BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

98-713

In the Matter of : DOCKET NO. 920199-WS

Application for rate increase in Brevard, Charlotte/Lee, Citrus, Clay, Duval, Highlands, Lake, Marion, Martin, Nassau, Orange, Osceola, Pasco, Putnam, Seminole, Volusia, and Washington Counties by SOUTHERN STATES UTILITIES, INC.; Collier County by MARCO SHORES UTILITIES (Deltona); Hernando County by SPRING HILL UTILITIES (Deltona); and Volusia County by DELTONA LAKES UTILITIES (Deltona)

FIFTH DAY - AFTERNOON SESSION

VOLUME XIII

Pages 1974 through 2111

PROCEEDINGS: FINAL HEARING

BEFORE: CHAIRMAN THOMAS M. BEARD
COMMISSIONER BETTY EASLEY
COMMISSIONER SUSAN F. CLARK

DATE: Thursday, November 12, 1992

TIME: Reconvened at 12:45 p.m.

PLACE: FPSC, Hearing Room 106
101 East Gaines Street
Tallahassee, Florida 32399

REPORTED BY: JOY KELLY, CSR, RPR
SYDNEY C. SILVA, CSR, RPR
PAMELA A. CANELL
Official Commission Reporters
and
LISA GIROD JONES, RPR, CM

APPEARANCES:

(As heretofore noted.)

I N D E X

WITNESSES - VOLUME XIII

EXHIBITS - VOLUME XIII

Number:		Identified	Admitted
130	(Composite) (Montanaro) 11 Schedules VAM-1 through VAM-11	1979	2047

P R O C E E D I N G S

(Transcript Continues in sequence from Volume XII.)

(Hearing reconvened at 12:45 p.m.)

CHAIRMAN BEARD: Are we ready?

MR. McLEAN: Yes, sir.

CHAIRMAN BEARD: Good.

MR. McLEAN: Mr. Chairman, during Ms. Dismukes' testimony, she was running down a list of persons employed by Southern States and mentioned one person's name who she could not pronounce, and she referred to that person as a Spanish person.

I think we all know this, but I'm not sure that the record would reflect that she meant that in no pejorative sense whatsoever.

MR. HOFFMAN: Thank you, sir.

MR. McLEAN: Citizens call Ms. Victoria Montanaro.

CHAIRMAN BEARD: I take no offense when people refer to me as "that red-necked idiot," so, you know. (Laughter)

MR. McLEAN: Well, we certainly meant it in no pejorative sense.

CHAIRMAN BEARD: I understood, I'm sure.

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VICTORIA A. MONTANARO

was called as a witness on behalf of the Citizens of the State of Florida and, after being duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. McLEAN:

Q State your name for the record, please, ma'am.

A My name is Victoria Montanaro.

Q By whom and in what capacity are you employed?

A I'm employed by the Office of Public Counsel --

Q Ms. Montanaro, -- go ahead.

A -- as a Legislative Analyst.

Q Okay. Have you caused to be filed testimony in this case?

A I have.

Q Do you have any changes, additions, deletions to make to that testimony?

A I do not.

Q And if I asked you the same questions as set forth in that testimony, would your answers be the same today?

A They would.

Q So it's your sworn testimony as of today, correct?

A It is, but I have not been sworn.

MR. McLEAN: Good point.

(Witness sworn.)

CHAIRMAN BEARD: Is Vicki Montanaro really your name?

WITNESS MONTANARO: It really is.

CHAIRMAN BEARD: Okay.

Q (By Mr. McLean) And you weren't lying about any of that other stuff I asked you, were you? (Laughter)

You have affixed to your testimony an exhibit, is that correct?

A That's correct.

Q How many schedules are in the exhibit, please, ma'am?

A I believe there are 11 exhibits attached.

MR. McLEAN: Mr. Chairman, may we have those exhibits marked as a composite exhibit?

A It will be Exhibit No. 130.

(Exhibit No. 130 marked for identification.)

MR. McLEAN: Thank you, sir. I move Ms. Montanaro's testimony inserted into the record as though read.

CHAIRMAN BEARD: It will be so inserted.

MR. McLEAN: And I think I neglected that particular motion on Ms. Dismukes.

CHAIRMAN BEARD: It's too late --

MR. McLEAN: Okay. Well --

CHAIRMAN BEARD: No, it's in the record.

MR. McLEAN: Thank you, sir.

(REPORTER'S NOTE: Prefiled testimony of Kimberly H. Dismukes inserted at Volume XII, Page 1866 for the convenience of the record.)

Q (By Mr. McLean) Do you have any additions, deletions or corrections to your exhibit?

A No, I do not.

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

DIRECT TESTIMONY

OF

VICTORIA A. MONTANARO

DOCKET NO. 920199-WS

Q. Please state your name and business address.

A. My name is Victoria A. Montanaro. My business address is 111 West Madison Street, Room 812, Tallahassee, Florida, 32399-1400.

Q. What is your present occupation?

A. I am employed by the Office of the Public Counsel, Florida Legislature as a legislative analyst. My responsibilities are primarily related to special assignments in the area of telecommunication.

Q. Will you summarize your educational background and your professional experience in the field of utility regulation?

A. I earned my Masters in Accounting from Florida State University in 1983. I hold a CPA certificate in the state of Florida and am a member of the American Institute of Certified Public Accountants. From 1983 - 1987 I served as regulatory utility analyst with the Staff of the Florida Public Service Commission. While employed by the Florida Commission, I participated in rate case examinations involving the water and sewer and the telecommunications utilities operating in Florida. In 1987, I accepted employment with the Office of Public Counsel. I have presented testimony to this Commission and participated in depositions and hearings as a class B practitioner.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to address the issue of whether using Statement of Financial Accounting Standard (SFAS) 106 to calculate postretirement benefit costs is appropriate for ratemaking.

Q. Does the Office of Public Counsel (OPC), support the adoption of SFAS 106 for ratemaking?

A. No.

Q. Why is Public Counsel opposed to Southern States Utilities, Inc. (Southern States) recovering the postretirement related costs as calculated using SFAS 106 in rates at this time?

A. There are several reasons why the rates set in this case should not include the estimate of SFAS 106 as identified by the company.

Q. Ms. Montanaro, before we get to the details of SFAS 106, will you provide its historical perspective.

A. Yes. Until the early part of this century, businesses in this country were primarily sole proprietorships and partnerships which did not look to the public for investment. Capital was acquired against the personal credibility and integrity of the principal(s) of the firm with which lenders were personally acquainted.

As our economy became more complex, ownership of firms became more diversified; common stock was offered to members of the public who could look only to the principals of the firm (and to the principals' appointees) for accurate information concerning the income and financial health of the firm. Banking firms and other lenders were less likely to be personally familiar with principals of the firm; lenders, like investors, could look only to representations of persons they did not know.

Needless to say, there is an ever present incentive for firms to optimistically represent their financial condition to those from whom they wish to attract investment and from whom they hope to borrow money. Moreover, even in the absence of such an incentive, there was no system of uniform accounting in place to insure that financial statements rendered by firms were reliable and presented in a uniform and consistent manner. The

Great Depression proved this notion in a tangible--and in some respects--terrible way.

After a false start, or two, and with the threat of pervasive governmental regulation of the accounting profession, the Financial Accounting Standards Board (FASB, Board) was established as a private, independent board. Statements of this board are considered Generally Accepted Accounting Principles (GAAP). SFAS 106 (Statement of Financial Accounting Standard) is a statement of that board.

In my view it is extremely important to understand the purpose of FASB in its historical and present perspective. FASB requires firms (and specifically, the accountants retained by them) to accurately represent the financial condition of the firm primarily by ensuring that each firm utilizes similar accounting procedures which are generally accepted by the accounting profession.

The beneficiaries of FASB are those who were historically at risk in its absence; namely, those from whom firms seek investment and those from whom firms wish to borrow money.

Q. Ms Montanaro, your treatise on the history of FASB is interesting: please tell why you believe it relevant.

A. Because there is sometimes a notion advanced by regulated utilities that the Commission, must recognize expenses the utility incurs under SFAS 106 because FASB requires the utility to calculate its potential postretirement liability for external reporting using this standard. To the contrary, SFAS 106 is devoid of any of the traditional inquires of utility regulation. With respect to obligations which the company might incur for OPEBs (other post employment benefits), SFAS 106 suggests no inquiry of whether the obligations ought to have been incurred; whether obligations might be unilaterally modified by the company during the time rates are in effect; and no inquiry as to whether company-employee negotiations, or governmental regulations yet to be adopted might affect the obligations in a material way.

SFAS 106 was designed for external financial reporting purposes. It was not designed to ascertain whether expenses associated with OPEBs were reasonably incurred in the provision of utility service to the People of the State of Florida. To put it simply, it is the wrong tool for the job: it has no place in regulatory accounting.

Q. Would you please apply your view on SFAS 106 to this case in particular?

A. Yes. First, there is significant reason to believe that the company may restructure its benefit plan to reduce costs in the future. We would applaud the company's attempt to reduce the costs that are assigned in the ratemaking environment. However, if the rates set in this case are established before those cost-saving mechanisms can be instituted, then the revenues will recover costs greater than what the company is experiencing and rates will generate more cash than the company is entitled to.

Second, there is reason to believe that the SFAS 106 calculations are inherently unreliable in a rate setting environment. SFAS 106 requires that several assumptions be made in order for the company to calculate postretirement benefits per SFAS 106. The Financial Accounting Standards Board (FASB) and the accountants within the profession recognize the calculations are tentative and not precise on a period-to-period basis. The Actuarial Standards Board has questioned the accuracy of the calculations in the long run. Throughout SFAS 106 there is mention of the need to modify traditional accounting principles to achieve a pragmatic goal. The calculations require retroactively calculating service costs for these prior periods, which could date back as far as twenty or thirty years. The calculations, for both the current period costs and those retroactive costs, are based upon the estimated future costs of health care. The calculations do not reflect either the cost containment measures that the company may institute or governmental intervention which may very well occur in the future.

Third, the company's postretirement calculation assigns costs of prior periods (the transitions obligation) plus current costs (the service costs) to current ratepayers. The assignment of prior period costs results in an intergenerational inequity. The point made by many utility companies is that today's costs (earned benefits as defined under SFAS 106) should not be assigned to future ratepayers, as would happen under the pay-as-you-go method. It should be noted that the adjustment proposed by Southern States Utilities does just that. It assigns costs to today's ratepayers for costs that the company says relate to a prior period. The actual current period service costs represents approximately 50% of the SFAS 106 costs which Southern States is asking recovery of.

Fourth, as these cost estimates become more reliable and cost containment measures are instituted, future ratepayers would receive the benefits from those events if the company's rates are still set based on rate of return regulation.

Fifth, there are no assurances that the funds taken from the ratepayers' pockets will be used to pay for the postretirement benefits of Southern States employees. The regulatory framework is designed to provide an opportunity to recover actual costs and a return on actual investment. This change in accounting, which is not pure accrual accounting, has the potential for violating the regulatory framework by compensating a company for expenses that will not be incurred.

Continuing the current method of cost recovery (pay-as-you-go) ensures that there is a consistent methodology for all ratepayers for all periods. No set of ratepayers is funding more than the company is paying in any specific period. If the company does continue its efforts to contain costs, then the costs in the future, under the pay-as-you-go method, could be substantially less than are estimated today.

Q. Can you briefly explain the purpose of SFAS 106?

A. Yes. Financial accounting standards are premised upon certain accounting principles. The purpose of these principles is to enhance the usefulness and reliability of the external general purpose financial statements by providing information that is useful in assessing the plan's present and future ability to pay its obligations when due and report the earnings for the period.

In adopting Financial Accounting Standard 106 the Financial Accounting Standards Board wanted to alert the users of the financial statements that a company has a growing potential postretirement benefit liability. For external financial statements, the company under SFAS 106 will be required to accrue a portion of the future liability as if a portion of the benefit is earned in each accounting period.

Q. Is the Commission obligated to follow Financial Accounting Standards for setting rates?

A. No. This Commission in the past has reserved the right to review the appropriateness of adopting a particular financial accounting standard. A standard that furthers the goal of sound accounting for external, general financial statements can be inappropriate for ratemaking.

Financial Accounting Standards are not designed for rate setting. The Financial Accounting Standards Board recognized that standards designed to strengthen the usefulness of the external financial statements might not be appropriate for ratemaking. In recognition of this fact FASB adopted SFAS 71 which is an accounting standard adopted to address issues unique to a regulated company.

Q. Does SFAS 71 have the same standing as a pronouncement as any other FASB pronouncements?

A. Yes, however, paragraph 7 of SFAS 71 states:

> Authoritative accounting pronouncements that apply to enterprises in general also apply to regulated enterprises. However, enterprises subject to this Statement shall apply it instead of any conflicting provisions of standards in other authoritative pronouncements.

Q. Has the accounting profession recently recognized that there is the possibility that in some circumstances the application of an accounting standard or other principles may not be appropriate?

A. Yes. In Statement of Auditing Standard 69, <u>The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principle in the Independent Auditor's Report</u>, AICPA recognized that there is a possibility that the application of an accounting standard could render misleading financial statements. Within that Statement, there is reference to Rule 203 of the AICPA Professional Standards Volume II. This rule implies that adherence to officially established accounting principles would normally result in financial statements which are not misleading. If further states however:

> in establishment of accounting principles it is difficult to anticipate all of the circumstances to which such principles might be applied. This rule therefore recognizes that upon occasion there may be unusual circumstances where the literal application of pronouncements on accounting principles would have the effect of rendering financial statements misleading. In such cases, the proper accounting treatment is that which will render the financial statement not misleading.

Q. Would you please explain what is meant by the term GAAP?

A. As stated in SAS 69:

> The phrase "generally accepted accounting principles" is a technical accounting term that encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time.

Q. Do generally accepted accounting principles change?

A. Yes. The chairman of the Financial Accounting Standards Board in his article, What's right with the FASB, stated, "we are committed in our mission statement and rules of procedure to review the effects of our decisions and interpret, amend or replace standards in a timely fashion when necessary."

Q. Would you please explain the theoretical difference in the presentation of SFAS 106 costs and the current method of pay-as-you-go?

A. The current method of pay-as-you-go is a cash receipts methodology. SFAS 106 is premised on accrual accounting.

When using the cash receipts form of accounting, the level of postretirement expense is presented in terms of the dollars that the company actually pays out within the current accounting period.

The theory behind the accrual method is premised upon an employee earning this benefit over the years that he is employed. When using SFAS 106, methodology of accounting for postretirement costs, the level of postretirement expense presented in the external financial statements is based upon a calculation of the future health care costs of an employee after he retires. A portion of this future cost is prorated to each accounting period in which the employee works.

Q. What is the difference between accrual accounting and cash receipts accounting?

A. FASB Statement of Concepts, Concept 6, paragraph 144, states the major difference is the timing of the recognition of revenues, expenses, gains, and losses. All other things remaining equal the costs incurred and reported would be the same over time.

Q. What is the goal of accrual accounting?

A. The goal of accrual accounting is to account for the economic impacts of events on an entity within the accounting period in which they occur. Embodied within the accrual accounting concept is a presumption that the economic impact of the event or transaction is recognizable and measurable.

