SSU
Southern States Utilities

BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NO. 950495 - WS

APPLICATION FOR A GENERAL RATE INCREASE

VOLUME I
BOOK 1 OF 22

MINIMUM FILING REQUIREMENTS
PREFILED DIRECT TESTIMONY

Containing

SCOTT W. VIERIMA

DIRECT TESTIMONY OF SCOTT W. VIERIMA
BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION
ON BEHALF OF
SOUTHERN STATES UTILITIES, INC.
DOCKET NO. 950495-WS

Q. **WHAT IS YOUR NAME AND BUSINESS ADDRESS?**

A. My name is Scott W. Vierima. My business address is 1000 Color Place, Apopka, Florida 32703.

Q. **BY WHOM ARE YOU EMPLOYED AND WHAT IS YOUR POSITION?**

A. I am employed by Southern States Utilities, Inc. Hereinafter I will refer to Southern States Utilities, Inc. as "SSU" or the "Company". I currently serve as interim president of the Company.

Q. **WHAT IS YOUR EDUCATIONAL AND PROFESSIONAL BACKGROUND?**

A. I received a Bachelors Degree in Electrical Engineering from Montana State University in 1973, and a Masters Degree in Business Administration from the University of Iowa in 1975. I also have completed various continuing education courses related to financial planning and administration. I have served in the utility industry for approximately 17 years, all with Minnesota Power or one of its affiliates, in the capacity of analyst, manager, officer and/or director. I am an active member of the American Water Works Association.

Q. **HAVE YOU PREVIOUSLY TESTIFIED BEFORE A REGULATORY AGENCY?**

A. Yes. I have testified on behalf of SSU before the Florida Public Service Commission in multiple dockets and before hearing officers in Sarasota

County.

Q. PLEASE DESCRIBE YOUR RESPONSIBILITIES AS INTERIM PRESIDENT OF SSU.

A. As interim president, I oversee the management of all aspects of SSU's business operations including the utility operations, finance, engineering, environmental, administration, legal, ratemaking and customer service areas. I also am responsible for SSU's long and short range business planning while serving in this position.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. My testimony will provide a general overview of SSU's filing, including a brief overview of the Company's financial performance since rates were last established.

I also will discuss SSU's innovative financing efforts which have served to reduce SSU's cost of debt since the last rate filing. These innovative financings include securing no cost funding from the Southwest Florida Water Management District and the South Florida Water Management District. In addition, SSU secured a $10.3 million private activity bond which was jointly issued by Hernando County and Volusia County at extremely competitive interest rates.

I will identify the portion of SSU's revenue requirements related to interaffiliate transactions and other parent company assessments, particularly liability insurance premiums and shareholder costs.

Q. PLEASE IDENTIFY THE OTHER WITNESSES WHO WILL TESTIFY IN THIS PROCEEDING ON BEHALF OF SOUTHERN STATES AND THE TOPICS THEY WILL ADDRESS.

A. The following is a list of witnesses who will provide direct testimony in this proceeding. Of course, additional witnesses may be required to address issues not contemplated in our pre-filed direct testimony which subsequently may be raised by the Staff of the Public Service Commission (Staff) or Intervenors in this proceeding, including the Office of Public Counsel.

Witnesses	Topics
Scott Vierima	Overview/Policy/Cost of Capital
Arend J. Sandbulte	Shareholder Expectations
Roger A. Morin, Ph.D.	Cost of Capital
Forrest L. Ludsen	Overview/Rate Design/Service Availability
John Whitcomb, Ph.D.	Conservation Rates
Carlyn Kowalsky	Conservation Program/Re-use
Judy Kimball	Revenue Requirements
Morris Bencini	Budgets/Rate Design
Dennis Westrick	Capital Projects
John Hilton	Purchasing
Dale Lock	Salaries/Benefits
Bruce Gangnon	Income Taxes

