UNITIL CORP
Form 10-Q
April 28, 2006
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For Quarter Ended March 31, 2006

Commission File Number 1-8858

UNITIL CORPORATION

(Exact name of registrant as specified in its charter)

New Hampshire	**02-0381573**
(State or other jurisdiction of incorporation or organization)	***(I.R.S. Employer Identification No.)***

6 Liberty Lane West, Hampton, New Hampshire	**03842-1720**
(Address of principal executive office)	***(Zip Code)***

Registrant s telephone number, including area code: (603) 772-0775

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.   Yes x   No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large Accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	**Outstanding at April 27, 2006**
Common Stock, No par value	5,620,672 Shares

Table of Contents

UNITIL CORPORATION AND SUBSIDIARY COMPANIES

FORM 10-Q

For the Quarter Ended March 31, 2006

Table of Contents

		Page No.
Part I. Financial Information		
Item 1.	Financial Statements	
	Consolidated Statements of Earnings - Three Months Ended March 31, 2006 and 2005	13
	Consolidated Balance Sheets, March 31, 2006, March 31, 2005 and December 31, 2005	14-15
	Consolidated Statements of Cash Flows - Three Months Ended March 31, 2006 and 2005	16
	Notes to Consolidated Financial Statements	17-28
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	2-12
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	29
Item 4.	Controls and Procedures	29
Part II. Other Information		
Item 1.	Legal Proceedings	29
Item 1A.	Risk Factors	29
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	29
Item 3.	Defaults Upon Senior Securities	Inapplicable
Item 4.	Submission of Matters to a Vote of Security Holders	Inapplicable
Item 5.	Other Information	Inapplicable
Item 6.	Exhibits	31
Signatures		32
Exhibit 11	Computation of Earnings per Weighted Average Common Share Outstanding	33

Table of Contents

PART I. FINANCIAL INFORMATION

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

SAFE HARBOR CAUTIONARY STATEMENT

This report and the documents we incorporate by reference into this report contain statements that constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, Section 21E of the Securities Exchange Act of 1934 and the Private Securities Litigation Reform Act of 1995. All statements, other than statements of historical fact, included or incorporated by reference into this report, including, without limitation, statements regarding the financial position, business strategy and other plans and objectives for the Company s future operations, are forward-looking statements.

These statements include declarations regarding Management s beliefs and current expectations. In some cases, forward-looking statements can be identified by terminology such as may, will, should, expects, plans, anticipates, believes, estimates, predicts, potential or negative of such terms or other comparable terminology. These forward-looking statements are subject to inherent risks and uncertainties in predicting future results and conditions that could cause the actual results to differ materially from those projected in these forward-looking statements. Some, but not all, of the risks and uncertainties include the following:

- Variations in weather;
- Changes in the regulatory environment;
- Customers preferences on energy sources;
- Interest rate fluctuation and credit market concerns;
- General economic conditions;
- Increased competition; and
- Fluctuations in supply, demand, transmission capacity and prices for energy commodities.

Many of these risks are beyond the Company s control. Any forward-looking statements speak only as of the date of this report, and the Company undertakes no obligation to update any forward-looking statements to reflect events or circumstances after the date on which such statements are made or to reflect the occurrence of unanticipated events. New factors emerge from time to time, and it is not possible for the Company to predict all of these factors, nor can the Company assess the impact of any such factor on its business or the extent to which any factor, or combination of factors, may cause results to differ materially from those contained in any forward-looking statements.

RESULTS OF OPERATIONS

Earnings Overview

One of the warmest winters on record in the United States adversely affected the Company s sales of electricity and natural gas in the first quarter of 2006. The National Oceanic and Atmospheric Administration reported that the United States experienced the warmest January on record in 2006. On average, heating degree days were 12% below the first quarter of 2005 in the Company s utility service territories.

The Company s Earnings Applicable to Common Shareholders (Net Income) was $2.0 million for the first quarter of 2006, a decrease of $0.7 million compared to the same period in 2005. Earnings per common share were $0.36 for the first quarter of 2006, a decrease of $0.12 per share compared with earnings of $0.48 per share for the first quarter of 2005. Earnings for the first quarter of 2006 reflect lower unit sales of electricity and natural gas in 2006 compared to the first quarter of 2005 largely due to a milder winter heating season in 2006. Unitil also recorded higher operating costs in the first quarter of 2006 compared to the same period a year earlier.