Q. Does SFAS 106 represent traditional accrual accounting?

A. No. It is a hybrid. It deviates from Accounting Principles Board's Opinion (APB) 20 which provides guidance on the generally accepted treatment for a change in accounting estimates.

Q. Normally, does accrual accounting require immediate recognition of any prior period impacts of an accounting change?

A. Yes. FASB indicated in paragraph 252 that "conceptually, the immediate recognition of the cumulative effect of the accounting change would be most appropriate.... However, recognizing the magnitude of the obligation and the limited availability of historical data on which to base its measurement suggests the need for a more pragmatic approach."

Q. Does the recognition of the transition obligation over the next twenty years distort the reporting of period specific results for those years?

A. Yes. In fact, several corporations including utility companies have or are considering recognizing the transitional obligation immediately for that reason.

For example, GTE in their letter dated November 9, 1989, to the Financial Accounting Standards Board stated on page 4 the following:

> ...we believe that amortization of essentially prior year costs against current earnings is not conceptually sound nor does it serve the interest of financial statement users. This "doubling up" of costs in future years distorts current earnings for a significant number of future years and does not properly reflect the current earning power of the

enterprises. In GTE's case, we estimate that postretirement costs (which are not insignificant) initially would be increased by over 60% by the inclusion of these prior period costs. [see attachment 1 p.4]

Q. Did regulated utilities advocate the treatment of the transition obligation for regulated companies be different from the treatment for non-regulated companies?

A. Yes. In another letter written by GTE dated June 28, 1990 the company wrote," the treatment of rate regulated companies must, of necessity, be different." [see attachment 2 p. 3]

Q. Was there an effort by several utility companies to address the concern of the transition obligation for the regulated companies?

A. Yes. According to a letter dated July 11, 1990, USTA, BellSouth, Bell Atlantic and GTE participated in a conference call with Diana Scott the OPEB Project Manager- FASB Staff on June 18, 1990 to discuss the industry's position on immediate recognition versus amortization of the transition obligation. The letter states that FASB's decision of June 27, 1990 to allow the option of either amortizing the obligation or immediately recognizing the expense "...is optimal from a regulated accounting prospective". A decision to mandate immediate recognition and/or to charge the obligation to retained earnings could have provided ammunition for federal or state Commissions to deny the recovery of these expenses. [See attachment 3]

Q. Have you identified any documents from Southern States or any other utility which indicates that the FASB revised its exposure draft ruling regarding recognition of the transition obligation as an accommodation to the regulated industry?

A. Yes. In the memo attached to the joint Bell Atlantic and BellSouth letter, it states:

> ...the FASB plans to address recognition of the transition obligation at its June 27 Board meeting (and is considering modifying the existing exposure draft proposal to allow the immediate recognition option or even go so far as to mandate immediate recognition of the transition obligation). [See attachment 3 p. 3]

The memo goes on to state:

> After discussing and analyzing the issue, we agreed to communicate the following industry consensus position to the FASB, prior to the

Board's scheduled meeting on June 27, 1990, to resolve this issue:

1. If the FASB modifies the Exposure Draft to give companies the option of either immediate recognition or amortization of the transition obligation, the industry would not object to this modification.

2. If the FASB modifies the Exposure Draft to mandate immediate recognition, the industry is strongly opposed for the following reasons:... [See attachment 3, p.3-4]

Q. From your reading of the memorandum did those reasons focus on the issue of sound accounting principles or strategies for increasing the revenue requirement?

A. The telephone industry wanted the costs amortized and reflected in the income statement to advance their argument for increased revenues to support the effect of the new accounting standard. The thrust of their argument was not to advance sound accounting principles. [See attachment 3, p. 5-7]

Q. What is the effect on Southern States's ratepayers as a result of the company seeking recovery of this transitional amount?

A. The adoption of SFAS 106 for ratemaking shifts Southern States's estimates of these prior period costs (as retroactively calculated by SFAS 106) onto the current and future ratepayers for the next twenty years. In effect, the Southern States customers will be double charged for postretirement benefits. The customers will be charged for costs associated with the employee's services of the current period as well as costs associated with employee's services rendered to a prior generation of customers.

Q. Do you have some concern with the way Southern States has applied SFAS 106?

A. Yes. SFAS 106 attempts to alert the user of the financial statement that the company has incurred a liability or future cost and reports the costs associated with that liability in the proper accounting period. In addition to the improper assignment of prior period costs to current ratepayers, it is possible that the cost which the company is attempting to recover in future rates may not meet the commonly understood term of costs.

Q. Please explain.

A. An accounting cost is commonly understood to represent an occurrence of a sacrifice in financial or monetary terms. Southern States may never experience a sacrifice of its monetary resources to the extent presented in its calculation of its postretirement cost based on SFAS 106.

Q. Is SFAS 106 based upon the following assumptions: (1) the company has promised a benefit to the employee; (2) the benefit is earned over the period of employment; and (3) the plan in effect today will remain in effect in the future?

A. Yes. FASB is attempting to recognize through SFAS 106 the postretirement obligations that the company has undertaken. These costs are viewed as a form of deferred compensation which should be accrued as a liability over the period of service or employment. SFAS 106 does not address the issue of possible or potential gratuities that a company may grant to its employees after retirement. Rather, SFAS 106 addresses the issue of a promise between an employee and its employer. It reflects a promise by the company to pay an employee providing services in a particular accounting period for those services after the employee's retirement.

Q. Why do you say Southern States may not experience an economic loss at the level presented in this case?

A. There are two main reasons. One reason is Southern States is continuing to review options to modify its benefit plan; and therefore, the level of benefits which the company is presenting in this case may or may not be offered in the future. The other reason is the accuracy of the estimate of postretirement benefit costs as calculated using the SFAS 106 methodology.

Q. Would you please explain your concern with the level of benefits which the company may or may not be providing in the future?

A. Yes. A modification of the plan will impact the costs calculated by SFAS 106. If the modification is for the purpose of containing health care costs in the future, then the costs calculated under SFAS 106 in the MFRs would be overstated.

Q. Are you aware of any plans which Southern States has regarding modifying its postretirement benefit plans?

A. Yes, In the May 29, 1992 Actuarial study undertaken by McMillian and Robertson three alternatives to the current plan are evaluated. [See attachment 4, p.8 of 19]

Q. What is the calculated percent change in the net periodic cost for each of these alternatives when compared to the plan presented in this rate case?

A. Alternative 1, which would increase the retiree contribution, generates a 5% decrease in annual expense;

Alternative 2, which would cap benefits for participants 65 years of age and older at $10,000 for their lifetime, generates a 44% decrease in annual costs; and, Alterative 3, which would define the dollar benefit and match the level of benefits to the number of years of service rendered, generates a 32% decrease in annual costs compared to the costs presented in this case. [See attachment 4 p.8 of 19]

Q. Does SFAS 106 accommodate the possibility of modifications to the postretirement plans?

A. Yes, SFAS 106 speaks to the possibility that many companies, upon seeing the dollar magnitude of the liability, may well look for ways to curb this growing liability. The study, <u>Retiree Health Benefits How to Cope with the Accounting, Actuarial, and Management Issues</u>, written by Coopers and Lybrand, one of the larger accounting firms, states, "It is anticipated that the nature and prevalence of retiree health benefits will change over time as employers respond to increasing pressure to hold down costs as well as to changing demographics and retiree needs."

Q. Has there been a more recent report on efforts of corporations to contain their health care costs?

A. Yes. In the July 1992, Journal of Accountancy, Stanley Zarowin, senior editor of the Journal and an employee of the AICPA, wrote the following:

> An increasingly popular idea, from the employers' point of view is dollar-denominated benefits, sometimes called defined-dollar or company caps. Under such a plan, recently adopted by both AT&T and IBM, a company sets a cap on future payments for retirement health-care benefits; costs exceeding the cap shift to the retirees.

Q. Does the calculation of postretirement costs as prescribed by SFAS 106 include the possibility that the benefit levels of a plan may change?

A. No. In paragraphs 173-176 of SFAS 106, FASB discusses the rationale for basing the calculation of future health care costs on the assumption that the current level of compensation will continue in the future unless there is evidence to the contrary. Only, if a company has communicated to its employees that the company is amending its plan would the company incorporate the reduction of benefits in the calculation of postretirement benefits under SFAS 106. Further, if the company's past practices differ from the written plan, then the substantive plan is based upon the past practices. In the event a company has deviated from the written plan or has communicated to its employees that there will be plan amendments, then the substantive plan should reflect the impact of the amendment to the extent known. In the case where the benefits have been collectively bargained, then the calculations are based upon the written plan for those employees.

Q. Is it your position a company should not try to control its costs?

A. No. The point is postretirement costs, as calculated under SFAS 106, could and probably would cause overrecovery in the rate making environment. SFAS 106 costs, as calculated by the company, are based upon today's substantive plan. By the time the employees retire, ten or twenty years from now, the company could be offering a very different plan. If SFAS 106 were adopted for rate recovery, it is very probable the ratepayer will be paying for a transitional obligation and current costs which has little resemblance to the health benefits provided under the plan at the time the employee retires.

Q. Would you agree the level of benefits that a company offers its employees is a management prerogative?

A. While it can be argued that it is management's prerogative to determine the level of compensation given to their employees or to modify their promise of deferred compensation, it is the Commission's responsibility to evaluate the reasonableness, accuracy and certainty of costs that are to be included in rates.

If it is likely that a company will institute cost cutting measures or even terminate a plan, then the Commission should not include postretirement costs as calculated under SFAS 106 in rates. To do so could allow overrecovery of the company's actual expense level.

Q. Has there been any study of the level of benefits offered to utility employees as compared to the employee of other industries?

A. Foster and Higgins, consultants on employee benefits constructed a study of on health care benefits. In their study, utilizing 1991 survey data, they reported that the utility industry had the highest average per employee medical plan costs. [See attachment 5 p.7]

Q. Do you have concerns regarding the SFAS 106 calculation methodology for purposes of setting rates?

A. Yes. In addition to the possibility that Southern States may modify, suspend or terminate its postretirement plan and therefore never incur the costs for which they are seeking recovery of today, there are other concerns with the postretirement plan. The main concern relates to the assumptions that are employed in the calculation of the future costs and the apportionment of those projections to the various accounting periods.

Q. Would you please describe the method for calculating the future health care costs?

A. Yes. The methodology used in computing SFAS 106 costs is multi-faceted and based upon many assumptions. The interplay between the assumptions can have a significant impact on the final calculation. The calculation (like pensions) is based upon actuarial data. But further, assumptions have to be made regarding the future health needs of Southern States's "employee/retiree" population, the marital status of the employee during retirement, the dependent status of future employees, health care costs during retirement as well as the usual retirement date and longevity assumptions.

Q. Have other accountants questioned the complexity and reliability of the calculations of future health care costs which are produced using the SFAS 106 methodology?

A. Yes. The accounting firm of Arthur Young stated in its comments on the exposure draft of SFAS 106, that the estimates "suggest that the amounts shown are precise, when in fact they are at best ballpark estimates." The firm further described the computations used in calculating SFAS 106 costs as an "approach to measuring the postretirement benefit without basis in fact and an arbitrary exercise."

Q. Does SFAS 106 recognize the unreliable nature of the calculation of future health care costs?

A. Yes. In its discussion regarding whether to allow immediate recognition of the transition liability, SFAS 106 states the following in paragraph 256 of the appendix:

> [FASB] also note that the actuarial techniques for measuring postretirement health care benefit obligations are still developing and should become more sophisticated and reliable with time and experience. They observe that near-term measures of the accumulated postretirement benefit obligation from which the transition obligation is derived will reflect the deficiencies of insufficient data collection in the past and the evolving actuarial practice in this area....

Q. Does the SFAS 106 acknowledge there will be significant volatility in the calculation of SFAS 106 estimates over time?

A. Yes. In paragraph 293 the FASB discusses the volatility in estimating the health care costs of employees who will retire years in the future. The Board admits the volatility,

> ... may reflect an unavoidable inability to predict accurately the future events that are anticipated in making period-to-period measurements. That may be particularly true for postretirement health care plans in light of the current inexperience in measuring the accumulated postretirement benefit obligation for those plans.

Q. Are there mechanisms within SFAS 106 to recognize the change in the actuarial assumptions, such as the level of coverage?

A. Yes. After the first year of implementation, the actuary will evaluate the actuarial gains or losses. If the plan or cost calculations have been modified, then there will be an adjustment. However, the level of the adjustment reflecting the modification will be repressed. In an attempt to deal with volatility between accounting periods, in paragraph 294, of SFAS 106, FASB concluded that the impact of changes in estimates should not be recognized in the period in which they occur. Rather, the FASB requires a delayed recognition of gains or losses. Only the portion of the gain or loss that exceeds 10% of the accumulated postretirement benefit obligation will be reflected in the net periodic costs.

Q. Does FASB acknowledge that the smoothing mechanism is contrary to normal accrual accounting?

A. Yes. Paragraph 294 states, "Both the extent of reduction in volatility and the mechanism adopted to effect it are essentially practical decisions without conceptual basis."

Q. Why did FASB believe that it was necessary to have a mechanism that reduced volatility in the calculation of the SFAS 106 obligation?

A. FASB states in paragraph 293:

> In the case of the accumulated postretirement benefit obligation, reported volatility may not be entirely a faithful representation of changes in the status of the obligation (phenomenon represented). It also may reflect an unavoidable inability to predict accurately the future events that are anticipated in making period-to-period measurements. That may be particularly true for postretirement health care plans in light of the current inexperience in measuring the accumulated postretirement benefit obligation of those plans. The difference in periodic measures of

the accumulated benefit obligation for a postretirement health care plan, and therefore the funded status of the plan, results partly from the inability to predict accurately for a period, or over several periods, annual expected claims costs, future trends in the cost of health care, turn over rates, retirement dates, dependency status, life expectancy, and other pertinent events. As a result, actual experience often differs significantly from what was estimated, which leads to changes in the estimates for future measurements. Recognizing the effect of revisions in estimates in full in the period in which they occur may produce financial statements that portray more volatility than is inherent in the employer's obligation.

Q. In your opinion is the concern regarding the volatility heightened because of the magnitude of postretirement expense that the company is presenting on their financial statements?

A. Yes. It is my belief that, if the current service costs were the only expense at issue, it is probable that the smoothing mechanism would not have been adopted by FASB. For example, the current service costs represent only 50%

of the cost which Southern States is seeking to recover. However, because the calculation includes recognition of a portion of the transition or prior period obligation, a change in an assumption could have a significant impact on the cost presented for the financial statements.

Q. What impact does this smoothing mechanism have on the ratepayer?

A. If the Commission adopts SFAS 106, then there is little hope the current ratepayer will see any benefit from cost containment provisions or improvement in estimates made by Southern States. If the company were to reduce its costs, the expense recovery would remain the same unless the effect of the cost containment provisions exceed 10% of the accumulated postretirement benefit obligation and rates were reset. It should be noted that an overcharge can only be corrected prospectively, and then only if the rates are adjusted.

