

Northern Utilities, Inc.
Direct Prefiled Testimony of Michael Smith
Redacted/Public Version

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

2 A. Michael Smith, Senior Business Development Executive, Northern Utilities, 1075
3 Forest Ave, Portland, Maine 04104.

4 **Q. Please describe your employment responsibilities.**

5 A. My responsibilities include retaining, expanding and attracting business within
6 Northern Utilities' service territories. I am the point of contact with Northern's
7 designated key business and industrial customers, and I am responsible for insuring
8 quality service and opening business communications to counter competitive pressures.

9 **Q. Please describe your education and employment background.**

10 A. I received a Bachelor of Science in Mechanical Engineering Technology in 1989
11 from Wentworth Institute of Technology in Boston, Massachusetts. From 1989 to 1996, I
12 was employed at Northrop, Devine and Tarbell in Portland, Maine. While there I worked
13 as a consulting engineer focusing on energy projects. In 1996, I began my career with
14 Northern Utilities and have held several positions in which I have been responsible for
15 managing Northern's industrial and key account customers in New Hampshire and
16 Maine.

17 **Q. What is the purpose of your testimony in this docket?**

18 A. The purpose of my testimony is to present information to support Northern's
19 proposal for extending the terms and conditions of an existing Special Contract for firm
20 transportation service with National Gypsum for two (2) additional years beyond the
21 expiration date of November 30, 2009. Please refer to Schedule NU-1-1 for a copy of the
22 Customer letter requesting extension of the existing Special Contract.

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2 **Q. Does your testimony include input from other individuals employed by**
3 **Northern Utilities?**

4 A. Yes. My testimony includes information supplied by James L. Harrison of
5 Management Applications Consulting who contributed the marginal cost of service and
6 value of service information used in this filing.

7 **Q. Are you familiar with the provisions of the Special Contract that is submitted**
8 **with this filing as Schedule NU-1-2 and the Second Amendment of Agreement that is**
9 **submitted with this filing as Schedule NU-1-4.**

10 A. Yes. I worked directly with the Customer to negotiate the Special Contract in
11 1999 and the Second Amendment of Agreement.

12 **Q. Please describe the circumstances that led to the negotiation and execution of**
13 **the initial Special Contract (Schedule NU-1-2).**

14 A. National Gypsum is a manufacturer of gypsum wallboard. Its corporate offices
15 are located in Charlotte, North Carolina and one of its manufacturing facilities is located
16 at 1 Succi Drive, Portsmouth, New Hampshire. Gas is consumed in the facility's drying
17 and mill operations. National Gypsum had been an interruptible transportation customer
18 of Northern's since 1990. Because of the extremely large volumes of gas (i.e.
19 approximately 6,950,000 therms) it consumed between July 1998 and June 1999 and
20 because Northern's interruptible customers were going to experience at least a thirty-day
21 curtailment period for the subsequent winter, the Customer wanted the security associated
22 with firm transportation service. In addition to that circumstance, newly-installed
23 interstate pipeline facilities provided the Customer with a viable option to bypass

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1 Northern's system by interconnecting directly to the pipeline to obtain 365 days per year
2 firm gas service. These circumstances led the Customer to approach Northern for a
3 special pricing arrangement for firm transportation.

4 **Q. Please summarize the terms and conditions of the existing Special Contract**
5 **relating to the services provided by Northern and the payment for those services by**
6 **the Customer.**

7 A. A copy of the Special Firm Transportation Agreement dated August 2, 1999 is
8 submitted with this filing as Schedule NU-1-2. Article 1 obligates Northern to transport
9 and deliver to the Customer during any Gas Day up to a Maximum Transportation
10 quantity of 27,000 therms. In each contract year, the Customer is required to use and/or
11 pay Northern for the transportation services for a minimum of 2,500,000 therms of
12 natural gas. After the initial ten year term of the contract, the company will determine the
13 cumulative average usage of gas over the initial term. The Customer is obligated to have
14 used and/or to pay Northern for transportation services for an annual average of
15 5,000,000 therms per year during the initial term. This requirement is explained in
16 Article 3 of the Special Contract. Initially, the Customer was required to pay a customer
17 charge of \$ per month and a volumetric rate of \$ per therm for the first year. After
18 the second year, Northern was allowed to apply an annual inflation adjustment to that
19 charge and rate as described in Article 3 of the Special Contract. Based on these inflation
20 adjustments, the current rates are now \$ per month for the customer charge and a
21 volumetric rate of \$ per therm. In addition to the above-described service and
22 payment provisions, the Special Contract incorporates by reference and makes a part of
23 the contract all of Northern's General Terms and Conditions and Transportation Terms