Table of Contents

Total electric kWh sales decreased 1.2% in the three months ended March 31, 2006 compared to the same period in 2005 primarily due to the milder winter heating season in 2006. The weather in the Company s service territories in the first quarter of 2006 was approximately 12% warmer than in the same period for 2005.

Gross electric sales margin decreased $0.9 million in the three month period ended March 31, 2006 compared to the same period in 2005. The decrease in electric margin is due to lower sales volume ($0.2 million) and electric service rate changes ($0.7 million) in the current period compared to the same three month period a year earlier. In particular, in the fourth quarter of 2005, a rate surcharge on Regulatory Assets, the Seabrook Amortization Surcharge (SAS), expired. As a result, the revenues from the SAS are no longer included in electric sales margin. The decrease in revenues resulting from expiration of the SAS is offset by a corresponding decrease in amortization expense related to this Regulatory Asset. The SAS was being collected from customers of the Company s Massachusetts utility operating subsidiary, Fitchburg Gas and Electric Light Company (FG&E) to recover the FG&E s former investment in Seabrook Station, which became fully amortized in 2005.

The Company s New Hampshire utility operating subsidiary, Unitil Energy Systems, Inc. (UES) filed a request for a base rate increase of $4.65 million with the New Hampshire Public Utilities Commission (NHPUC) which established temporary rate relief at current rate levels, effective January 1, 2006. Any rate change ultimately awarded by the NHPUC will be retroactive to January 1, 2006. The overall rate filing is currently under review, with a NHPUC order anticipated before the end of 2006. The Company has evaluated the gain contingency criteria under Financial Accounting Standards Board (FASB) Statement No. 5, Accounting for Contingencies (SFAS No. 5) and will continue to recognize UES utility revenues at current rates until such time as the outcome of the rate case can be more clearly determined.

The milder weather caused unit sales of natural gas to residential customers to decline 11.7% in the three months ended March 31, 2006 compared to the same period in 2005. Gas sales to commercial and industrial (C&I) customers were up 8.0% in the three months ended March 31, 2006 compared to the same period in 2005, primarily due to a new special contract with a large industrial customer. Absent the sales associated with this special contract, sales to C&I customers were down 13.8%, reflecting the milder weather.

Gross gas sales margin decreased $0.8 million in the three month period ended March 31, 2006 compared to the same period in 2005. The decrease in gas sales margin is attributable to the lower gas sales volume, as discussed above. A portion of the margin earned by the Company under the new special contract discussed above is deferred for recognition pending the final review of the contract by the Massachusetts Department of Telecommunications and Energy (MDTE) and so the favorable impact on gas firm therm sales due to this contract is not matched by a similar increase in gross gas sales margin.

Total Operation & Maintenance expense increased $0.2 million, or 2.9%, in the three month period ended March 31, 2006 compared to the same period in 2005. The increase reflects higher salaries and compensation costs of $0.2 million, higher retiree and employee benefit costs of $0.1 million, partially offset by lower audit and legal fees of $0.1 million.

Depreciation and Amortization expense decreased $0.9 million for the three month period ended March 31, 2006 compared to the same period in 2005. This decrease was primarily due to lower amortization on regulatory assets. As discussed above, the Company s regulatory assets related to its former abandoned property investment in Seabrook Station became fully-amortized in the fourth quarter of 2005.

Interest Expense, net increased by $0.2 million in the three month period ended March 31, 2006 as compared to the same period in 2005. The change in Interest Expense, net was primarily driven by a higher weighted average cost of debt in the first quarter of 2006 compared to the same period in 2005.

Operating Revenues Electric

Electric Operating Revenues - Total Electric Operating Revenues, increased by $9.6 million, or 20.5%, in the three month period ended March 31, 2006 compared to the same period in 2005. Total Electric Operating Revenues include the recovery of costs of electric sales, which are recorded as Purchased Electricity and Conservation & Load Management (C&LM) in Operating Expenses. The net increase in Total Electric Operating Revenues reflects higher Purchased Electricity costs $10.6 million, offset by lower sales margin of $0.9 million and lower C&LM revenues of $0.1 million.