Q. Does the company have a great deal of flexibility regarding the assumptions that are used in the actuarial valuation?

A. Yes. Coopers and Lybrand illustrated the flexibility in its study. The firm stated in reference to that illustration, "Employers should be aware that the use of different plan terms and actuarial assumptions would have resulted in significantly different estimates of obligations and expense."

Further, Coopers and Lybrand in the study referenced above, stated:

> The measurement of the obligations and expense related to retiree health benefits is in an evolutionary stage. Employers, their actuaries, and accountants are continuing to improve their understanding of the complex issues surrounding the measurement of these benefits.

Q. Does the actuarial firm select the assumptions for the calculation of SFAS 106?

A. No. According to SFAS 106, the actuarial assumptions represent the company's best estimate of what will occur in the future.

Q. Is there variation in the discount rate used by companies?

A. Yes. Attached is late filed deposition exhibits 1 and 6 filed by Hewitt and Associates in the Florida Power Corporation rate case which depicts the variability in the discount rate selected by companies using this actuarial firm. [See attachment 6]

The second attachment is a survey conducted by Towers Perrin Company. The discount rates used varied from a range of 5.1% to 10.0%. [See attachment 7]

Q. What is the significance of a low versus high discount rate?

A. The lower the discount rate the higher the present value calculation. This high present value calculation translates into a higher expense for the accounting period. The decrease in the discount rate would increase the period costs because the transition obligation portion would increase, the interest component would decrease, and the service costs would increase.

Q. Is it true that over time the cost would be the same?

A. This is only true if you assume that the discount rate used for the calculation will not change over time.

Q. Does this variation in discount rates effect the integrity of the calculation?

A. Yes.

Q. What is the discount rate that Southern States used in calculating the SFAS 106 costs?

A. Southern States used a discount rate of 8.00%.

Q. Is the use of the rates of return on long term fixed investments an appropriate discount amount for ratemaking?

A. No. For the unfunded plan using the company's cost of capital as the discount rate would better reflect the economic effect of the passage of time.

Q. Are there any utilities who would agree with you?

A. Yes. GTE's filed the following comments in their August 7, 1989 letter to Timothy S. Lucas regarding the appropriate basis for calculating the present value of the potential post retirement obligation: ...

> It is probable that benefits for unfunded plans will be paid with funds generated from operations or raised through debt or equity financing. Accordingly, we believe that the company's cost of capital would more appropriately reflect the rate at which obligations of unfunded plans will be settled and should be used as the discount rate for these plans.
>
> We understand that the Board disagrees with this approach. The Board believes that it would reduce comparability since the cost of capital differs among companies. However, we believe that if the cost of capital is the cost of paying these benefits, using it as the discount rate will better reflect these

economics in the financial statements. Comparability should provide assurance the differences can be seen, not hidden. The latter would occur if a similar discount rate is used for all companies with unfunded plan. [See attachment 8 p. 5]

Q. Would you recommend that this Commission use the company's cost of capital as the discount rate for ratemaking purposes for Southern States?

A. Yes. While FASB rejected the use of the cost of capital as the discount rate in determining the calculation for external, general purpose financial statement purposes, it should be considered in the calculation of postretirement costs for ratemaking purposes.

Q. You mention an actuarial study earlier in your testimony, in order to implement this standard, is there a need for an actuary to assist in the calculations?

A. Yes.

Q. Were there any actuaries who commented on the FASB exposure draft on postretirement benefits?

A. Yes. David J. D. Mecleish, Chairman and Chief Executive Officer of Godwins International Holdings Inc. commented that, "...traditional thinking which underpins the accounting treatment of employee retirement benefits is fundamentally flawed. More simply, that is wrong." [See attachment 9, p.1]

The comments go on to state that the methodology used to calculate the postretirement obligation creates a false liability and violates the intent of the accounting profession which emphasizes the representational faithfulness of the balance sheet. He further states:

> Presumably the liability is an "accounting liability" and just as with the actuarial liability I referred to earlier, I would observe that it would not represent a true liability in any legal sense nor indeed in any other sense that normally would be attached to that word. [see attachment 9 p.4]

Q. Does the actuarial profession have standards which would provide guidance on the development of the actuarial calculations required by SFAS 106?

A. Yes. In addition to the standards the Actuarial Standards Board had previously issued to meet the needs of their profession, the Board has issued an exposure draft of guidelines to be used in the calculation of SFAS 106 costs. The proposed Actuarial Compliance Guidelines, entitled <u>Compliance with Statement of Financial Accounting Standards No. 106 Employer's Accounting for</u>

Postretirement Benefits other than Pensions was released in October 1991. The guidelines are in the comment phase. The comment deadline was March 15, 1992. The Board is currently reviewing those comments and the Board will decide whether to adopt these guidelines at their October 1992 meeting. According to the Board staff the Board may decide to continue to revise the proposed guidelines.

Q. Do the guidelines deviate from other procedures which are required for generally accepted actuarial purposes?

A. Yes. In the transmittal letter of the exposure draft the Board indicated:

> Enclosed in this booklet is an exposure draft of a proposed actuarial compliance guideline of actuarial calculation required under SFAS 106, promulgated by the Financial Accounting Standards Board(FASB). The purpose of the guideline is to set forth generally accepted actuarial principles for such calculations. Because this document is a standard for compliance with an outside requirement (i.e., an accounting standard), certain procedures may or may not be generally accepted for other actuarial purposes. [See attachment 10 p. ix-x]

Q. Does the Actuarial Board comment on the level of reliability that can be expected from the actuarial calculations?

A. Yes. In the background section, it is stated:

> The committee recognized the SFAS 106 implies more precision and accuracy than exists in this area of actuarial practice. The relatively long-term nature of the obligations, the significant year-to-year variations in the trend rates, and the underlying political and economic nature of the benefits almost assure substantial variations between the actual results and expected results. [See attachment 10 p. ix-x]

Q. Does the exposure draft make a reference to a scope limitation?

A. Yes. The guideline reads, "This guideline is believed to accurately represent current understanding of SFAS 106 as it pertains to actuarial calculations; the guideline is not an actuarial standard of practice." [See attachment 10 p. 1]

Q. Are there disclosure requirements?

A. Yes. The actuarial communication for purposes of SFAS 106 should be identified as such, and should disclose that the results of calculations performed for other purposes (e.g., plan reporting, government requirements, etc.) may differ significantly from the results for purposes of SFAS 106. [See attachment 10 p. 33]

Q. Would you please review the components that are involved in calculating SFAS 106 costs for external, general purpose financial statements?

A. There are six possible components involved in the calculation of SFAS 106 costs. Not every company will include each of these costs. The cost components included will depend upon a company's particular circumstances. The possible cost components are:

(1) service costs
(2) interest costs
(3) returns on plan assets
(4) prior service costs
(5) gains and losses
(6) amortization of the unrecognized transition obligation or asset.

Q. Is Southern States requesting cost recovery of postretirement costs that relate only to the current period for ratemaking purposes?

A. No. Southern States has included service costs, amortization of its prior period costs (unrecognized transitional liability) and interest costs in its test period costs.

Q. Do the components included in Southern States's calculation for ratemaking match the components which would be included in their calculation for external, general purpose financial statements?

A. It can not be determined. We do not know how the company will treat the transition obligation for external financial statements.

Q. Would you please explain service costs?

A. Yes. Service costs represent the increase in the accumulated post retirement obligation that relates to the present period. It is that portion of the postretirement benefits that is earned by the employee during the current period. The cost is stated in terms of present value.

Q. What is the unrecognized transitional obligation cost?

A. It is defined in SFAS 106 paragraph 46 as "the amortization of the unrecognized obligation or asset existing at the date of initial application of this statement...." Under SFAS 106 definition of period costs, these costs would represent the benefits earned in prior periods.

Q. Does the company have the option of either recognizing the obligation immediately or delaying the recognition of the costs and amortizing it over future periods.

A. Yes.

Q. Please explain the accounting entries for immediate recognition of the accumulative effect of implementing SFAS 106.

A. Immediate recognition of the accumulative effect of SFAS 106 is reflected as a charge or debit to the income statement and a credit to the liability account for the period in which it was recognized. It would be treated as the effect of an accounting change as outlined in APB 20.

Q. Were companies prohibited from recognizing postretirement costs on an accrual basis in the past?

A. No. The issue of postretirement liability and its growing impact on the financial statements has been discussed by the accounting standards-setting body since 1979.

Q. Is it true that the generally accepted accounting principles in existence prior to the issuance of SFAS 106 would have allowed for the accrual of postretirement benefits.

A. Yes. If the company has a liability, that is a company will experience an economic sacrifice in financial or monetary terms as defined in FASB Statement of Financial Accounting Concept 6, then the company could and should accrued for the expense. This basis of accrual accounting has been in practice for years and would have provided the authority to recognize the postretirement cost in the past.

Q. If this is true, then why weren't corporations accruing for this postretirement costs are calculated under SFAS 106 in the past?

A. The main reason is the postretirement costs recognized by SFAS 106 do not represent a legal liability or a liability as previously defined by the accounting literature. However, for purposes of SFAS 106 the definition of a liability has been broadened.

Q. Does the broaden definition of liability as it relates to postretirement benefit reflect the normal definition of costs to be included in the ratemaking process?

A. No. It has been the Commission's prior practice and the interpretation of statutory language as referenced in the Water and Sewer DORP under the Operation and Maintenance Expense that the "... regulated utilities are entitled to recover through their rates prudently and reasonably - incurred expenses, necessary to the provision of adequate, sufficient and efficient service. The law provides that entitlement, but no more."

Q. It is your testimony that the SFAS 106 is an inadequate and inappropriate measure of postretirement benefits costs for ratemaking?

A. Yes. The current method of pay-as-you-go for recognizing and compensating the company for the postretirement costs which it has or will incur is adequate to meet any the statutory requirements placed upon this Commission. Further, it is my testimony that SFAS 106 will over compensate the company for these expenses and therefore is in conflict with the intent of the statute and the Commission's own policy as outlined in the DORP.

Q. Are postretirement benefits characterized as deferred compensation in SFAS 106?

A. Yes.

Q. If this is in fact a form of deferred compensation, is there reason to believe that in a projected test year the costs of wages and compensation should be limited to the inflation rate?

A. Yes. The Water and Sewer DORP, under the topic of Employee Compensation, states that projected expenses should be adjusted to reflect the current projection of inflation. Further there is a reference to wages increases being limited for non-union employees. The wage increase is to be limited to the inflation rate. Since the Commission is not bound by union negotiated contracts and Southern States does not bargain postretirement benefits, the issue of treating union personnel differently is mute.

Q. Is it fair to assume a company will adjust its total compensation package if one component of that package is increased disproportionately?
A. Yes. A rationale company would evaluate its compensation package as a whole if one portion of that package were to increase disproportionately. There is no basis to believe that the company will allow a portion of the compensation package to increase without some compensating decrease elsewhere.
Q. Have you reviewed any documents which would indicate that a Florida regulated utility has in fact adjusted benefits as you have suggested?
A. Yes. Two electric companies have done just that. Florida Power Corporation in the last union contract reduced postretirement benefits and increased pension benefits. TECO has a stated policy of maintaining the benefit to salary ratio. TECO has adjusted its benefits to maintain the relationship of no more than 42 cents toward benefits for each dollar of compensation. [See attachment 11]
Q. Is there an interest component included in the postretirement costs as calculated using SFAS 106?
A. Yes.
Q. Please define the interest costs in the SFAS 106 calculation of costs for postretirement benefits.

A. The interest costs in the SFAS 106 calculation represents the passage of time costs associated with calculation. The costs are initially presented in terms of present value. Because the Board did not require funding, there was a need to recognize the increase in the liability as time passed. For those companies who do fund, the interest costs are offset by the earnings on the fund. If the company recovers service cost in rates and invests those funds, then there is no need to assign interest to the current or future ratepayer.

Q. Should the ratepayer be assessed for interest costs associated with the transitional obligation?

A. No. As characterized the Financial Accounting Standards Board these are prior period costs. If one accepts the premise that the postretirement benefits are earned ratably over the attribution period (length of employment until eligible to retire), then it is not appropriate to assign the current ratepayer the passage of time costs associated with services provided in prior periods to prior generation of customers.

Q. In Southern States's calculation of its postretirement costs, does the company include any expected earnings?

A. No. Although the company states on schedule B-3 page 2-2 that the company intend to fully fund its postretirement benefits liability, there is no indication that the company has recognize interest earnings on those funds.

Q. Why do you recommend that the interest associated with the service costs, interest costs and transition costs which have been recognized be recorded as a below the line expense?

A. If the company funds the plan the cash would be earning a return to offset the interest associated with the recognized service costs, recognized interest costs and recognized transition costs. Additionally, the regulatory ratemaking process should eliminated costs which relate to prior periods.

Q. Should the ratepayer pay a return on the cash flow the company experiences from collecting the expense prior to paying the associated costs?

A. No. Just as the Commission does not allow the company to earn a return on the deferred taxes, the Commission should not allow the company to earn on return on the cash flow generated by the adoption of SFAS 106. Any expense recovered in excess of the pay-as-you-go amount, should be recognized as a zero-cost source of capital.

Q. Is it your testimony that the company should reflect the full liability as zero source of capital even if the company funds their plan as indicated on schedule B-3 page 2 of 2?

A. Yes. Unless the company establishes a non-revocable external trust, then the company could still have control over the funds. If the company still has control of those funds then the cash flow from the adoption of SFAS 106 is in fact an other source of funds to the company.

Q. Why is there a need to recognize any special adjustment to the capital structure?

A. When an accrued expense is greater than the current cash outlay for that expense, then there is a concern that the customer will be paying a return to the company on those funds through the working capital adjustment. This possibility arises because the cash in isolation will increase the working capital balance. For regulatory purposes the balance of cash working capital is viewed as a component of the ratebase.

Q. Should the company be recording a liability for the recognized portion of their postretirement costs?

A. Yes. Unless the company has established a non-revocable external trust for these benefits, then a liability should be recorded.

Q. Would you please review the journal entries involved in recognizing postretirement benefit costs.

A. Yes. The debits are to the expense and cash accounts with a corresponding credit to the long term liability account and revenue accounts.

The following illustrates the entries. It should be noted that pay-as-you-go amount is included within the postretirement expense recorded for the period.

1. Postretirement Exp.	$110	
OPEB liability		$110
2. Cash/Accts Rec/d (dr.)	$110	
Revenue		$110
3. OPEB Liab (paygo portion)	$10	
Cash		$10
4. OPEB Liab. (to fund Trust)	$100	
Cash		$100

The entries above would be the same, in isolation, for a regulated or non-regulated corporation assuming each increased the price of its product to cover its increased costs as calculated under SFAS 106.

Q. Does the application of SFAS 106 create a tax timing difference?

A. Yes. Unless a corporation funds its postretirement plan using a taxed advantaged fund, the revenues generated from the price increase will be taxable. The postretirement expense is tax deductible only to the extent that there is an actual cash outlay for the tax period (pay-as-you-go). For book purposes the cost is tax deductible. Whether it is permanent or temporary is dependent upon the actual occurrence of a tax deductible expense in the future.

