even a decline in usage for the average customer.

The implications are clear – utilities will of necessity be seeking rate increases from their regulators. As a result, the decisions regulators make will largely determine the financial health of the utilities, and may encourage or potentially undermine the incentives for utilities to make additional investments in their systems. In balancing the interests of investors and consumers, a regulator may see the direct connection between a higher award and higher customer rates in the short term, without seeing the direct connection between a lower award and the financial strain which will create much higher costs in the long term.

In this context, it is worth noting that the FERC has provided rates of return for transmission investments that are consistently higher than the rates of return New England state PUCs have been providing for delivery system investments. FERC, and some state PUCs, also use techniques that seek to anticipate future cost changes, with the goal of supporting the financial health of the utilities under their jurisdiction and avoiding more rate cases. Traditional

rate cases are extraordinarily costly and time consuming, and in an increasing cost environment they can fail to keep pace with utility costs, resulting in an extended cycle of rate cases yielding higher costs for customers and poor financial results for utilities.

Some of the non-traditional techniques utilized by the FERC and other state jurisdictions include: utilization of a forecasted test year, as opposed to a historic test year, in determining cost levels; utilizing a variety of approaches in determining an appropriate rate of return; utilizing a mid-range rather than a low range when setting a rate of return; providing higher returns in response to higher needs for investment; providing for flow-through cost recovery of certain highly variable cost items; including provisions for inflation adjustments in future rates; or adopting Performance Based Ratemaking that allows for modest annual rate increases in return for utilities achieving specific performance standards for reliability and customer service.

New Hampshire needs to provide adequate financial support for its utilities. In an increasing cost, slow growth environment, this may mean having to evaluate past approaches in a new light, or considering new approaches, particularly those that other states or the FERC have found useful.