Table of Contents

As discussed above, the Company has evaluated the gain contingency criteria under SFAS No. 5 regarding the base rate case currently in process with the NHPUC and will continue to recognize UES utility revenues at current rates until such time as the outcome of the rate case can be more clearly determined.

Purchased Electricity and C&LM revenues increased a net $10.5 million, or 22.4% of Total Electric Operating Revenues in the three month period ended March 31, 2006 compared to the same period in 2005, reflecting higher electric commodity prices and decreased spending on energy efficiency programs that were implemented during those periods. Purchased Electricity revenues include the recovery of the cost of electric supply as well as other energy supply related restructuring costs, including long-term power supply contract buyout costs. C&LM revenues include the recovery of the cost of energy efficiency and conservation programs. The Company recovers the cost of Purchased Electricity and C&LM in its rates at cost on a pass through basis.

Gross electric sales margin (Total Electric Operating Revenues less cost of electric sales) was $12.8 million in the three month period ended March 31, 2006. This represents a decrease of $0.9 million, or 1.9% of Total Electric Operating revenues in the three month period compared to the same period in 2005. The lower sales margin reflects $0.2 million related to lower sales volume and $0.7 million related to lower SAS and other utility service revenues. This decrease in SAS revenues reflects the expiration in the fourth quarter of 2005 of the SAS surcharge on Regulatory Assets, which is offset by a corresponding decrease in amortization expenses on Regulatory Assets (see discussion of Depreciation & Amortization below).

The following table details total Electric Operating Revenues and Sales Margin for the three months ended March 31, 2006 and 2005:

Electric Operating Revenues and Sales Margin (000 s)

	Three Months Ended March 31,			
	2006	**2005**	**$ Change**	**% Change[1]**
Electric Operating Revenue:				
Residential	**$ 24,221**	$ 20,992	$ 3,229	6.9%
Commercial / Industrial	**32,209**	25,820	6,389	13.6%
Total Electric Operating Revenue	**$ 56,430**	$ 46,812	$ 9,618	20.5%
Cost of Electric Sales:				
Purchased Electricity	**$ 42,912**	$ 32,326	$ 10,586	22.6%
Conservation & Load Management	**738**	800	(62)	(0.2%)
Gross Electric Sales Margin	**$ 12,780**	$ 13,686	$ (906)	(1.9%)

(1) Represents change as a percent of Total Electric Operating Revenue.

Kilowatt-hour Sales On a composite basis, Unitil s total electric kWh sales decreased 1.2% in the three months ended March 31, 2006 compared to the same period in 2005 primarily due to the milder winter heating season in 2006 compared to 2005. The weather in the Company s service territories in the first quarter of 2006 was approximately 12% warmer than in the same period for 2005. Sales to residential customers and commercial and industrial (C&I) customers decreased 1.9% and 0.8%, respectively in the three month period as compared to the prior year period.

The following table details total kWh sales for the three months ended March 31, 2006 and 2005 by major customer class:

kWh Sales (000 s)

Three Months Ended March 31,			
2006	**2005**	**Change**	**% Change**

Residential	**183,164**	186,716	(3,552)	(1.9%)
Commercial/Industrial	**267,841**	269,958	(2,117)	(0.8%)
Total	**451,005**	456,674	(5,669)	(1.2%)

Table of Contents

Operating Revenues - Gas

Gas Operating Revenues Total Gas Operating Revenues increased $1.0 million, or 7.9% in the three month period ended March 31, 2006 compared to the same period in 2005. Total Gas Operating Revenues include the recovery of the costs of gas sales, which are recorded as Purchased Gas and C&LM in Operating Expenses.

The net increase in Gas Operating Revenues reflects higher Purchased Gas costs $1.8 million, offset by lower sales margin of $0.8 million related to lower sales volume.