Q. What effect does the tax timing difference have in the regulatory process?

A. For ratemaking, the deferred taxes are treated as a zero-cost source of funds for the utility in the capital structure. If SFAS 106 is adopted for ratemaking, the booked tax expense is less than the tax payable amount. The difference is recorded as a debit to deferred taxes. The effect is to increase the cost of capital in the regulatory revenue requirement calculation. For example (in isolation):

Tax expense (dr.deducted for books.)	$0	
Deferred taxes (dr.)	$34	
Tax Payable (cr.)		$34

When the tax is paid the following entry would be made:

Tax payable (dr.reverse the liab.)	$34	
Cash (Cr. remit the tax)		$34

Q. Has the Commission ruled in any prior case that the revenue requirement should be reduced to reflect a reduction in the ratebase for the unfunded amount of the accrued postretirement liability?

A. Yes. In the Order NO. PSC-92-0708-FOF-TL, it states on page 40, the following:

> We believe that treating the liability as a reduction to working capital fully recognizes the effect of the liability in reducing the revenue requirement. Accordingly, we find it appropriate to treat the liability as a reduction to working capital.

Q. Is there any other reference made regarding the Commission's intent to reduce ratebase by the accrued liability?

A Yes. The order referenced above further states on page 40, "We believe that there are two positive aspects to not funding. By not funding, the company can reduce its external financing needs. Additionally, the accrued liability serves to reduce rate base".

Q. Does the recognition of the revenues associated with postretirement expenses as a zero-cost source of capital, in isolation, lower the revenue requirement that a company experiences?

A. No. The recognition of the expenses recovered as a zero-cost source of capital prevents the company from charging the customer a return on these funds. If it is the Commission's intent to reduce the revenue requirement by the amount of the liability, as stated in order PSC-92-

0708-FOF-TL, then the final order for Southern States should reflect that intent.

Q. How could this be accomplished?

A. If the commission were to order that the company reduce equity by the amount of the postretirement benefits this would prevent the company from having excess cash and would reduce the revenue requirement of the company.

Q. In Southern States's MFRs did the company record a liability equal to the debit in the expense account?

A. No. Mr. Gangnan stated at the time of his deposition that the company would fund this plan. It should be noted, however, that he stated to the best of his knowledge the company had not determine what vehicle that the company would use to fund the plan. In response to staff's question, he stated the company wanted to fund "primarily because we don't want to have that liability shown on the balance sheet."

Q. You mentioned that several problems associated with SFAS 106 would be solved if the company were to fund the plan. Would the customer be better off with funding versus not funding?

A. If the company does establish an external trust, then the incentive to inflate the costs is curbed since the company's control of those funds would be irrevocably relinquished. Further, if the plan were funded, the revenues associated with recovery of the postretirement costs would be placed in a postretirement fund and all earnings would remain in the trust. There would be no need to charge the customer for interest costs on the funds the company had already collected. Nor, there would be any need to track the rate base or capital structure impact.

Funding the plan through a tax deductible plan would prevent the reduction of deferred taxes (a zero-cost source of capital). Additionally, funding the plan could reduce the costs assigned to the ratepayer in the future through earnings much like the earnings on pension funds has done.

Q. Since Southern States is planning to fund its plan, if the Commission accepts the company's adjustment for postretirement benefits as calculated under SFAS 106, should an adjustment be made to normalize the cost of postretirement benefits?

A. Yes. There should be an adjustment to recognize the benefit of funding.

Q. Have any of the accounting firms analyzed the impact of funding, not funding and continuing a pay-as-you-go method?

A. Yes. Coopers & Lybrand's Joint Study with the National Association of Accountants Retiree Health Benefits How to cope with the Accounting, Actuarial, and Management Issues, illustrated a hypothetical case which depicts the long run impact of prefunding. The assumption in the prefunding case was that the contributions and earnings were each tax deductible. In this illustration, pay-as-you-go is the least costly. However, if SFAS 106 is adopted, this illustration indicates a funded, tax deductible plan is less costly than an unfunded plan.

Q. Is it true that the attribution period for SFAS 106 is less than the service life of the employee?

A. SFAS 106 requires that the cost of postretirement benefits be accrued by the time the employee is eligible for full benefits. This may and probably will be prior to the time an employee will retire. This has the effect of "front loading" the costs onto the current ratepayers.

Q. Does the adoption of SFAS 106 by Southern States "front load" cost on to current ratepayers?

A. Yes. According to the company's current plan any employee with 5 years of service and 55 years of age is eligible for benefits. Under SFAS 106, the full benefit obligations for that employee must be accrued on the books by the time the employee is eligible for benefits. However, according to the McMillian and Robertson's actuarial valuation report only 2% of the employees will retire by 55 years of age. [See attachment 4 p.19 of 19]

Q. If the Commission does not adopt SFAS 106 for rate making does this create an accounting problem for the company?

A. No. The company can recognize the costs under an accrual method of accounting for their external, general purpose financial statements and recover in rates on a pay-as-you-go basis.

Q. Does a Commission have a choice of whether it uses SFAS 106 or some other method for ratemaking purposes?

A. Yes. The Financial Accounting Standards Board cannot dictate to this Commission or any commission what costs are to be included in rates or how those costs are to be calculated. The Financial Accounting Standards Board recognized this when it adopted SFAS 71.

Q. Does SFAS 71 envision the situation where rates are set based upon accounting estimates that may not come to pass?

A. Yes, paragraph 11 gives three examples where the rate-setting action of a regulator can impose a liability on a regulated enterprise. The second example addresses the question of how to account for a commission's actions which are designed to protect the customer when rates are set based upon an estimate or anticipated cost. Item b in paragraph 11 states:

A regulator can provide current rates intended to recover costs that are expected to be incurred in the future with the understanding that if those costs are not incurred future rates will be reduced by corresponding amounts. If current rates are intended to recover such costs and the regulator requires the enterprise to remain accountable for any amounts charged pursuant to such rates and not yet expended for the intended purpose, the enterprise shall not recognize as revenues amounts charged pursuant to such rates. Those amounts shall be recognized as liabilities and taken to income only when the associated costs are incurred.

Q. Do you believe there is a need for the Commission to address the issue of recapturing changes in estimates if they do include the cost of postretirement benefits as calculated using SFAS 106?

A. Yes, the order should require that the company recalculate the SFAS 106 costs and record a credit to the postretirement expense account to reflect any changes in estimates. A change in the estimate could significantly affect the costs that should be charged to the ratepayer.

Q. Is the company harmed if the Commission does not adopt SFAS 106?

A. No. Whether the Commission continues the current pay-as-you-go method or adopts SFAS 106, the company recovers its costs. It is a matter of timing. Under the pay-as-you-go method the company recovers its costs in the year it pays the expense. Under the SFAS 106 method, the company recovers its estimate of costs years prior to expending those funds on the associated postretirement liability.

Q. Does the pay-as-you-go method prevent overrecovery of costs from the ratepayer?

A. Yes, under the pay-as-you-go method all cost containment adjustments are reflected in the costs that are assigned to the customer.

Q. Why is Public Counsel opposed to Southern States recovering its estimate of postretirement related costs in rates at this time?

A. As indicated above postretirement costs as calculated under SFAS 106:

1. Do not represent a legal liability,
2. Can not be calculated with any accuracy, and
3. Represents the most costly recovery of post-retirement costs for the next twenty years.

Continuing the current method of cost recovery (pay-as-you-go) ensures that there is a consistent methodology for all ratepayers for all periods. No set of ratepayers is funding more than the company is paying in any specific period. If the company does continue its efforts to contain costs, then the costs in the future, under the pay-as-you-go method, could be substantially less than are estimated today.

Q. Does this conclude your testimony on postretirement benefits?

A. Yes.

MR. McLEAN: Thank you, ma'am. We tender Ms. Montanaro for cross.

MR. ARMSTRONG: Thank you, Commissioners.

CROSS EXAMINATION

BY MR. ARMSTRONG:

Q Good afternoon, Ms. Montanaro.

A Good afternoon.

Q You would agree that, whether the Southern States uses the pay-as-you-go method for recognizing OPEB expenses or switches to the accrual method and recovers transition costs, that the fact will remain that expenses will be paid today for services which have been rendered in the past. Wouldn't you agree with that statement?

A Okay. Let's see if I understand your question.

I think your question was, Under the pay-as-you-go method, will services or will benefits be provided that were earned over a wide range of years?

Q In the past.

A In the past? Yes, that would be true under a pay-as-you-go method.

Q Okay. And if we switch to the accrual method, isn't it one of your contentions that because the Company will recover transition costs under that accrual method, that that same type of relationship will exist, that past services will have been rendered but we'll be recovering those expenses currently?

A I think the point we're making is that Financial Accounting Standard 106 requires a retroactive calculation of prior service costs. And that while your point is well-taken that under a pay-as-you-go method when you pay those benefits out you could have attributed those benefits to a prior period, we are willing to accept that benefit being paid out, though you might be able to assign it to a prior period under pay-as-you-go, for the consistency and the reliability of the amount you're paying. That's a trade-off we're willing to make.

Q Okay. Ms. Montanaro, you said you would -- you say you accept the point, or the point is well-made? Or do you agree with the statement that I made that under the accrual method, the recognition of transition costs would reflect expenses currently for services provided in the past? If you could just say you agree or you don't agree, then we will be able to move on.

A Under Financial Accounting Standards 106, the accrual method, as they're describing it there, requires that prior period costs be recognized in a current period.

Q Thank you very much. (Pause)

Can we also agree that in the first few years that the transition costs -- of the transition, I should say -- that the ratio of OPEB expenses to payroll will appear large in comparison to the ratio of pension costs to payroll? Will you agree with that?

A I have seen an interrogatory response provided by the Company that would indicate that, yes.

Q Would you also agree that as the Company moves further into the 20-year transition period the ratio of OPEB costs to payroll will decrease?

A I have nothing to base that statement on.

Q Okay. Well, if we have a sum certain today and we're paying down that sum certain over a 20-year period, isn't it just logical that if we're paying down that sum certain, the ratio of OPEB expenses to payroll will decrease?

A Okay. What I can say is, based on my reading of your particular plan, your plan does front load. You are assigning prior period costs, as well as future costs, as well as current costs, to the ratepayers for the next few years. That's the way your plan is designed, it's working. It's assuming that all your employees working will be taking early retirement at age 55. That's just the way the assumption is built into that plan.

So under the analysis that I think it's about 14% of your people would need to have their full benefits amortized within the next five years since this is a new plan, then I guess you could make that assumption that your OPEB costs would be decreasing. But again, it would be disproportionately assigning costs to this particular group of ratepayers.

Q Okay. You have agreed that the OPEB costs would be decreasing. Now, if we could take that one step further, wouldn't it also be true that the ratio of OPED costs to payroll also will be decreasing? It will no longer reflect what you saw in the interrogatory, that is, it looks like a significantly greater amount. Wouldn't you agree with that?

A And I've not seen your numbers projected out to the next 20 years. And so while the fact that you're making the assumption that all your people will be retiring at the age of 55 would lead one to believe that, I have not seen your calculations, so I can't give a certain --

Q Okay, that's fine. Thank you.

Okay, now, with your statement that it would lead a person to believe that, then you also could agree, or you also could be led to believe, then, that what we'll see over time as we go further into the transition period is that the ratio of OPEB expenses to payroll will more closely approximate or approach the ratio that exists currently for pension costs to payroll. Isn't that true?

A Again, I --

Q Would it lead you to believe that?

A I really do not have any basis to make that assumption, the relationship of pension to wage, and OPEB to wage, and OPEB to pension; I don't have the basis for that.

Q Okay. Thank you.

I'm going to ask you to turn to Page 3, Lines 17 through 24, of your testimony, where you speak of "an ever-present incentive for firms to optimistically represent their financial condition to those from whom they wish to attract capital." Do you see that?

A Yes, I do.

Q Have you ever owned a business?

A No, I have not.

Q Have you ever requested a business loan from a bank or other lender?

A No, I have not.

Q Have you ever approached potential equity investors to encourage them to invest money into a business which may have been a former client of yours?

A No, I have not.

Q You're a CPA, is that correct?

A That is correct.

Q Have you ever counseled a former client or any entity whatsoever to optimistically represent their financial condition to potential lenders or investors?

A No, I have not.

Q In fact, your testimony suggests that your work experience consists of approximately five years with the Public Service Commission and six years with the Office of Public Counsel, is that correct?

A I think each one of those was overstated about a year. But yes.

MR. ARMSTRONG: Thanks, okay.

COMMISSIONER EASLEY: It just seems that long.

MR. ARMSTRONG: I'm not knocking that, by the way.

WITNESS MONTANARO: This year is especially long.

Q (By Mr. Armstrong) In your opinion, and that is as a CPA --

A Yes.

Q -- would it be advisable for a utility whose stock is publicly traded to optimistically represent their financial position to lenders and equity investors?

A If I may expand?

Q Yes, you may.

A Okay. We're speaking here of firms in general. And I think the fact that you have CPAs auditing management's presentation of their financial statements is an indication there is a desire either on the part of borrowers or investors for someone to verify, if not in fact scrutinize, the presentation by management.

So, I think whether corporations have or have not overstated, there certainly is a concern that they might. And that's what I'm speaking to here -- that there is an inherent bias within the financial statements, external financial statements, to overstate earnings and understate expenses.

Q You said the "external financial statements" there is that bias?

A Right. Has that bias, that the auditor would go in looking for the overstatement of revenues, the understatement of expenses; the overstatement of earnings, the understatement of liabilities.

Q In other words, the auditor is going to go in and he's going to look for those things; and if he finds them, he is going to say, "Client, don't be overly optimistic or you might get yourself into trouble." Is that correct?

A He would make an adjustment if it were material.

Q Okay. Thank you.

A He or she.

Q Yes. (Pause) Would you agree that lenders or investors who even suspect that a utility company, for instance, which might be publicly traded, have been presenting them with overly-optimistic projections would be less likely to provide the Utility with funds in the future?

A I think it would certainly be one of those factors -- again, this is my opinion. It would be one of those factors a lender would take into consider when evaluating future loans, yes.

Q Okay. Now, if that utility had subsidiaries of which it owned 100% of the stock, the lenders and investors also would be interested, would they not, in the existing financial situation as well as the projections and the projected financial situation of those subsidiaries?

A That's correct. But I think our concern for the regulated company is that they would understate their earnings and overstate their liabilities for costs in a regulatory setting. (Pause)

Q I just have one final question.

If that subsidiary of a utility company was overly optimistic in projections, financial projections, that also might get the parent in some difficulty with lenders and borrowers in terms of future financing as well as possible other liabilities? Is that true?

A One, the over-optimistic factor you're speaking of would have to be material, and so you would have to determine how material the subsidiary was to the total consolidated picture. So I think that would certainly play in.

Q I accept that. Thank you.

I said I only have one, but I have just a couple more. Sorry.

You're aware that publicly-traded companies are regulated by the Securities and Exchange Commission, is that correct?

A That's correct.