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1 and Conditions as are in effect from time to time and filed with the New Hampshire
2 Public Utilities Commission. In the event of a conflict, the provisions of the Special
3 Contract govern.

4 **Q. Please describe the initial term of the Special Contract.**

5 A. Commission Order No. 23, 314 approved the Special Contract for a ten year term
6 and required that the provisions of the Special Contract describing the term thereof be
7 amended to require Commission approval for any extension period beyond ten years.
8 The Amendment of Agreement dated October 30, 1999 (submitted herewith as Schedule
9 NU-1-3) was filed in compliance with Commission Order No. 23, 314. It provides that,
10 the initial term of the contract is ten (10) years from the Service Commencement Date
11 which is described in Article 5 of the Special Contract. The Service Commencement
12 date was December 1, 1999; accordingly the initial term of the contract expires on
13 November 30, 2009.

14 **Q. Please describe the provisions of the Second Amendment of Agreement**
15 **submitted with this filing as Schedule NU 1-4.**

16 A. The Second Amendment of Agreement (Schedule NU-1-4) is intended to extend
17 the provisions of the Special Contract (Schedule NU-1-2) as amended by the Amendment
18 of Agreement (Schedule NU-1-3) for an additional two (2) years beyond the contract's
19 initial term. The Second Amendment contains language that modifies Article 4 of the
20 Special Contract as amended by the first amendment to extend the term of the contract as
21 indicated above. The Second Amendment also provides that all of the other provisions of
22 the Special Contract remain in full force and effect.

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1 **Q. Please explain the circumstances that led to the execution of the Second**
2 **Amendment.**

3 A. The special circumstances that led to the negotiation, execution and approval of
4 the Special Contract as described above continue to exist today. In addition to those
5 circumstances, National Gypsum is facing increasing competitive pressures. High energy
6 costs have led to the closing of one of its plants in New York. The Customer's direct
7 competitor, Georgia Pacific, which is located in Newington, New Hampshire, has
8 bypassed Northern and is taking gas service directly from the interstate pipeline which is
9 located in close proximity. This enables the competitor to avoid costs that National
10 Gypsum is paying to Northern and therefore puts the competitor in a stronger economic
11 position than National Gypsum. Accordingly, the National Gypsum plant in Portsmouth
12 is under pressure to control its energy costs to enable it to remain competitive with
13 Georgia Pacific and to avoid suffering the same fate as its sister plant in New York.
14 Additional information regarding the Customer's circumstances is contained in Schedule
15 NU-1-1.

16 **Q. Please describe the steps Northern has taken to evaluate whether the**
17 **Customer continues to have a viable bypass option.**

18 A. Northern's engineering and construction personnel have estimated and analyzed
19 the costs associated with the Customer's bypass option presented in Schedule NU-1-5
20 and have determined that the Customer continues to have an economically viable option
21 to physically bypass Northern's facilities by interconnecting with the interstate pipeline.
22 National Gypsum has indicated that it would minimize costs associated with this bypass
23 by constructing the bypass pipeline using a high-density plastic rather than using more

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1 expensive steel as previously proposed in 1999. Northern has experience/knowledge of
2 another customer who recently installed a plastic pipeline within the railroad right of
3 way, and therefore believes that National Gypsum's bypass option remains economically
4 viable.