Purchased Gas and C&LM revenues increased a net $1.8 million, or 13.8% of Total Gas Operating Revenues in the three month period ended March 31, 2006 compared to the same period in 2005, reflecting higher gas commodity prices and an increase in spending on energy efficiency programs that were implemented during those periods. Purchased Gas revenues include the recovery of the cost of gas supply as well as the other energy supply related costs. C&LM revenues include the recovery of the cost of energy efficiency and conservation programs. The Company recovers the cost of Purchased Gas and C&LM in its rates at cost on a pass through basis.

Gross gas sales margin (Total Gas Operating Revenue less the costs of gas sales) was $3.4 million in the three month period ended March 31, 2006. This represents a decrease of $0.8 million, or 5.9% of Total Gas Operating Revenues in the three month period compared to the same period in 2005 and is attributable to lower firm therm sales volume, as discussed below.

The following table details total Gas Operating Revenues and Sales Margin for the three months ended March 31, 2006 and 2005:

Gas Operating Revenues and Sales Margin (000 s)

	Three Months Ended March 31,			
	2006	**2005**	**$ Change**	**% Change[1]**
Gas Operating Revenue:				
Residential	**$ 7,845**	$ 7,475	$ 370	2.9%
Commercial / Industrial	**5,735**	5,205	530	4.2%
Total Firm Gas Revenue	**$ 13,580**	$ 12,680	$ 900	7.1%
Interruptible Gas Revenue	**106**	7	99	0.8%
Total Gas Operating Revenue	**$ 13,686**	$ 12,687	$ 999	7.9%
Cost of Gas Sales:				
Purchased Gas	**$ 10,186**	$ 8,424	$ 1,762	13.9%
Conservation & Load Management	**59**	71	(12)	(0.1%)
Gross Gas Sales Margin	**$ 3,441**	$ 4,192	$ (751)	(5.9%)

[1] Represents change as a percent of Total Gas Operating Revenue.

5

Table of Contents

Therm Sales Firm therm sales of natural gas declined 1.9% in the three months ended March 31, 2006 compared to the same period in 2005. Sales to residential customers were 11.7% lower in the first quarter of 2006 compared to the same period in 2005 due to the extremely mild winter heating season in 2006. Sales to C&I customers were 8.0% higher in the current quarter, primarily due to a new special contract with a large industrial customer. Absent the sales associated with this new special contract, sales to C&I customers were down 13.8%, primarily reflecting the extremely mild winter weather in the first quarter of 2006 compared to the same period in 2005. The weather in the Company s service territories in the first quarter of 2006 was approximately 12% warmer than in the same period for 2005, as the United States experienced a record warm January.

The following table details total firm therm sales for the three months ended March 31, 2006 and 2005, by major customer class:

Firm Therm Sales (000 s)

	Three Months Ended March 31,			
	2006	**2005**	**Change**	**% Change**
Residential	**4,902**	5,551	(649)	(11.7%)
Commercial/Industrial	**5,934**	5,495	439	8.0%
Total	**10,836**	11,046	(210)	(1.9%)

Operating Revenue - Other

Total Other Revenue increased $0.1 million, or 17.2%, in the three month period ended March 31, 2006 compared to the same period in 2005. The increase was the result of growth in revenues from the Company s unregulated energy brokering business, Usource.

The following table details total Other Revenue for the three months ended March 31, 2006 and 2005:

Other Revenue (000 s)

	Three Months Ended March 31,			
	2006	**2005**	**$ Change**	**% Change**
Other	**$ 587**	$ 501	$ 86	17.2%
Total Other Revenue	**$ 587**	$ 501	$ 86	17.2%

Table of Contents

Operating Expenses

Purchased Electricity Purchased Electricity expenses include the cost of electric supply as well as the other energy supply related restructuring costs, including long-term power supply contract buyout costs. Purchased Electricity increased $10.6 million, or 32.7%, in the three month period ended March 31, 2006 compared to the same period in 2005, reflecting higher electric commodity prices. The Company recovers the costs of Purchased Electricity in its rates at cost on a pass through basis and therefore changes in these expenses do not affect Net Income.