Gerald Hartman	Used & Useful
Robert C. Edmunds	Hydraulic Flow Method
Chuck Bliss	Used & Useful/AFPI/Service Availability
James P. Elliott	Hydraulic Flow Method
Rafael Terrero	Environmental
Ray Gagnon	Unaccounted For Water/Emergency Preparedness Plan
William (Dave) Denny	Operations
Craig Anderson	Central Analytical Laboratory
John Guastella	Marco Effluent and Raw Water Rates
Hugh Gower	Margin Reserve and Imputation of CIAC

Q. **ARE YOU THE SPONSOR OF ANY OF THE SCHEDULES FROM THE MINIMUM FILING REQUIREMENTS?**

A. Yes. For the Commission's convenience and that of the parties in this proceeding, we would like to introduce the Company's minimum filing requirements ("MFRs") as one exhibit, Exhibit ___ (SWV-1). Portions of the MFRs were prepared under the direction and supervision of SSU employees who will testify and sponsor the relevant portions of the MFRs. I am the individual sponsor of the D Schedules and also prepared the documents and other information related to the interaffiliate transactions and parent assessed costs.

Q. **PLEASE DESCRIBE SOUTHERN STATES' FILING IN THIS CASE.**

A. In June 1995, Southern States filed tariff changes for final rate relief designed to increase annual water and wastewater revenues in the amount of $11,791,242 and $6,346,260, respectively (a total of $18,137,502) for the projected test year ending December 31, 1996. The filing was prepared in accordance with the Commission's minimum filing requirements and other applicable rules. The filing is based on a historic base year consisting of the twelve months ended December 31, 1994 and projected test years for the twelve month periods ending on December 31, 1995 for interim rates and December 31, 1996 for final rates.

Q. COULD YOU BRIEFLY DESCRIBE THE CORPORATE GOALS AND PHILOSOPHY OF SOUTHERN STATES' MANAGEMENT?

A. Southern States' management is dedicated to ensuring that our customers receive the highest quality service at the lowest possible cost, while meeting or exceeding regulatory requirements and providing a fair and reasonable return to investors. The Company is an advocate of prudent natural resource preservation. Unfortunately, we are in an era in which significant capital investments are required and cost increases are unavoidable for water and wastewater utilities if they are to consistently comply with exacting water safety and environmental protection laws.

Q. WHAT ARE THE PRINCIPAL CAUSES FOR SOUTHERN STATES' RATE FILING?

A. The primary reasons for Southern States' rate filing are:

1. Southern States will have invested approximately $56 million in our water facilities, $31 million in our wastewater facilities and $11 million in general plant facilities since the date that rate relief was last granted to SSU through December 31, 1996 for the various facilities included in this proceeding;

2. Since the date rate relief last was provided by the Commission for the various facilities, operations and maintenance costs also have increased as a result of new rules, standards, ordinances and other requirements of federal, state and local regulators;

3. With the exception of index and pass through adjustments in 1993 and 1994 averaging around 1.5% each year, the rates SSU currently is authorized to charge customers located in 90 of our water service areas and 37 of our wastewater service areas are based upon 1991 historical costs -- therefore, by the time rate relief is granted in this proceeding, Southern States' actual investments and increased costs over a period of almost five years will not have been reflected in customer bills;

4. The rates of return for the fiscal year ended December 31, 1994 were 5.32 percent for the water facilities and 5.62 percent for the wastewater facilities. This is equivalent to a return on equity of 0.26 percent and 0.98 percent, respectively. Returns on equity for water and wastewater, without rate relief, in the interim period are

negative 1.87% and negative 2.05%, respectively, and negative 5.52% and negative 2.26% for water and wastewater in the projected 1996 test year. These returns are for the plants included in this application, and are exclusive of extraordinary income or losses. These returns will not allow Southern States to remain viable much less continue to attract capital to finance investments and operate our land and facilities throughout Florida.

These deficient returns have caused us to initiate this proceeding for rate relief. SSU has placed or will place approximately $20 million of plant into service each year during the period 1992 through 1996. These investments are not reflected in the rates we currently are authorized to charge our customers.

Also, since 1991, SSU has incurred significant, non-discretionary increases in operating costs such as chemicals, sludge hauling costs, wholesale water and wastewater costs, testing costs, etc., which have resulted primarily from rules and standards passed by environmental regulators.