Q And the Securities and Exchange Commission, as well as the Financial Accounting Board that you referred to, also would be interested in whether or not the utilities that are publicly traded are making overly-optimistic projections of financial situations, isn't that true?

A That's correct. And that's one of the reasons that they came out with Financial Accounting Standard 106 is that they were concerned that the Company may be understating their liabilities for external financial statements, yes.

Q This is the last question. If Southern States Utilities was to provide overly-optimistic projections of revenue increases and sales increases to its parent, Minnesota Power, upon which the parent relied when approaching investors or lenders, and those investors or lenders subsequently came back and determined or could establish that those projections were overly optimistic, wouldn't that cause some problems -- or couldn't that cause some problems, I should say -- in the future with the abilities of Minnesota Power as well as Southern States obtaining financing?

A Certainly. And I think we have seen that with other corporations that have done similar.

MR. ARMSTRONG: Thank you, Ms. Montanaro. I have no further questions.

MS. BEDELL: Staff has no questions.

CHAIRMAN BEARD: Commissioners?

COMMISSIONER CLARK: No questions.

CHAIRMAN BEARD: Redirect?

MR. McLEAN: No redirect, thank you.

CHAIRMAN BEARD: The witness may step down. Exhibits?

MR. McLEAN: I move Ms. Montanaro's exhibits.

CHAIRMAN BEARD: Exhibit No. 130, without objection.

(Exhibit No. 130 received into evidence.)

(Witness Montanaro excused.)

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CHAIRMAN BEARD: The next witness is John Williams. Have you been sworn in?

WITNESS WILLIAMS: No, sir.

(Witness sworn.)

JOHN D. WILLIAMS

was called as a witness on behalf of the Staff of the Florida Public Service Commission and, after being duly sworn, testified as follows:

DIRECT EXAMINATION

BY MS. BEDELL:

Q Mr. Williams, would you state your name and your business address, please?

A My name is John D. Williams. My business address is 101 East Gaines Street, Tallahassee, Florida.

Q And by whom are you employed and in what capacity?

A I'm employed by the Florida Public Service Commission. I'm the Bureau Chief of Certification in the Division of Water and Wastewater.

Q And did you prepare prefiled testimony in this proceeding?

A Yes, I did.

Q And if I were to ask you the same questions today that are in your prefiled testimony, would your answers be the same?

A Yes.

Q And do you have any corrections to that testimony?

A No.

MS. BEDELL: We would like to have his testimony entered into the record as though read, please.

COMMISSIONER EASLEY: It will be inserted into the record as though read.

MS. BEDELL: Mr. Williams, did you have any exhibits to your testimony?

A No.

DIRECT TESTIMONY OF JOHN D. WILLIAMS

Q. Would you please state your name and address?

A. John D. Williams, 101 E. Gaines Street, Tallahassee, Florida 32399.

Q. By whom are you employed?

A. The Florida Public Service Commission (PSC).

Q. How long have you been so employed?

A. For approximately 18 years.

Q. Would you state your educational background and give a summary of your experience?

A. I received a Bachelor of Science Degree from the University of Florida with a major in Business Administration. During the course of my employment with the Florida Public Service Commission, I have spent approximately 15 years as a rate analyst, rate supervisor or Rate Bureau Chief. I have testified and made recommendations regarding rate structure, rate design and service availability policies and charges in more than 100 cases over the course of my employment. For the last 3 years, I have been the Bureau Chief of Certification. I have attended many training courses and seminars on utility regulation and rate making sponsored by the NARUC and the American Water Works Association. I am a member of the staff subcommittee of the NARUC Water Committee, and for the last 5 years have been on the faculty of the Eastern Rate Seminar sponsored by the NARUC Water Committee.

I am currently responsible for the PSC's role in developing a statewide Water Conservation Plan with the Florida Water Management Districts and the Department of Environmental Regulation.

Q. Have you ever testified as an expert witness?

A. Yes, I have testified as an expert witness in Commission hearings. I testified in Docket No. 800161 (Investigation of CIAC), Docket No. 800634 (Dyna-Flo Rate Case), Docket No. 810433 (Seagull Utility Rate Case), Docket No. 810485 (Palm Coast Utility Company Rate Case), and Docket No. 870743 (Marco Island Utilities New Class of Service). I have also been qualified as an expert witness in several proceedings before DOAH hearing officers. In each of these cases, my testimony was related to rates and service availability.

Q. What is the purpose of your testimony today?

A. The purpose of my testimony today is to discuss the various options the Commission has regarding rate structure for Southern States Utilities, Inc. (SSU).

Q. Please explain some of the alternatives the Commission has with respect to rate structure?

A. The Company has provided sufficient data that allows the Commission staff to calculate separate rate base, revenue requirement and rate schedules for each SSU system on an individual basis. When the staff prepares its recommendation at the conclusion of this case, taking into consideration all adjustments, "stand alone" rates will be calculated for each system. Pure, "stand alone" rates for each system can be one rate structure alternative. The obvious advantage of stand alone rates is that each system would pay its true cost of service. On the other hand, there would be tremendous extremes in the final rates of the systems so that some customers would see large increases or decreases from their current rates. Many SSU systems have never operated under stand alone rates. Also, customers in systems in close proximity to one another could have large rate variances depending on the age of the systems, contribution level, and type of treatment.

In contrast, all water or wastewater systems could be combined to calculate a company wide revenue requirement and rate structure. This would certainly be the simplest approach, is easily understood, and could be economically implemented. It has been Commission policy in the past to consolidate water and wastewater systems operated by one company for ratemaking purposes. For example, Jacksonville Suburban Utilities Corporation operates multiple systems in Duval, Nassau, and St. Johns Counties under one rate structure. It has had uniform rates for all of its systems, going back to the early 1970's. Other examples are Marion Utilities, Sunshine Utilities, and Utilities Inc. of Florida. Averaging rates recognizes the economies of scale that a large multi-system company can bring to its customers. At any time during the life of a system, major capital improvements may be required as a result of plant upgrades, expansion, or regulatory requirements. Statewide rates would allow unusually high plant costs and operating expenses to be spread over more customers to mitigate rate shock.

There are several rate structure options that fall in between these two ends of the spectrum. During the 1980's, the Commission grouped systems together by county in setting rates for SSU. The rationale for combining these systems for ratemaking purposes was that the systems shared certain costs of operation, maintenance, and meter reading, as well as similar types of treatment. For example, the rates for the SSU systems in Lake, Marion, Martin, Orange, Duval and Seminole Counties were grouped for ratemaking purposes. As I mentioned previously, there are many SSU systems within these counties that have never had stand alone rates in effect. In evaluating the implementation of a countywide rate structure, the Commission should consider whether the common costs are better associated with systems within a county or some other regional basis.

Along these lines, another rate structure option is to group systems into regions of the state. It is my understanding that the SSU systems are divided into a North Division, a Central Division, a West Division, and a South Division for purposes of engineering and operations. The benefit to this type of grouping is that it is consistent with the way the company operates its systems currently. If the Commission's goal in this rate case is to work toward statewide rates, this would be a step in that direction.

In any of the rate structure options, other than stand alone rates, an additional feature to consider would be adding a surcharge for systems with advanced methods of water or wastewater treatment to recognize the higher cost of service for these systems.

Q. Would you please comment on SSU's proposed rate structure?

A. It appears that SSU is proposing to move toward statewide rates in an effort to alleviate the disparity in the rates on a stand alone basis. SSU's proposed rate structure results in a maximum bill at 10,000 gallons for the residential class for all systems of $52 for water service and $65 for wastewater service. The revenue deficiencies resulting from these caps are made up by increasing all systems by a small percentage across the board except those that are currently overearning on a strict stand alone basis. Rates for these systems will not be reduced. SSU's proposal is the beginning of the move to uniform rates, which is probably inevitable for this company.

Q. Do you support the Company's rate structure proposal?

A. Yes. I think that the Company's proposal is a good first step in the gradual move to some type of uniform rate structure. I support the concept the company developed, although not necessarily the specific dollar amounts of the caps. It would probably be too extreme to go all the way to uniform rates in the first major rate case for all systems since the merger of the Deltona Companies into SSU. However, a key element in the plan to move this utility to a uniform rate structure is missing. The Company has not proposed any change to its service availability charges in this rate case. Carefully designed service availability charges can, to the extent that there is growth, move each system's average investment per customer closer together which supports the uniform rate structure concept. Some of the SSU systems have contribution levels as low as 15% and others as high as 100%. I believe that service availability charges analyzed on an individual system basis would cause the utility's average investment per customer to be more uniform. If the Commission approves the Company's rate structure proposal, or any variation of a uniform rate structure proposal, it should also require the Company to file a service availability case as soon as it could be prepared.

Q. Do you believe the Commission should move SSU toward statewide rates?

A. Yes. Uniform, statewide rates for SSU should be a Commission goal; however not in this rate case. The utility's revised service availability charges will need to be in place for some period of time in order to support the uniform rate concept.

A uniform, statewide rate would put SSU on par with telephone and electric utilities which charge the same rates for service whether the customer is in downtown Miami or in rural Gadsden County. Allowing SSU to implement a statewide rate would provide a strong incentive for them to continue acquiring small systems throughout the state.

From a public policy standpoint, the merger of utilities and the acquisition of one utility by another is a favorable solution to the fragmented provision of water and wastewater service in Florida and the inherent viability problem. The larger utility resulting from the merger or acquisition should benefit from economies of scale in production, better access to capital, a larger customer base, more management capabilities, etc. The overall financial character of the larger system is less precarious than the small stand alone systems. Most importantly, the larger system is in a better position to meet all regulatory requirements, both economic and public health, and provide a higher standard of service.

Q. Do you have any further comments on the rate structure of SSU?

A. Yes I do. If the Commission approves any variation of a uniform rate structure in this case, some thought should be given to the effect this should have on the rates of systems acquired by SSU in the future. Some systems acquired by SSU have existing rates and others do not. If the Commission's goal is to move the utility toward countywide, regional, or statewide rates, some provision should be made to allow SSU to implement an existing SSU rate for the acquired system. While this rate case is not the vehicle for approving rates for systems to be acquired in the future, the issue should be addressed in future certification cases.

Q. Should the Commission consider a conservation rate structure for SSU?

A. For most of the SSU systems, the base facility charge rate structure may be considered an adequate conservation rate structure, as well as a cost based rate structure. However, for systems located within a critical use area as defined by the Water Managment Districts, and where the customer usage is excessive, the Commission should consider a rate structure which would provide stronger incentives for conservation. For example, the rate structure could be designed to increase the gallonage charge and decrease the base charge to encourage conservation. This would provide a more direct incentive to customers with high usage to conserve water.

I have noted that three water systems that are in the St. Johns River Water Management District have what appears to be excess water consumption (average residential consumption in excess of 15,000 gallons per month). All of the St. Johns River Water Management District has been designated as a critical water use area. The systems with excess water consumption are Dol Ray Manor, Silver Lake Estates, and Stone Mountain. I believe that for these systems, a conservation rate incentive should be implemented. There are several methods available. One would be to reallocate the revenue requirement so that more revenue is recovered in the gallonage charge than the base charge. Another method would be to increase the gallonage charge, leaving the base charge alone, and use any excess revenue generated to offset the revenue deficiencies created by the move to a uniform rate structure.

Q. Does that conclude your direct testimony?

A. Yes, it does.

Q (By Ms. Bedell) And would you give us a brief summary of your testimony, please?

A My prepared testimony explains various rate structure options in this case. I briefly give the pros and cons of these alternatives. I comment on the Company's proposed rate structure. I discuss modification of service availability charges in the event the Commission is going to move towards uniform rates. And I discuss conservation rates for systems that have excess residential consumption in critical use areas.

MS. BEDELL: Staff would tender the witness for cross.

MR. HOFFMAN: No questions.

CHAIRMAN BEARD: Mr. Twomey?

MR. TWOMEY: Yes, Mr. Chairman, thank you.

CROSS EXAMINATION

BY MR. TWOMEY:

Q Mr. Williams, on Page 2 of your prefiled testimony, Line 21, speaking about stand-alone rates, you say that the obvious advantage of stand-alone rates is that each system would pay its true cost of service; is that correct?

A Yes.

Q Let me ask you, what do you mean by that?

A Well, by developing rates on a stand-alone basis, you, to the best extent you can, attempt to tailor-make rates for each individual system.

Q Does it mean that if you had stand-alone rates that each system would be providing a return on the investment used to serve it?

A Yes.

Q That is, the used and useful investment used to serve it?

A Yes.

Q Okay. Likewise, does that term mean that each system, aside from the common costs that have been allocated to it from the pooled, so-called pooled expenses of A&G and other common type costs, would support the expenses associated with that plant?

A That's what you attempt to do.

Q Okay. Now, were you here when there was the discussion that I think led to some question, at least, on the part of Commissioner Easley about which type of rates the Company itself is advocating? Did you hear that?

A I believe so.

Q Okay. Well, let me ask you. What type of rates is the Utility advocating or what type of rates are they requesting in this case?

A From my review of their request, they're asking for stand-alone -- they've calculated stand-alone rates for each system. However, they have capped some systems, the higher cost systems, in their request.

Q Okay. Now, you've testified to the concept of uniform rates, is that correct?

A I discussed it, yes.

Q Do you advocate uniform rates?

A Not necessarily. I think that generally it's my belief that a company like Southern States should begin moving towards uniform rates.

Q Why?

A I think it makes common sense or practical sense for a company of their nature and I, believe, to encourage the Utility to continue acquiring systems, and I think it generally is the logical and reasonable thing for them to do.

Q Okay. On Page 5 of your testimony, at the bottom, you indicate that a uniform statewide rate would put the Utility on par with telephone and electric utilities. What advantage is there to that?

And first of all, let me ask you, do you equate a water and sewer utility such as this that has as many systems that are geographically spread apart with a great distance between them in many cases that are in most cases not interconnected, do you equate this Utility to a electric or gas company, telephone company?

A Not necessarily.

Q Do you find they have similarities?

A There may be some.

Q What would they be, Mr. Williams?

A Well, it's a monopoly service that's regulated; it's a utility, fixed utility service.

Q Okay. At the top of Page 6, you say, beginning at Line 1, "Allowing SSU to implement a statewide rate would provide a strong incentive for them to continue acquiring small systems throughout the state." Why would it provide that incentive?

A To require the Company to continue keeping separate records and calculating separate rates for each system and to require them to continue seeking separate rate relief every time a major new component of plant goes in in an individual system, I think, is unnecessarily burdensome. And to move towards a uniform rate or to at least have one rate with perhaps a differentiation based on the type of treatment is ultimately where we would like this Company to be.

Q So, did I understand then that you see the provision for the implementation of statewide rates or uniform rates as providing an ease of administration for operating a number of systems, somewhat like Mr. Ludsen testified to, is that correct?

A Yes, and cost savings, hopefully.

Q Where would the cost savings accrue?

A In regulatory expense, such as rate cases, rate case preparation, and in recordkeeping requirements.

Let me take one point that I don't think has been made real clearly. Southern States has several systems that have never had their rates set separately. They have always been included within a group of systems. And so their proposal in this case could be viewed as a departure from the groupings that have occurred in the past.