Purchased Gas Purchased Gas expenses include the cost of gas purchased and manufactured to supply the Company s total gas supply requirements. Purchased Gas increased $1.8 million, or 20.9%, in the three month period ended March 31, 2006 compared to the same period in 2005, reflecting higher gas commodity costs. The Company recovers the costs of Purchased Gas in its rates at cost on a pass through basis and therefore changes in these expenses do not affect Net Income.

Operation and Maintenance (O&M) - O&M expense includes electric and gas utility operating costs, and the operating cost of the Company s unregulated business activities. Total O&M expense increased $0.2 million, or 2.9%, in the three month period ended March 31, 2006 compared to the same period in 2005. The increase reflects higher salaries and compensation costs of $0.2 million, due to annual salary and wage increases, and higher retiree and employee benefit costs of $0.1 million, partially offset by lower audit and legal fees of $0.1 million.

Conservation & Load Management C&LM expenses are associated with the development, management, and delivery of the Company s Energy Efficiency programs. Energy Efficiency programs are designed, in conformity with state regulatory requirements, to help consumers use electricity and natural gas more efficiently and thereby decrease their energy costs. Programs are tailored to residential, small business and large business customer groups and provide educational materials, technical assistance, and rebates that contribute toward the cost of purchasing and installing approved measures. Approximately 90% of these costs are related to electric operations and 10% to gas operations.

Total C&LM expenses decreased by $0.1 million, or 8.5%, in three month period ended March 31, 2006 compared to the same period in 2005. The decrease reflects the timing of spending on the implementation of Energy Efficiency programs. These costs are collected from customers on a pass through basis and therefore, fluctuations in program costs have no impact on Net Income.

Depreciation, Amortization and Taxes

Depreciation and Amortization - Depreciation and Amortization expense decreased $0.9 million, or 17.5%, for the three month period ended March 31, 2006 compared to the same period in 2005. This decrease was primarily due to lower amortization on regulatory assets. The Company s regulatory asset related to its former abandoned property investment in Seabrook Station became fully-amortized in the third quarter of 2005.

Table of Contents

Local Property and Other Taxes - Local Property and Other Taxes increased by less than $0.1 million, or less than 1.0% for the three month period ended March 31, 2006 compared to the same period in 2005. This increase was due to higher payroll taxes partially offset by lower property tax rates.

Federal and State Income Taxes - Federal and State Income Taxes are lower by $0.3 million for the months ended March 31, 2006 compared to the same period in 2005 reflecting lower pre-tax earnings.

Interest Expense, net

Interest expense is presented in the financial statements net of interest income. Interest expense is mainly comprised of interest on long-term debt and short-term borrowings. Certain reconciling rate mechanisms used by the Company s distribution operating utilities give rise to regulatory assets (and regulatory liabilities) on which interest is calculated.

The Company operates a number of reconciling rate mechanisms to recover specifically identified costs on a pass through basis. These reconciling rate mechanisms track costs and revenue on a monthly basis. In any given month, this monthly tracking and reconciling process will produce either an under-collected or an over-collected balance of costs. In accordance with the Company s tariff, interest is accrued on these balances and will produce either interest income or interest expense. Interest income is recorded on an under-collection of costs, which creates a regulatory asset to be recovered in future periods when rates are reset. Interest expense is recorded on an over-collection of costs, which creates a regulatory liability to be refunded in future periods when rates are reset.

Interest Expense, net (000 s)

	Three Months Ended March 31,	
	2006	**2005**
Interest Expense		
Long-term Debt	**$ 2,320**	$ 2,102
Short-term Debt	**305**	216
Regulatory Liabilities	**42**	39
Subtotal Interest Expense	**2,667**	2,357
Interest Income		
Regulatory Assets	**(728)**	(587)
AFUDC and Other	**(26)**	(15)
Subtotal Interest Income	**(754)**	(602)
Total Interest Expense, net	**$ 1,913**	$ 1,755

Interest Expense, net increased by $0.2 million, or 9.0% in the three month period ended March 31, 2006 compared to the same period in 2005. Interest expense on long-term borrowings in the three month period ended March 31, 2006 increased $0.2 million compared to the prior year period due to the refinancing of variable rate short-term debt with fixed rate long-term debt. In December 2005 Unitil s Massachusetts utility subsidiary, FG&E issued $15 million of unsecured long-term notes to institutional investors. Interest expense on short-term debt increased $0.1 million in the three month period ended March 31, 2006 compared to the same period in 2005 primarily due to higher average short-term interest rates. These increases in interest expense were partially offset by an increase in interest income on regulatory assets of $0.1 million primarily due to higher carrying charges on regulatory assets.