Faced with these large investments and operating cost increases, SSU has endeavored to reduce or stabilize costs in other areas to the greatest extent possible. As SSU witness Dale Lock will testify, SSU's current salary structure is below market, in some instances significantly so, largely because SSU could not afford to pay market rates under existing rates.

We have created a staffing review committee which evaluates every request for new positions, as well as requests to fill vacated positions to ensure least cost staffing levels.

A budget evaluation team comprised of individuals from finance, rates, engineering, customer service, operations and environmental services was formed to evaluate each capital expenditure for necessity and cost effective alternatives.

As SSU witness John Hilton will describe, we have implemented statewide purchasing practices and procedures designed to maximize economies of scale and reduce equipment, materials and supplies costs.

We also have constructed a central laboratory in Volusia County which will serve all of our facilities throughout the state in an effort to control our testing costs and improve testing quality.

We have consolidated or closed customer service offices, made possible by our provision of a 1-800 number and computerized linking of our satellite offices to SSU's central offices in Apopka.

As I will describe later in this testimony, SSU also has secured debt at what we believe to be extremely cost effective rates and terms by pooling our assets statewide, obtaining access to county and multi-county private activity bonds and, as SSU witness Carlyn Kowalsky will testify, securing contributed matching funds from water management districts.

As Ms. Kowalsky also will testify, the participation of SSU in rulemakings and other activities at the various agencies has prevented the passage of rules and ordinances or the issuance of agency dictates which would have unnecessarily increased customer costs significantly.

These are just a few examples of SSU's efforts to hold the line on investments and costs. We believe these examples demonstrate that SSU is doing as much as any utility in this industry to keep the costs of providing water and wastewater service as low as possible.

Q. **HOW DO SSU'S OPERATING EXPENSES COMPARE TO ITS PEERS IN THE WATER INDUSTRY?**

A. SSU compares favorably with the 104 respondents to the National Association of Water Companies' (NAWC) 1993 financial survey. Total operating, maintenance, customer and administrative costs were $199 per customer for all NAWC participants, and $211 per customer for only those companies with customer counts between 100,000 and 200,000. SSU's 1994 expenses averaged $196 per customer for its approximate 150,000 customer base. Furthermore, SSU's average annual wage/salary for its 475 employees in 1994 ($27,723) was 27% below the average of all NAWC companies ($38,005) and 24% below the average for companies with comparable customer bases ($36,254).

Q. **ARE THERE ANY ADVANTAGES WHICH SOUTHERN STATES OFFERS TO ITS CUSTOMERS IN MEETING THE COST OF**

COMPLIANCE WITH TODAY'S LAWS AND REGULATIONS WHICH MIGHT NOT BE AVAILABLE TO OTHER CONSUMERS OF WATER AND WASTEWATER SERVICES IN FLORIDA?

A. Yes. Southern States' customers can expect to be served by a professional utility dedicated solely to providing high quality utility service at the most reasonable rates possible. Our management goals and practices are not influenced by the desire to sell lots or to achieve other conflicting objectives. Rather, Southern States is in the water and wastewater utility business for the long haul. Southern States provides tax, accounting, billing, collections, customer service, payroll, pensions, legal, engineering, environmental compliance, permitting and other administrative and general services on a consolidated basis from our Apopka headquarters. In addition to benefits in economies of scale and other efficiencies, Southern States' size enables us to hire specialists who concentrate their efforts on certain limited fields of expertise and identify areas where costs can be decreased or the quality of service improved. In this way, Southern States is able to, among other things, keep abreast of the latest advances in water and wastewater treatment technology, capitalize on cost-saving measures in medical and health insurance as they arise, reduce or otherwise minimize increases in the costs of chemicals and other supplies through bulk purchases made under a bidding process and better monitor customer service orders and complaints so as to identify problem areas more quickly and increase customer satisfaction. In addition, as Southern States' witness Raymond Gagnon will testify, as a result of being served by Southern States, our customers obtain immediate access to considerable personnel resources during times of emergency or unusual occurrences thereby reducing both the response time as well as the possibility that service to our customers will be interrupted. Also, Southern States' size has permitted us to develop a process by which spare utility equipment and accessories have been identified and may be made available to any facility in emergency situations with a minimum amount of delay. This process often will eliminate the waiting period for equipment to be ordered from and delivered by a third party supplier thus further reducing the possibility of service interruptions.