In other words, they are recommending a rate cap because several of those systems that the rate cap is going to apply to, are little systems that have never had stand-alone rates. And this would be the first case if you went to stand-alone rates where these systems would actually be paying the full cost of service. So this particular recommended -- or the Company's proposal could be viewed two ways. In one sense, you could view it as a beginning of a move towards uniform rates. But in another step, it's a departure from the previous groupings that have occurred in the past. And the rate cap is a step -- going more towards separate system rates with the cap being, perhaps, a transition to help buffer the rate shock that will occur.

Q I see. Now, let me ask you, do you recognize that the rate cap proposal that the Company has apparently advocated here. Do you recognize that inherent in that there is a subsidy being -- a subsidy flowing from one group, one group of systems of utilities, to the remaining systems?

A Yes.

Q Okay. And it is a -- did you hear Mr. Cresse's testimony?

A Some of it.

Q Did you hear the part where he said, I believe, that the subsidy of the revenue responsibility transfer is apparently flowing from a mix of the return on rate base and the nonallocated expenses that are associated with each utility. Did you hear that?

A Yes.

Q Do you agree with him?

A Yes.

Q Okay. Now, is it your testimony then that you find that the incentives provided by ease of operation, ease of administration of number of systems, and perhaps the reduced administrative cost associated with rate cases and the like, benefit of those -- exceed any adverse consequences associated with the subsidy?

A Generically, yes, I believe that.

Q Now, let me ask you this: You -- pardon me. You say, again on that Page 6, you said that the -- "a statewide rate would provide an incentive for them to continue acquiring small systems throughout the state." My question is: Do you envision some goal with respect to the number of small systems this utility, SSU, should acquire?

A Not necessarily a goal. I think from a public policy standpoint, it makes sense for the Public Service Commission to encourage the acquisition of small nonviable stand-alone utilities by a larger, better equipped company -- larger Company better equipped to deal with the necessary regulatory requirements that are being placed on utilities. In other words, we are encouraging -- discouraging the proliferation of small individual systems and encouraging larger companies in acquiring or preventing the creation of new small utilities. So this very much is our goal here.

Q How much of a factor is the aspect of

preventing or reducing rate shock? How important is that to you and the Staff, vis-a-vis the ease of administration aspect?

MS. BEDELL: Mr. Twomey, Mr. Williams is giving his testimony as to his opinion, I don't think he can give an opinion for Staff.

MR. TWOMEY: I'm sorry, I misunderstood.

MS. BEDELL: In answer to that particular question.

MR. TWOMEY: Okay. Strike that.

Q (By Mr. Twomey) What is your view on the relative importance of reducing rate shock vis-a-vis providing greater ease of administration?

A Basically, I think the idea that you have several hundred systems put together for ratemaking purposes will help mitigate the dramatic increases that happen when new plants are put on-line.

Generally, a large body of customers can absorb increases that would be gradual increases when put together, but would be very dramatic if the systems are -- or the rates are set on a separate system-by-system basis.

Q Let me ask you, are a great many of the systems involved -- that is the 127 that are involved here -- are a great many of those developer systems, that is systems that were initially put together to help in the development of real estate, or do you know?

A I don't know for sure, but I would say that's probably the case.

Q Would you have an opinion on whether individuals, when they move into a development inquire, among other things, about the level of their utility rates?

A Do they inquire?

Q Yes, sir. Do they inquire or is that rational?

A They do now. I don't think they did in the past.

Q Do you think, Mr. Williams, to the extent that one group of customers, that is of the systems, let's say right now in the rate cap, there is a certain group of systems and their customers will have -- provide the subsidy to the remaining systems; is that correct?

A Yes.

Q Do you think it is fair for them to have to provide that subsidy merely by the acquisition -- the common acquisition of their systems with the others by SSU?

A Well, it certainly isn't a very easy thing to explain to people in those situations, but if I had to explain it to them, I would have to say that perhaps you're in a system where there have been some economies of scale or the plant has worked successfully in the past but at some point in the future you're going to have to have a new treatment plant too, and at some point in the future, perhaps the rest of the thousands of customers will help insulate you from major increases. So --

Q Would you agree with me -- let me ask you first, under the statewide common rate, would that, in essence, involve throwing all the rate bases together and of all the systems and all of the operating and maintenance expenses of all the systems and dividing by the number of customers, essentially?

A That's what it would be.

Q That would be real easy to administer, wouldn't it?

A Yes.

Q Okay. Would you agree with me that more likely than not, such a system of -- would involve a greater subsidy than is likely to be imposed by the rate cap system being suggested by SSU now?

A Yes.

Q And you would still recommend that, notwithstanding the subsidy?

A In this case?

Q Yeah.

A No.

Q You still recommend it as a goal?

A An eventual goal for this Company, but not in this case, and perhaps not even in the next case.

Q I have a last line of questions and that is: Are there other utilities, aside from SSU, that have been identified as being candidates for acquiring smaller systems?

A You mean are there other utilities that are acquiring small systems? Yes.

Q How many are there?

A Three or four.

Q Okay. But do you see the advantages of those systems acquiring -- those utility acquiring systems as being the same as the advantages inherent with SSU acquiring them?

A Yes

MR. TWOMEY: That's all I have. Thank you.

CHAIRMAN BEARD: Public Counsel is not here? I assume no questions. Staff? I mean -- that's it. Are all these witnesses yours, or am I just trying to give them to you?

MR. FEIL: Commissioners?

COMMISSIONER CLARK: I don't have any.

CHAIRMAN BEARD: Redirect?

MS. BEDELL: Just one question.

REDIRECT EXAMINATION

BY MS. BEDELL:

Q Mr. Williams, Mr. Twomey was asking you if we implemented -- or if statewide rates were implemented if you would take the rate bases, dump them all into one pile and divide them by the customers and your answer was yes.

Is there -- in your testimony, you mentioned service availability. Can you explain how that would work with the statewide rates to help even out the fairness issue that Mr. Twomey raised?

A Yes. That's one of the things that I think needs to happen before, or as a part of a process, if we're moving this Company towards uniform rates. And that is a system-by-system evaluation needs to be done to attempt, to the extent there is growth in systems, to attempt to help move the rate bases closer together individually. This would help support uniform rates.

There are other companies, for example Jacksonville Suburban Utilities that operates in St. Johns, Duval and Nassau Counties. They are actively acquiring systems. The Commission has allowed them to go to uniform rates, even in acquisitions. But as a key part of that is that each system service availability charges are designed separately, and the point is to help try to get the average investment per customer closer together in an attempt to help support the concept of uniform rates.

So you may have to pay a substantially higher hook-up fee to enjoy a uniform rate in a particularly high-cost system. And I think that if the Commission does move this utility towards uniform rates, they ought to require them to come in for a service availability case, which would be a substantial case for all of these systems, within some reasonable period of time at the conclusion of this case.

COMMISSIONER EASLEY: You mean the giga case isn't enough?

WITNESS WILLIAMS: Pardon?

COMMISSIONER EASLEY: The giga case isn't enough? What's after giga?

CHAIRMAN BEARD: Gagga.

MS. BEDELL: Mr. Chairman, we don't have any further questions of Mr. Williams and I've been told that --

COMMISSIONER EASLEY: I do have one that I should have asked. Is the banding of rates, in your opinion, is that a step toward uniform? Is it a step away from uniform? What is it in the scheme of things?

WITNESS WILLIAMS: I would say it's a step towards uniform.

COMMISSIONER EASLEY: Could it be an end in itself?

WITNESS WILLIAMS: Yes.

COMMISSIONER EASLEY: Would you recommend it?

WITNESS WILLIAMS: I think that down the road that may be where we are. I don't think in this case that we have the -- enough data to actually do a good job at it.

COMMISSIONER EASLEY: You don't think we're ready for that yet either?

WITNESS WILLIAMS: I don't think so.

COMMISSIONER EASLEY: That's it.

CHAIRMAN BEARD: Okay, witness is excused.

(Witness Williams excused.)

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MS. BEDELL: Mr. Chairman, I understand that Staff -- if the parties don't mind -- would like to take Mr. Todd now.

CHAIRMAN BEARD: Okay.

MR. HOFFMAN: Chairman?

CHAIRMAN BEARD: Um-hum.

MR. HOFFMAN: We would prefer to do Mr. Chapdelaine first, stay in order, if that's possible.

CHAIRMAN BEARD: Okay. You all want to take them as a panel? (Laughter) It will be Mr. Chapdelaine then.

(Witness sworn.)

JERROLD E. CHAPDELAINE

called as a witness on behalf of Staff of the Florida Public Service Commission, having been duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. FEIL:

Q Could you please state your name and business address for the record?

A My name is Jerrold E. Chapdelaine. I work for the Florida Public Service Commission, Division of Water and Wastewater, 101 East Gaines Street, Tallahassee, Florida.

Q Did you prepare prefiled direct testimony in this docket consisting of seven pages?

A Yes, I did.

Q Did you have any exhibits attached to your testimony?

A I did not.

Q If I asked you the same questions asked in that testimony, would your answers be the same?

A Yes, they would.

Q Do you have any changes to the testimony?

A I do not.

MR. FEIL: Mr. Chairman, I'd move that Mr. Chapdelaine's testimony be inserted into the record as though read.

CHAIRMAN BEARD: It will be so inserted.

DIRECT TESTIMONY OF JERROLD E. CHAPDELAINE

Q. WOULD YOU PLEASE STATE YOUR NAME AND ADDRESS?

A. Jerrold E. Chapdelaine, 101 East Gaines Street, Tallahassee, Florida 32399-0873.

Q. BY WHOM ARE YOU EMPLOYED?

A. The Florida Public Service Commission.

Q. HOW LONG HAVE YOU BEEN SO EMPLOYED?

A. For approximately 14 years.

Q. WOULD YOU STATE YOUR EDUCATIONAL BACKGROUND?

A. I received a Bachelor in Mathematics with major studies in Electrical Engineering and Naval Science from the University of Minnesota (1954), a Bachelor in Accounting from the University of West Florida (1978), and a Master of Business Administration from Florida Atlantic University (1977). I am a graduate of the United States Naval Test Pilot School with major studies in Aeronautical and Flight Test Engineering (1961). During my employment with the Florida Public Service Commission I have served as an Accounting (Regulatory) Analyst, Management Analyst, Management Review Specialist, and Engineer IV. My current duties are as a Utility Systems/Communication Engineer. I am a Certified Internal Auditor and a Class B Practitioner before the Florida Public Service Commission.

Q. WOULD YOU EXPLAIN WHAT YOUR GENERAL RESPONSIBILITIES ARE AS A UTILITY SYSTEMS/COMMUNICATION ENGINEER?

A. My general responsibilities include review and analyses of complex system designs associated with certification of jurisdictional investor owned utility systems, frequent interaction with other governmental agencies involved in regulation of water and wastewater utilities, making recommendations concerning water source development, water treatment and delivery of potable water, wastewater collection and pumping, and treatment and disposal of wastewater, conducting plant site evaluations and inspections, conducting cost studies of plant systems, handling customer complaints, preparation of agenda recommendations for the Commissioners, preparation of testimony and testify on engineering and associated rate making matters at hearings, making presentations at customer service meetings, preparation of technical cross-examination questions for hearings and technical questions for deposition of witnesses, and staying abreast of the latest design criteria and standard engineering practices utilized in the utility industry for water and wastewater systems.

Q. HAVE YOU EVER TESTIFIED AS AN EXPERT WITNESS?

A. Yes. I have been accepted and testified as an expert witness in hearings which include Docket No. 820073-WS (Seacoast), Docket No. 830059-WS (Deltona-Spring Hill), Docket No. 840419-SU (Florida Cities Water Company), Docket No. 850100-WS (Du-Lay), Docket No. 850151-WS (Deltona-Marco Island), Docket No. 870981-WS (Miles Grant Water and Sewer Company), all before the Florida Public Service Commission, and Docket No. 881425-WS (St. Johns North Utility Corp.) before the Division of Administrative Hearings.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY TODAY?

A. The purpose of my testimony today is to describe and present the bases for Commission policy regarding used and useful adjustments incident to rate applications of water and wastewater utilities under Commission jurisdiction.

Q. WHY IS IT NECESSARY FOR USED AND USEFUL ADJUSTMENTS TO BE CONSIDERED IN A RATE PROCEEDING?

A. Used and useful adjustments to the investment in plant in service generally may be required when a utility is providing service in its territory but does not utilize the full design capacity of the system due to the connected load being less than that expected at build-out or design load.

Q. WHY IS THE ADJUSTMENT IMPORTANT IN A RATE PROCEEDING WHERE THE UTILITY IS PROVIDING, SERVICE AT LESS THAN ITS DESIGN SYSTEM LOAD?

A. The failure to make adjustments for utilization at less than full design capacity would cause the customers being served to pay, through their service rates, for plant capacity which should more properly be paid for by future customers. Furthermore, if current customers pay, through service rates, for plant which is not being utilized or furnished in their behalf, growth in customers would result in the utility earning above its last authorized rate of return on its rate base.

Q. WHAT CONCERNS MUST THE COMMISSION BALANCE IN DETERMINING AND ESTABLISHING THE LEVEL OF ADJUSTMENTS TO USED AND USEFUL PLANT IN A RATE PROCEEDING?

A. The Commission must balance the fairness of the level of the investment in plant that should be borne by the customers under a readiness to serve concept with a degree of encouragement for the utility to make prudent decisions and proper investment in plant necessary to serve its territory in the context of effective long-range planning and least-cost design and construction. On one hand, if the used and useful adjustment results in excessive rate base relative to the test year customers, service rates will be comparatively elevated and the potential for the utility to earn excess returns during periods of growth will exist. Alternatively, if the used and useful adjustment results in a rate base which is unfairly low, the utility will have little incentive to employ effective long range planning and seek economies of scale, the result being higher incremental costs and service rates to future customers.

Q. WHAT CONSIDERATIONS ARE EMPLOYED IN THE DETERMINATION OF USED AND USEFUL PLANT IN SERVICE?

A. A utility must recover its prudent investment costs incurred in satisfying statutory requirements to provide safe, efficient and sufficient service to its customers. The utility should be able to recover the cost of its investment as well as earn a fair rate of return on the rate base used and useful in serving its customers. A used and useful analyses would begin with a determination of the hydraulic share of the plant used and useful in service to the customers in the test year used for the rate application. Such a beginning would consider only the connected load on the system under average flow conditions. For instance, if the system provided one-half of its design capacity to current customers, then it should have a 50% used and useful adjustment applied. However, there are a number of other considerations which should be taken into account in determining the final used and useful adjustment.