CAPITAL REQUIREMENTS

Cash provided by operating activities was $0.7 million during the First Quarter of 2006, a decrease of $8.1 million over the comparable period in 2005. Net Income was $0.7 million lower in the first quarter of 2006 compared to 2005. Cash required for Accounts Payable increased $4.9 million compared to last year mainly due to the higher costs of purchasing electricity and natural gas for our customers. Cash from Accrued

Revenue decreased $2.0 million quarter over quarter mainly due to higher energy costs, which will be collected from customers in future

periods. During the First Quarter of 2006 as compared to the same quarter in the prior year, Taxes Payable declined by $1.5 million dollars, reflecting higher estimated tax payments in 2006 compared to the refunds received in the first quarter of 2005. In addition, uses of cash for Deferred Restructuring Costs declined by $1.7 million in the first quarter of 2006 compared to the same quarter last year. Deferred Restructuring Costs are regulatory assets that will be recovered from customers in future periods. All other changes in cash flows from operating activities were a net decrease of $0.7 million in cash provided by operating activities.

Cash used in investing activities was $5.6 million for the three months ended March 31, 2006 and increased by $1.2 million over the comparable period in 2005. Annual capital expenditures are presently budgeted to be $37.2 million in 2006 compared to $24.4 million expended in 2005. These 2006 capital expenditures include approximately $9.5 million of cash outlays for the Automated Meter Infrastructure projects, which are expected to be completed in 2007. Capital expenditure projections are subject to changes during the fiscal year.

Cash flows provided by financing activities were $3.9 million in the first three months of 2006. In the comparable period of 2005 cash used in financing activities amounted to $3.2 million, a net change between the two periods of $7.2 million. Cash provided for financing activities in the current period includes the proceeds from short-term bank borrowings of $6.0 million as compared to the repayment of $1.4 million of short-term bank borrowings during the same period in 2005. The current period reflects the early repurchase of $0.2 million of preferred stock. Both periods reflect the payment of dividends to shareholders of approximately $2.0 million. During the First Quarter of 2006 and 2005, normal sinking fund payments amounted to approximately $0.1 million during both periods. Both periods include the proceeds of approximately $0.3 million received from the sale of Unitil Common Stock through the Dividend Reinvestment and Stock Purchase Plan and 401(k) plans.

At March 31, 2006 Unitil had an aggregate of $44.0 million in unsecured revolving lines of credit through three banks. The Company expects to renew its lines of credit annually on or about June 30, 2006 and anticipates that it will be able to secure, renew or replace its revolving lines of credit in the future in accordance with its projected requirements. Average daily short-term borrowings during the first three months of 2006 were approximately $23.5 million, a decrease of approximately $2.0 million over the comparable period in 2005. At March 31, 2006, the Company had available approximately $19.3 million of unused bank lines of credit and had short-term debt outstanding through bank borrowings of approximately $24.7 million. In addition, Unitil had $2.2 million in cash at March 31, 2006.

The Company provides limited guarantees on certain energy contracts entered into by its regulated subsidiary companies. The Company s policy is to limit these guarantees to two years or less. As of March 31, 2006, there are $6.0 million of guarantees outstanding and the longest term guarantee extends through October 24, 2007.

Critical Accounting Policies

The preparation of the Company s financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. In making those estimates and assumptions, management is sometimes required to make difficult, subjective and/or complex judgments about the impact of matters that are inherently uncertain and for which different estimates that could reasonably have been used could have resulted in material differences in its financial statements. If actual results were to differ significantly from those estimates, assumptions and judgments, the financial statements of the Company could be materially different than reported. The following is a summary of the Company s most critical accounting policies, which are defined as those policies where judgments or uncertainties could materially affect the application of those policies. For a complete discussion of the Company s significant accounting policies, refer to the Note 1 to the Consolidated Financial Statements in the Company s Annual Report on Form 10-K, as filed with the Securities and Exchange Commission on February 22, 2006.