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6 **Q. Has Northern performed an analysis of the Customer's value of service**
7 **alternative.**

8 A. Yes. The Company performed a value of service (VOS) analysis as described in
9 Schedule NU-1-6. The VOS considers the case where the Customer invests to bypass
10 Northern and buy directly from the interstate pipeline. Under this scenario, the customer
11 incurs an initial capital expenditure of \$ million, labeled "Customer Investment" and
12 subsequent expenses for operations and maintenance of the distribution pipeline, labeled
13 "O&M", as well as property taxes. Since the base case is defined as the customer
14 continuing with a special contract, under the bypass option the Customer avoids paying
15 the rates of the special contract. These savings labeled "Net Revenues" are the revenues
16 foregone by Northern. Finally, the Customer incurs some additional income taxes,
17 computed in the remaining columns of Schedule NU-1-7. Based on a potential annual
18 usage of Dt per year, the Customer's bypass would payback in just over 4 years and
19 would generate a rate of return of 27.62% over ten years. The second page of Schedule
20 NU-1-7 is based on the minimum annual usage of Dt per year, this scenario results in
21 a payback in almost 7 years with a rate of return of 15.51% over ten years.

22 **Q. Has Northern performed an analysis of its long-run marginal costs of serving**
23 **the customer? If so, please describe that analysis.**

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1 A. Yes. Northern has updated its most recently filed marginal cost study. The
2 marginal cost study was originally developed to support unbundling and has since been
3 used as a basis for computing the floor price used in connection with special contracts.
4 Marginal costs may be easily updated. They can be estimated from one year to the next
5 by simply escalating the prior period marginal costs. This fact stems from the
6 economist's fixed charge rate used to convert capital investments into annual carrying
7 charges. Unlike a conventional fixed payment mortgage, payments to recover fixed costs
8 rise in nominal dollars. Similarly, marginal operating and maintenance (O&M) expenses
9 can be estimated by simply applying an appropriate escalation factor to the prior measure
10 of marginal O&M expenses. The results of Northern's prior marginal cost study were
11 updated to current price levels by identifying the customer-related and capacity-related
12 unit costs, escalating to current levels and multiplying by National Gypsum's billing units
13 to compute the marginal costs to provide delivery service.

14 **Q. Please explain whether the price to be paid by National Gypsum during the**
15 **two (2) year extension of the Special Contract proposed in this filing is above**
16 **Northern's long-run marginal cost to serve this Customer.**

17 A. The price for the two year extension period exceeds the estimated marginal costs
18 to provide service over the proposed extension period. Based on current rates, revenues
19 of \$ are generated, exceeding the marginal costs estimate presented on Schedule
20 NU-1-8 of \$. During each year of the contract extension, costs are subject to the
21 same escalation factors, therefore revenues will continue to exceed the marginal costs.

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1 **Q. Based on your analysis, do you believe that extending the Special Contract**
2 **for two years beyond the initial term will allow National Gypsum to gain an unfair**
3 **advantage over its competitor?**

4 A. No. National Gypsum's competitor, Georgia Pacific has already bypassed
5 Northern and does not pay any costs to Northern. Each company is subject to
6 transportation costs on the interstate pipeline.

7 **Q. Based on your analysis, do you have an opinion as to whether extending the**
8 **Special Contract for two years beyond the initial term is just and consistent with the**
9 **public interest?**

10 A. Yes. I believe that National Gypsum's situation continues to present special
11 circumstances which renders departure from Northern's tariffed rates and conditions just
12 and consistent with the public interest. Extending the term of the Special Contract for
13 two more years provides benefits to Northern and its customers because the annual
14 revenues under the Special Contract exceed Northern's long-run marginal costs of
15 serving National Gypsum. Thus, retaining National Gypsum as Northern's customer will
16 continue to keep the average system costs of transporting gas applicable to all of
17 Northern's firm customers lower than it would be if Northern were to lose this Customer
18 to bypass. In addition, the Special Contract helps the Customer to remain competitive
19 and to continue its operations in New Hampshire, which contributes to the state's
20 economy.

21 **Q. Please explain the need for the instant filing.**

22 A. As indicated in Commission Order No. 23, 314 and the Amendment to
23 Agreement (Schedule NU-1-3) filed in compliance with that Order, Commission

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1 approval is required to effectuate an extension of the Special Contract beyond the initial
2 ten (10) year term.

3 **Q. Does this conclude your testimony?**

4 A. Yes.

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