Q. WHAT CONSIDERATIONS SHOULD BE TAKEN INTO ACCOUNT OVER AND ABOVE AN HYDRAULIC SHARE BASIS?

A. Design and construction of the facility, as set forth in Chapter 17-555 and Chapter 17-600, Florida Administrative Code, are considered in the context of sound engineering, standard industrial practices and regulatory requirements. The prudence of the investment concerning source, treatment, storage, transmission and distribution, collection and pumping, disposal, economies of scale, growth rates, demand levels, customer mix, seasonal effects, natural occurrences, demographics and topography are all taken into account. Various maximum flows may be taken into account based on peak month, peak day and peak hour demands to determine the highest level of capacity which is indicated for the system based on the test year data which may be adjusted for natural occurrences, line breaks and fire fighting. It is Commission practice to utilize maximum daily production water flow based upon the average of the five highest pumping rate days in the highest pumping rate month. In the case of wastewater used and useful determinations, the Commission utilizes average daily flow from the peak flow month. Consideration may be given to the class of customer and the characteristics of demand which the peak capacity situation indicates in cases where customer class, such as an industrial entity, may have a bearing on the peak requirement. A margin reserve is determined based upon growth characteristics in the service area for periods of the past five years. Generally, the margin reserve is designed to provide sufficient capacity for growth in the customer base for a specific period into the future, usually up to 18 months for treatment facilities and 12 months for distribution and collection systems or up to 20% of the plant in service. Regulatory requirements such as redundancy of equipment and the provision for adequate service and plant operation with portions down for maintenance and repair are taken into account. Fire flow is taken into account for the water system based on Insurance Services Organization (ISO) and other governmental agency requirements depending on the type of service territory and customer mix. Fire flow requirements may range from a minimum of 500 gallons per minute (GPM) for two hours (60,000 gal.) to more than 1,500 GPM for 4 hours (360,000 gal.). Fire flow requirements can make a considerable difference in establishing used and useful adjustments, particularly in smaller systems. Unaccounted-for water is determined, and levels exceeding specific limits (10%) are investigated for possible adjustment to used and useful plant levels. Infiltration and inflow into the wastewater system are examined, and excessive amounts (above 10%) may effect the level of adjustment for used and useful plant.

Q. WOULD YOU ADDRESS ASPECTS OF THE SOUTHERN STATES' FILING WHICH IMPACT UPON USED AND USEFUL ADJUSTMENTS AND WHICH ARE NOT BASED UPON STANDARD COMMISSION PRACTICE?

A. Several adjustments in the filing were not done strictly in accordance with Commission practice regarding used and useful adjustments and no explanation or justification was found as to why deviations occurred. The utility made adjustments based upon a single peak day rather than the average of the peak five days mentioned previously in this testimony. The use of a single peak day makes it likely that an anomalous occurrence will result in an excessive used and useful level. The utility calculated hydro-pneumatic tank used and useful based upon a factor of 15 rather than a factor of 10 relative to the well capacity as called for in the Ten State Standards (Recommended Standards for Water Works). The utility included fill-in lots in the distribution and collection systems used and useful adjustment rather than only lots which were or would be developed as is the basis pursuant to Commission practice. Commission policy with regard to contributions-in-aidof-construction (CIAC) calls for 100 % of the distribution and collection systems to be contributed. Compliance with CIAC policy obviates used and useful determinations involving distribution and collection systems. Furthermore, non-used and useful plant should be accommodated through recognition of an allowance-for-funds-prudently-invested (AFPI). Used and useful determinations should be made based upon Commission practice and the MFR requirements, all of which are known to utilities such as Southern States. It is incumbent upon the utility to justify its filing, prove its case, and indicate why it chose to deviate from Commission practice. Absent detailed evidence justifying the utility's deviations from Commission practice in this filing, the Commission should calculate used and useful in accordance with its practice.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY FOR THIS PROCEEDING?

A. Yes it does.

MR. FEIL: And we tender the witness for cross.

CROSS EXAMINATION

BY MR. HOFFMAN:

Q Good afternoon. I'm Ken Hoffman and I represent Southern States Utilities. Have you ever provided expert testimony before this Commission on the methodologies to be employed in conducting a used and useful analysis?

A I have not.

Q Did you conduct the used and useful analysis for any of the systems in this application?

A I did not.

Q Have you reviewed all of the work papers of all of the Staff engineers who have performed used and useful analyses in this docket?

A I have not.

Q Did the Staff engineers in this case employ the used and useful methodology which you advocate in your testimony?

A To the best of my knowledge, yes.

Q Sir, you previously testified that you have not reviewed the work papers. So, I guess, my question is: How would you know what methodology the Staff engineers follow?

A I don't think it required any kind of

in-depth analysis to determine that. I attended some meetings and have had some interactions and conversations with the engineers, but have not -- that's not supported by any type of analytical work. It's just a general knowledge of what they did and how they do their work.

Q Okay. Thank you, sir. Do you know how many water systems are included in this application?

A I saw some evidence about that, and I don't recall what it is. I would say maybe 60.

Q Would you accept, subject to check, 90?

A Sure.

Q Are you aware that the Staff agrees with the Company's used and useful percentages for water treatment plant on 73 of the 90 water systems?

A I'm not surprised.

Q Are you aware that the Staff agrees with the the Company's used and useful percentages with respect to water distribution lines on 81 of the 90 water systems?

A Could be.

Q Do you know how many wastewater systems are included in the application?

A Not really, no.

Q Mr. Chapdelaine, can you tell me what an economy of scale is?

A I would say that an economy of scale would be a measurement or equalitative statement, perhaps, of value associated with building or creating or designing something that could serve at a lower cost a certain number of customers than doing it in a fragmented way or discontinous way.

Q All right, sir. Is it the Commission's policy to include considerations of economies of scale in the used and useful analysis?

A I think it is, if we can find out what it is. I don't think it's always very easy to determine that. In many cases it's very subjective.

Q Can you tell me how the Commission accomplishes considerations of economies of scale in the used and useful analysis?

A I don't think I could answer that. That's a very general question. I think we would almost have to deal in specifics, and I don't know about any specifics having to do with this particular case.

Q Okay. Is it fair to say that you would have to look at potential economies of scale on a system-specific basis. You would have to take it by on a case-by-case basis.

A I think you would, at least that's where you would have to begin. How you summed it all up at the end might be a totally different matter, but you would have to start that way.

Q Mr. Chapdelaine, would you agree that there are Florida Public Service Commission, Water Management District, and Department of Environmental Regulation regulatory requirements that a utility must meet in constructing plant and providing service?

A Yes, I do.

Q Are you aware that the Commission has approved a Memorandum of Understanding with the DER that addresses the consideration of DER's requirements in planning the construction of wastewater treatment plants?

A Yes.

Q Isn't Southern States required to comply with DER requiremetns in the construction of wasterwater treatment plants?

A Yes. And I think the emphasise should be on construction of plants.

Q Would that include also the design of wastewater treatment plants?

A Certainly.

Q Mr. Chapdelaine, isn't it possible that customers could experience a very wet year in which water consumption is, say, 25% less, but wastewater flows are greater because inflow and infiltration goes up?

A To the extent that we would allow infiltration, that we would allow that to be in the rate base -- you know, the answer to that is not very simple. But there could be years in which that would occur, yes.

Q Okay. And conversely, couldn't there be situations in which there has been a very dry year in which the water flow, particularly for irrigation, would be greater than the year before, but wastewater flows would go down because of less inflow and infiltration?

A Oh, sure. Anything in between could occur, sure.

Q Okay. And in your judgment, shouldn't these considerations be taken into account in the used and useful analysis?

A They should be examined and determined as to the merit and the value of those things in whether or not they should be considered in any type of adjustment, yes.

Q Do you agree that there are various components of water and wastewater systems that have different regulatory requirements which apply to them?

A I may not have been concentrating on that question. Say that again.

Q Do you agree that various components of water and wastewater systems have different regulatory requirements which apply to these components?

MR. FEIL: Excuse me. Perhaps it would help if Mr. Hoffman were a little more specific in the question.

WITNESS CHAPDELAINE: I think, you know, I'm trying to answer the question and trying to think of what you're really asking here.

Yes, I think there are some differences in the recognition of various components in the system, if that's the methodology that's being used for used and useful, but if it's not, then you look at it on a system basis.

Q (By Mr. Hoffman) Would you agree that the Water Management District's regulate the annual average and maximum day withdrawal of water wells?

A In their permitting process, yes.

Q Would you agree that the DER regulates the number of wells that are necessary for service, water quality parameters to be meet and sets forth engineering guidelines for water wells?

A I think that's what they do, yes, uh-huh.

Q Isn't it true that there are counties in this state which regulate the fire flow requirements for high service pumps and storage facilities?

A Yes.

Q And I think you previously testified that the DER regulates the design and construction of wastewater treatment plants; is that correct?

A Yes.

Q And isn't it true that the EPA regulates surface water discharge?

A I suppose they do. We don't get involved with EPA but perhaps they do.

Q Are you aware that the EPA and the DER impose, criteria for Class I reliability and treatment of effluent for public access reuse?

A Yes.

Q Mr. Chapdelaine, isn't it true that a design engineer -- isn't a design engineer required to design the various components of water and wastewater systems based on these regulatory requirements as they apply to each component of the system?

A Yes.

Q Would you agree that these different regulatory requirements affect the timing and necessity of investment in various components?

A I kind of feel like we're getting way off field of what I testified to begin with. I think we're getting into something that's beyond what I testified on in my direct testimony. Maybe I can't object to it, but I can interject it into the record. (Laughter) Go ahead, ask your question, again.

COMMISSIONER CLARK: Get ready, Matt.

Q (By Mr. Hoffman) My question was: Mr. Chapdelaine, isn't it true that the different regulatory requirements that we've been discussing over the last few minutes, affect the timing and whether there is a necessity to invest in various components of water and wastewater facilities?

A Yes.

Q Isn't it true that the economies-of-scale are different for different components of water and wastewater facilities?

A I don't know. That's pretty general. I don't know.

Q Let me try and be a little more specific. To your knowledge would the economy of scale involved in doubling the capacity of a storage tank be different from the economy of scale, if any, which would be attributable to adding an average size high service pump?

A I don't know.

Q Okay.

A Not without doing some analytical work on something like that could I answer that question. I just don't know the answer to it.

Q All right. Would you agree that there are different peak load customer service requirements used in the design of different components?

A There may be: If you look at it by component, there may be.

Q Mr. Chapdelaine, how do you determine the capacity of the water system using the method set forth in your testimony?

A Well, for one thing, I didn't do any work like that, so I don't know how I would be able to respond to your question. I didn't do analytical work in this case.

Q Well, would you agree -- let me go back. Have you ever conducted a used and useful analysis and derived used and useful percentages for water or wastewater facilities?

A I've reviewed information that was presented to the Commission, and reviewed that, but, no, I have not made any original calculations, no.

Q Okay. Wouldn't you agree that construction modifications occur which can either diminish or increase treatment capacity?

A Say that again, please?

Q Yes. Wouldn't you agree that construction modifications occurred which can either diminish or increase treatment capacity?

A Perhaps.

Q Aren't there system additions, such as storage tanks and additional wells, that are not reflected in the DER plant capacity of various systems?

A I don't think I understand what you're getting at here. I don't understand. Say that again now?

Q My question was: Aren't there system additions of facilities, for example, storage tanks and additional wells, that may not be reflected in the permitted capacity for the plant as issued by DER?

A I don't see how you could have that, no. I think in order to construct components of the plant you have to have a permit to do it.

Q Are you aware if there are instances where various components can compensate for each other to maximize capacity?

A I suppose that's possible, yes, uh-huh.

Q Water and wastewater facilities are normally constructed in standard sizes; isn't that true?

A Well, if you're referring to package plants, perhaps, but I think you can build any kind of a plant you wanted if you just constructed it from the beginning. You could build it any size you like.

Q Based on your experience and knowledge, isn't it more economical to use and construct standard sizes for the next increment of demand rather than custom-made sizes?

A Once you get beyond the initial phase, of course.

Q Mr. Chapdelaine, you are aware, are you not, that the Company has used what it calls the component method of used and useful analysis in this case. Are you aware of that?

A Yes.

Q Wouldn't you agree that the use -- that by only using the component method -- I'm sorry. Strike that.

Wouldn't you agree that in order to take into account economies of scale, one must use the component method of used and useful analysis?

A Well, I think in order to have something that would be advantageous to the utility itself, yes. In other words, I think that would tend to make the used and usefulness appear to be higher than it might be on some other average basis.

Q Well, I guess what I was getting to was to do a proper used and useful analysis and address each component of the system, don't you have to take a look at potential economies of scale attributable to each component in the system?

A I don't really think you would have to do that, no. I think you could isolate each individual unit.

Q But certainly under the methodology which you talk about in your testimony, one does not look at potential economies of scale attributable to each component; is that correct?

A I did not go into any kind of component analysis is there, no. I did not suggest that.

Q Would you agree that the presence of economies of scale would justified deviation from standard Commission practice as outlined in your testimony?

A Let me hear that one, again. I'm sorry.

Q Would you agree that the presence of economies of scale may justify deviation from standard Commission practice as you've addressed it in your testimony?

A I suppose that's possible.

Q Would you also agree that the application of federal, state and/or local regulatory requirements may justify deviation from standard Commission practice as you've outlined in your testimony?

A It's possible that it could, yes.

Q Would you also agree that presence of different peak load requirements for different components of a system may also justify deviation from standard Commission practice?

A Yes.

Q Would you also agree at that the interplay of various components and their impact on capacity, which we discussed earlier, may also justify deviation from standard Commission practice depending on the case?

A Sure. I think the responses to all these questions in the last couple of minutes is that I would generally not disagree with you. But once again, you would have to have some analytical basis for the determinations you'd make in each case.

Q All right, sir.

A It could be a plus or minus situation. Some could work for you and some could work against you.

Q Okay. Is it your opinion that the Company did not justify it's used and useful methodology?

A Yes, it is.

Q Did you review the information provided by the Company through its direct and rebuttal testimony and its MFRs and its discovery responses and depositions?

A Well, I think you'll have to remember that my direct testimony came before the rebuttal, so, you know. I really didn't have a chance to do anything about that when I made my direct testimony, but I've looked -- I've examined some of those responses but I think I addressed in my testimony the presentation that was made in the MFRs themselves. I did not discuss anything else.

Q Well, let me --

A The statements that were made in the MFRs.

Q Let me ask you to turn to Page 7 of your testimony.

A Okay.

Q On Line 9, you state, "Absent detailed evidence justifying the Utility's deviations from Commission practice in this filing, the Commission should calculate used and useful in accordance with its practice."

Now, when I read that sentence I could not tell whether you were taking a position as to whether or not the Utility had failed to justify or had succeeded in justifying --

A I think what I intended to portray there was the fact that it's incumbent on the Utility to prove its case. And in those areas where it does not, the Commission then certainly has every right to make a determination on its own basis. And that would be standard practice.

Q But you personally do not have an opinion as to whether or not the Utility has justified deviation from standard Commission practice?

A Well, I think I stated in here that they did deviate.

Q You think you stated in your testimony?

A That there was a deviation.

Q Where is that, sir?

A Well, let's see if we can find it. I can tell you that somewhere in here it says that the Utility used a peak day rather than the peak average five of the high peak month for water, and that they used the 15 rather than ten for the hydropneumatic tanks -- the ratio. And that they used fill-in lots rather than potential lots.

Q All right, sir. I think we may be talking past each other.

A Okay.