Regulatory Accounting - The Company s principal business is the distribution of electricity and natural gas by the retail distribution companies: UES and FG&E. Both UES and FG&E are subject to regulation by the FERC and FG&E is regulated by the MDTE and UES is regulated by the NHPUC. Accordingly, the Company uses the provisions of Financial Accounting Standards Board (FASB) Statement No. 71, Accounting for the Effects of Certain Types of Regulation. (SFAS No. 71). In accordance with SFAS No. 71, the Company has recorded Regulatory Assets and Regulatory Liabilities which will be recovered or refunded in future electric and gas retail rates.

Table of Contents

SFAS No. 71 specifies the economic effects that result from the cause and effect relationship of costs and revenues in the rate-regulated environment and how these effects are to be accounted for by a regulated enterprise. Revenues intended to cover some costs may be recorded either before or after the costs are incurred. If regulation provides assurance that incurred costs will be recovered in the future, these costs would be recorded as deferred charges or regulatory assets under SFAS No. 71. If revenues are recorded for costs that are expected to be incurred in the future, these revenues would be recorded as deferred credits or regulatory liabilities under SFAS No. 71.

The Company s principal regulatory assets and liabilities are detailed on the Company s Consolidated Balance Sheet. The Company is currently receiving or being credited with a return on all of its regulatory assets for which a cash outflow has been made. The Company is currently paying or being charged with a return on all of its regulatory liabilities for which a cash inflow has been received. The Company s regulatory assets and liabilities will be recovered from customers, or applied for customer benefit, in accordance with rate provisions approved by the applicable public utility regulatory commission.

The application of SFAS No. 71 results in the deferral of costs as regulatory assets that, in some cases, have not yet been approved for recovery by the applicable regulatory commission. Management must conclude that any costs deferred as regulatory assets are probable of future recovery in rates. However, regulatory commissions can reach different conclusions about the recovery of costs, which can have a material impact on the Company s consolidated financial statements. Management believes it is probable that the Company s regulated utility companies will recover their investments in long-lived assets, including regulatory assets. The Company also has commitments under long-term contracts for the purchase of electricity and natural gas from various suppliers. The annual costs under these contracts are included in Purchased Electricity and Purchased Gas in the Consolidated Statements of Earnings and these costs are recoverable in current and future rates under various orders issued by the FERC, MDTE and NHPUC.

If the Company, or a portion of its assets or operations, were to cease meeting the criteria for application of these accounting rules, accounting standards for businesses in general would become applicable and immediate recognition of any previously deferred costs, or a portion of deferred costs, would be required in the year in which the criteria are no longer met, if such deferred costs were not recoverable in the portion of the business that continues to meet the criteria for application of SFAS No. 71. If unable to continue to apply the provisions of SFAS No. 71, the Company would be required to apply the provisions of FASB Statement No. 101, Regulated Enterprises Accounting for the Discontinuation of Application of Financial Accounting Standards Board Statement No. 71. In management s opinion, the Company s regulated operations will be subject to SFAS No. 71 for the foreseeable future.

Utility Revenue Recognition - Regulated utility revenues are based on rates approved by state and federal regulatory commissions. These regulated rates are applied to customers accounts based on their actual or estimated use of energy. Energy sales to customers are based on the reading of their meters, which occurs on a systematic basis throughout the month. At the end of each calendar month, amounts of energy delivered to customers since the date of the last meter reading are estimated and the corresponding unbilled revenue is estimated. This unbilled revenue is estimated each month based on estimated customer usage by class and applicable customer rates.

Allowance for Doubtful Accounts - The Company recognizes a Provision for Doubtful Accounts each month. The amount of the monthly Provision is based upon the Company s experience in collecting electric and gas utility service accounts receivable in prior years. Account write-offs, net of recoveries, are processed monthly. At the end of each month, an analysis of the delinquent receivables is performed and the adequacy of the Allowance for Doubtful Accounts is reviewed. The analysis takes into account an assumption about the cash recovery of delinquent receivables and also uses calculations related to customers who have chosen payment plans to resolve their arrears. The analysis also calculates the amount of written-off receivables that are recoverable through regulatory rate reconciling mechanisms. Evaluating the adequacy of the Allowance for Doubtful Accounts requires judgment about the assumptions used in the analysis. Also, the Company has experienced periods when state regulators have extended the periods during which certain standard credit and collection activities of utility companies are suspended. In periods when account write-offs exceed estimated levels, the Company adjusts the Provision for Doubtful Accounts to maintain an adequate Allowance for Doubtful Accounts balance.

Table of Contents

Pension and Postretirement Benefit Obligations - The Company has a defined benefit pension plan covering substantially all its employees and also provides certain other post-retirement benefits (PBOP), primarily medical and life insurance benefits to retired employees. The Company also has a Supplemental Executive Retirement Plan (SERP) covering certain executives of the Company. The Company accounts for these benefits in accordance with FASB Statement No. 87, Employers Accounting for Pensions and FASB Statement No. 106, Employers Accounting for Postretirement Benefits other than Pensions. In applying these accounting policies, the Company has made critical estimates related to actuarial assumptions, including assumptions of expected returns on plan assets, future compensation, health care cost trends, and appropriate discount rates. For each of these plans, the development of the benefit obligation, fair value of plan assets, funded status and net periodic benefit cost is based on several significant assumptions.

The Company s reported costs of providing pension and PBOP benefits are dependent upon numerous factors resulting from actual plan experience and assumptions of future experience. The Company s health care cost trend assumptions are developed based on historical cost data, the near-term outlook and an assessment of likely long-term trends. Pension and PBOP costs (collectively postretirement costs) are affected by actual employee demographics, the level of contributions made to the plans, earnings on plan assets, and health care cost trends. Changes made to the provisions of these plans may also affect current and future postretirement costs. Postretirement costs may also be significantly affected by changes in key actuarial assumptions, including, anticipated rates of return on plan assets and the discount rates used in determining the postretirement costs and benefit obligations. If these assumptions were changed, the resultant change in benefit obligations, fair values of plan assets, funded status and net periodic benefit costs could have a material impact on the Company s consolidated financial statements. See Note 8.

Pension expense is calculated based upon a number of actuarial assumptions, including an expected long-term rate of return on Plan assets. In developing the expected long-term rate of return assumption, the Company evaluated input from actuaries and investment managers. The Company s expected long-term rate of return on Plan assets is based on target asset allocation assumptions of 60% in common stock equities and 40% in fixed income securities. The Company will continue to evaluate the actuarial assumptions, including the expected rate of return, at least annually, and will adjust the appropriate assumptions as necessary.

Income Taxes - Income tax expense is calculated in each of the jurisdictions in which the Company operates for each period for which a statement of income is presented. This process involves estimating the Company s actual current tax liabilities as well as assessing temporary and permanent differences resulting from differing treatment of items, such as timing of the deduction of expenses for tax and book accounting purposes. These differences result in deferred tax assets and liabilities, which are included in the consolidated balance sheets. The Company must also assess the likelihood that the deferred tax assets will be recovered from future taxable income, and to the extent that recovery is not likely, a valuation allowance must be established. Significant management judgment is required in determining income tax expense, deferred tax assets and liabilities and valuation allowances. The Company accounts for deferred taxes under FASB Statement No. 109, Accounting for Income Taxes. The Company does not currently have any valuation allowances against its recorded deferred tax amounts.

Depreciation - Depreciation expense is calculated based on the useful lives of assets and judgment is involved when estimating the useful lives of certain assets. A change in the estimated useful lives of these assets could have a material impact on the Company s consolidated financial statements. The Company conducts independent depreciation studies on a periodic basis as part of the regulatory ratemaking process and considers the results presented in these studies in determining the useful lives of the Company s fixed assets.

Commitments and Contingencies - The Company s accounting policy is to record and/or disclose commitments and contingencies in accordance with SFAS No. 5. SFAS No. 5 applies to an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss that will ultimately be resolved when one or more future events occur or fail to occur.

Refer to Recently Issued Accounting Pronouncements in Note 1 of the Notes of Consolidated Financial Statements for information regarding recently issued accounting standards.