Q I understand that the Utility on certain systems may have used a different methodology than what you espouse in your testimony. My question is whether or not you have an opinion as to whether or not the Utility justified using a methodology different from that that you espoused in your testimony.

MR. FEIL: Commissioner, I'm sorry. I have to object to that question. I think it's designed basically to get some sort of legal conclusion out of Mr. Chapdelaine, as to whether or not he believes that the Utility proved its case. I believe that's for the Commissioners to decide, not Mr. Chapdelaine.

MR. HOFFMAN: Mr. Chairman, I think that this goes to one of the portions of his testimony in which he is talking about whether or not the Utility justified deviation from Commission practice. He may not have an opinion on that, but I think that is certainly a mix of a factual question and a legal question.

MR. FEIL: I believe Mr. Chapdelaine testified that the Utility should justify its deviation; whether or not they have is a conclusion that the Commission makes, not Mr. Chapdelaine.

COMMISSIONER CLARK: Mr. Chapdelaine, do you have an opinion on that?

WITNESS CHAPDELAINE: I think I would still maintain that I have indicated in my testimony the three areas that we believe they deviated from. And we do not believe that the way they filed their case gave sufficient support to why they deviated from standard policy.

COMMISSIONER CLARK: Okay.

WITNESS CHAPDELAINE: I hope that's an opinion. Maybe it's not.

COMMISSIONER CLARK: I think it's all right.

Q (By Mr. Hoffman) Have you read the rebuttal testimony, Mr. Chapdelaine -- excuse me, the rebuttal testimony of Mr. Hartman?

A Yes, I did.

Q Does that change your opinion at all as to whether or not the Utility justified deviation from standard Commission practice?

A No.

Q Can you explain the basis for your opinion that the Utility failed to justify deviating from standard Commission practice?

A The MFRs, I believe, are designed to remove as much doubt about the case as is humanly possible to do. And it did not appear in those MFRs that sufficient justification was presented for why they made the deviations. It was, at best, very general and not specific. That's an opinion.

Q Mr. Chapdelaine, I may have asked you this, I'm not sure. Let me try it again.

Apart from the MFRs and the testimony, did you review the discovery responses relating to used and useful percentages that the Company provided to the Staff and to Public Counsel?

A No. It wasn't my purpose to evaluate that.

Q All right, sir. One last question on that area. Did you review the depositions which were taken in this proceeding of Mr. Hartman and Mr. Morse?

A Just briefly, I just scanned through them. I didn't make any kind of in-depth analysis of those at all.

Q All right, sir.

On Page 5 of your testimony, at Line 8?

A Okay.

Q You talk about the Commission practice to utilize maximum daily production water flow based upon the average of the five highest pumping rate days and the highest pumping rate month. Do you disagree with Mr. Hartman's opinion that manuals referenced in the

DER rules support the use of the maximum day rather than the average of the five highest days in the highest month?

A Yes, I do.

Q Can't the Company research their records to determine if there were any unusual occurrences and ensure that they were omitted?

A I think if we knew that for a fact that they in fact did that, that would be part of what we would look at and affect our determination of it, yes.

Q So your answer would be yes, the Company can do that research --

A Yes, it can. Yes, it can.

Q Okay.

A And I think it should make sure that that's clear that it's done that and show us what they've done.

MR. HOFFMAN: Okay.

CHAIRMAN BEARD: Question: About how much do you have or how long to a good breaking point?

MR. HOFFMAN: I'm at a good breaking point now. I've probably got another 15 minutes.

CHAIRMAN BEARD: Let's take a break.

(Brief recess.)

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Q (By Mr. Hoffman) Mr. Chapdelaine, do you recall earlier on in your testimony you acknowledged that the Staff agreed with the Utility on its water used and useful percentages with respect to treatment plant on 73 of 90 systems and with respect to distribution lines on 81 of 90 systems; do you recall that?

A Yes, you know, I'm just accepting that as a fact. I can't verify it, I didn't look at it.

Q Would you accept, subject to check, that the Staff agrees with the Utility's calculation of used and useful wastewater treatment plant on 29 of 30 systems?

A I won't disagree, I have no basis for it.

Q And would you accept, subject to check, that the Staff agrees with the Utility on 22 of 30 systems with respect to used and useful of wastewater collection lines?

A Yes, sir. This is something we already went over, I think. Is that true or not?

Q We're almost through.

A Okay.

Q In light of Staff's agreement with the Utility's used and useful percentages on the great majority of the water and wastewater systems in this application, wouldn't you agree that the Utility has justified its methodology?

A I don't think I really am prepared to give you an opinion yes or no on that. I just don't know, I really don't know that.

Q All right. Let me ask you a question about a statement on Page 7 of your testimony.

A Page 7, okay.

Q Lines 2 and 3, I was a little puzzled.

It reads, "Compliance with CIAC policy obviates used an useful determinations involving distribution and collection systems." Is it your position that used and useful determinations involving distribution and collection systems are not at issue in this case?

A I will say no in response to your question, but I think I need to elaborate on that if I am permitted to do that?

A What I intended to describe here, is something that I get up on a soap box about more times than I would like, about CIAC and AFPI and all these things that are related to capital recovery and so on. I have no intention of discussing capital, that's not my testimony, but I wanted to preface this with those remarks.

What I'm trying to say here is, given a situation where the Utility has gotten its CIAC policy adequately taken care of so that its investment level is relatively low -- in fact, perhaps, zero with respect to collection and distribution system, the pipe's in the ground -- used and useful problems basically vanish before your very eyes because they don't have an investment in it and there's no controversy. That's what I was trying to say here.

Q Okay, sir. Let me ask you a couple of questions following up on your statement.

A Sure.

Q Assume, if you will, that CIAC levels for a specific system were set by the Commission in 1980. Would you agree that the cost of constructing Utility facilities would have increased during the period of time between 1980 and 1992?

MR. FEIL: Commissioner, I'm going to object. I think that's a little bit beyond the scope of his direct testimony. I don't think he says anything about construction costs over the last ten years.

MR. HOFFMAN: Mr. Chairman, I'm just following up on his last answer when he kind of opened the door and started talking about CIAC levels and his theory on how CIAC allows the Utility to recover all of its investment. We happen to disagree with that, and I'm just following up with one or two questions on that issue.

MR. FEIL: I don't think his discussion of CIAC levels has anything to do with construction costs.

COMMISSIONER CLARK: To be honest, I didn't hear the question, did you?

CHAIRMAN BEARD: Why don't you try the question again.

Q (Mr. Hoffman) I started out with a hypothetical, where I ask you to assume that CIAC levels are established for a specific system by the Commission in 1980. Do you recall that?

A CIAC levels are established for a specific utility in 1980.

CHAIRMAN BEARD: Hypothetical.

MR. HOFFMAN: It's a hypothetical.

WITNESS CHAPDELAINE: Oh, hypothetically, Okay, I'm sorry, go ahead. I misunderstood that.

Q (Mr. Hoffman) And then my question, which was the subject of the objection was, would you agree that the cost of constructing utility facilities would have increased between 1980 and 1992?

MR. FEIL: And I still, for the record, would state my objection.

COMMISSIONER CLARK: You're asking -- I don't know that one necessarily follows the other, you're asking if the cost to construct something has increased from 1980 to 1990. That really doesn't have anything to do with CIAC.

MR. HOFFMAN: Well --

CHAIRMAN BEARD: The cost to construct a central office switch in a telephone company has gone down.

MR. HOFFMAN: Can that statement be assumed for the purposes of the hypothetical and allow me one more question?

COMMISSIONER CLARK: I think that's all right.

CHAIRMAN BEARD: We'll give it the old college try.

MR. HOFFMAN: Thank you.

Q (Mr. Hoffman) Mr. Chapdelaine, if you would assume that construction costs with respect to this particular system have increased from 1980 to 1992, all right, sir?

A Yes.

Q All right, so we've got a hypothetical so far, where CIAC was established by the Commission in 1980 and costs of construction increased between 1980 and 1992. Under that hypothetical, wouldn't you agree that the CIAC established by the Commission in 1980 would not permit the Utility to recover 100% of its investment in construction which took place after 1980?

MR. FEIL: Commissioner, again, I'm going to object to that question. I don't think that Mr. Chapdelaine necessarily addresses in his testimony anything about investment. He only addresses what the Commission policy regarding CIAC levels are.

CHAIRMAN BEARD: We're straying pretty far afield. Are you advocating that the Commission set CIAC and never change it in the future?

MR. HOFFMAN: The only point that I'm trying to make, Chairman, is that when the Commission sets CIAC, that that dollar amount stays constant unless it's modified by the Commission, while construction costs may increase. And, therefore, there may not be a full recovery of investment as contemplated by the original CIAC charge.

CHAIRMAN BEARD: Construction charge may increase. CIAC may increase. They may not increase simultaneously. There may be stair steps in which one gets ahead of the other, and vice versa. I mean, there's a lot of "mays," sure.

MR. HOFFMAN: Okay. I'll move on.

CHAIRMAN BEARD: Since your purpose is to educate Commissioners and we understand that, we're prepared to answer --

MR. HOFFMAN: Okay, sure.

COMMISSIONER CLARK: Are you under oath?

CHAIRMAN BEARD: No, I'm just trying to prove that I am semi-educated as opposed to semi-illiterate.

Q (By Mr. Hoffman) Mr. Chapdelaine, let me ask you a couple of questions of about the portion of your testimony -- and you don't need to refer to it, but you do refer to fill-in lots. We've been talking about fill-in lots a little bit this week?

A Yes, sir.

Q Are you aware of a utility's obligation to provide service to customers located within their franchise territories?

A Yes, sir.

Q A hypothetical question: let me set up the scenario. If you would assume that I owned Lot 1 and you owned Lot 4 on a street, and that Lots 2 and 3 are between us. Do you have the picture so far?

A Yes. (Nods)

Q Okay. If I connect first on Lot 1 and you desire service on Lot 4, isn't Southern States required to put in the necessary pipe to reach you on Lot 4?

A If it weren't already there, yes. If you had to construct something, yes.

Q Okay. And if you include fill-in lots -- or if you accept the position that fill-in lots are to be excluded in deriving used and useful percentages, that pipe that we talked about in our hypothetical would only be 50% used and useful because there are four lots on the block, and service is only connected up to two lots, correct?

A Yes.

Q Now, if you would continue on in the hypothetical and assume that you also own Lot 3, and that you have no intention of selling it in the near future -- let me strike that question.

Let me go to a different hypothetical. If I lived on Lot 1 and you lived on Lot 2, and each of those lots were five-acre lots. And the utility was providing service to both of us. That pipe running in front of our houses on Lot 1 and Lot 2 would be 100% used and useful; is that right? We're the only two houses on the block, only two lots?

A And that pipe was not designed to serve any more than that?

Q That's correct?

A Well, I want to be very careful how I answer this question because I would envision the possibility of that line, perhaps, having some other uses. For instance, there may be other customers who would eventually hook on to that thing. If you're going to tell me, though, that there's no possibility that anyone will connect to that line, perhaps 100% would be legitimate in that case.

Q Okay. I'm just trying to simplify it for the purposes of the numbers. Obviously we could use numbers like a thousand lots and whatnot, but let's just judgment assume --

A Well, I'm with you in that respect but my answer is still the same.

CHAIRMAN BEARD: And you've already put in your swimming pool and you've already built the stables on both of those five-acre lots.

Q Okay. I'm on Lot 1, you're Lot 2. Five acres each, 100% used and useful under this hypothetical. Now, if a zoning change were passed by the local governmental body, which would allow us to subdivide our lots. So I subdivide mine into five lots, you subdivide yours into five lots. Under a position in which fill-in lots are excluded, that pipe that was 100% used and useful, just became 20% used and useful; is that correct?

A It doesn't seem so to me.

Q Why not?

A Because if you had two owners there, and if they paid their service availability charges up front, it's gone, it's already paid for. Then you don't have to worry about any used and useful.

Q But if I was living on one corner of Lot 1 and you were living on one corner -- the farthest away corner of Lot 2, and these are five-acre lots, we had each paid our service availability charge. And those lots were subdivided, so now that there are eight potential connections between Lot 1, where I am, and the lot where you are. Aren't there now eight fill-in lots, as you understand it, on that block?

A There might be, but I kind of think you're leading me down the primrose path and trying to get me to answer something that -- if I understand this correctly, and hear what you're asking me, you're starting out at 100% and then moving yourself downward.

Q I'm asking you if your testimony is it would not move downward, I would accept that.

A I guess it could or couldn't. You know, that's the trouble of trying to talk about hypotheticals. The real world is a whole different place.

CHAIRMAN BEARD: Counselor at the risk of educating us, that also, I guess, assumes then that you put in enough pipe when you served those two people, assuming that was going to be all you were going to serve, to then serve ten people?

MR. HOFFMAN: Yes.

CHAIRMAN BEARD: That makes me scratch my head on prudency.

MR. HOFFMAN: The intent of the hypothetical --

CHAIRMAN BEARD: Or would you go back and replace that pipe with pipe big enough to serve all ten people then when they subdivided because they got new zoning ordinances?

MR. HOFFMAN: Well, the intent of the hypothetical, at least for the Commission's education was, I lived on one corner of the block and Mr. Chapdelaine lived all the way on the end of the block so the pipe had to extend all the way --

MR. FEIL: I'm sure he'd want to live on the end of the block.

CHAIRMAN BEARD: Well, I can see what's wrong with the educational system in the United States today. (Pause)

MR. HOFFMAN: Thank you, Mr. Chapdelaine.

CHAIRMAN BEARD: Mr. Twomey? You don't have any pipe you want to install?

MR. TWOMEY: No, sir.

CHAIRMAN BEARD: Public Counsel?

MR. McLEAN: No questions.

MR. FEIL: Mr. Chairman, I have, I think, two questions on redirect, if I may.

CHAIRMAN BEARD: Well, you'll have to wait your turn. Commissioners, do you all have any questions? Hearing silence, now it's your turn.

REDIRECT EXAMINATION

BY MR. FEIL:

Q Mr. Chapdelaine, is it your testimony that the used and useful is strictly a design concept or a regulatory concept, or some combination of the two?

A I think the simplest answer that I can give is that distinctions can be sufficiently made between those two concepts so that there is a chasm between the two. In other words, design on the one hand would have a certain set of rules to go by, and regulation on the other hand would have another set of rules to go by, such that we end up, perhaps, trying to move toward the middle when we make the determination about used and useful, but not necessarily all the way to the left or all the way to the right.

Q Mr. Hoffman asked you some questions regarding Staff's position with regard to used and useful for some systems. Isn't it possible that Staff may have agreed with the Company on used and useful for a particular system for a reason other than what the Company offered?

A I think so. And it was, perhaps, based on some reasonable test or a test of equity, or a combination of things that led the Staff to believe that a used and usefulness provided by the utility was okay in that circumstance.

MR. FEIL: We have nothing further.

MR. McLEAN: Mr. Chairman, I request we leave the record just for a moment.

CHAIRMAN BEARD: We'll leave the record.

MR. McLEAN: Thank you, sir.

(Discussion off the record)

(Transcript follows in sequence in Volume XIV.)