Q. SSU HAS DEMONSTRATED THAT IT IS A STATEWIDE NETWORK OF FUNCTIONALLY RELATED PLANTS OPERATING AS ONE UTILITY SYSTEM. CAN YOU BRIEFLY SUMMARIZE HOW THIS CONFIGURATION BENEFITS YOUR CUSTOMERS AND GIVE A PRACTICAL EXAMPLE?

A. Yes. Economies of scale and specialization of expertise are accepted business principles that have been actively pursued and achieved by SSU. In Docket No. 930880-WS, the investigation into the appropriateness of uniform rates for SSU and its customers, numerous specific examples of gained efficiencies and tangible cost savings enjoyed by our customers were documented. These included: inter-plant labor and equipment sharing, consolidated financing, bulk purchasing, emergency response capabilities and uniformity of service and design standards. Centralization of accounting, budgeting, engineering, risk management, tax and rates administration, payroll, data processing, cash and records management, legal, planning and communications functions has avoided substantial duplication of costs. Specialization of safety, environmental compliance, permitting, human resources, compensation and benefits, customer service and billing, and contract law staff ensures professionalism, compliance and accuracy in an increasingly complex and service driven industry. A dramatic example of how these attributes work to the advantage of our customers occurred on the night of March 10, 1995. On that night, a 30 inch water main passing under the Marco River between the mainland and Marco Island ruptured after 26 years of service. Not only was the location of the break a unique challenge, but the timing -- the peak of Marco's tourist season during which the island supports 30,000 residents, three times the off-season population -- magnified the urgency and potential economic impact to customers. As soon as the problem was located by SSU personnel stationed on the island, trained operators began to optimize the only remaining source of supply, which is the 4.0 MGD reverse osmosis facility at the south end of the island. Simultaneously, operations and engineering personnel in Apopka began an options assessment, environmental specialists notified the Department of Environmental Protection, purchasing staff assisted in the procurement of parts, contract labor and equipment, and the SSU communications staff coordinated an information distribution effort via radio, television and door to door contact with customers. Within hours, customers had responded by reducing consumption 50%, the DEP had authorized a contingency proposal, the contractor was on site removing the failed sections of pipe, hard to find replacement pipe was on its way from a Naples supplier, and SSU personnel were on their way from Citrus County with needed fittings and equipment. The end result of the system-wide coordinated effort was the restoration of the mainland water supply source within twenty-four hours without an interruption of service and the inconvenience or adversity associated therewith.

Q. **COULD YOU BRIEFLY DESCRIBE THE PHILOSOPHY OF SSU MANAGEMENT TOWARD WATER CONSERVATION?**

A. Southern States is a strong advocate of water conservation in the State of Florida. As Southern States' witness Kowalsky will confirm, Southern States has received a number of awards for our conservation efforts in the past. Also, Southern States owns and operates seven public access reuse facilities and is in the process of converting our wastewater facilities at our Spring Hill service area to public access reuse. Public access reuse technologies reduce the need to extract potable water from the underground aquifer system for irrigation purposes, thus conserving potable water supplies. We believe these facts demonstrate Southern States' commitment to satisfy Florida's, as well as our own, conservation goals.

Q. IS THERE A PRICE TO BE PAID FOR THE CONVERSION OF WASTEWATER PLANTS TO REUSE FACILITIES?

A. Yes. Compliance with DEP's treatment requirements for public access reuse requires Southern States' to make significant capital investments in its wastewater facilities. In addition, the acceptance of reuse water by former water customers will reduce water sales thus decreasing the sales base over which our fixed costs to provide water service may be spread. However, Southern States agrees with the policy of the State of Florida and its regulatory agencies that although the treatment process for reuse is expensive, reuse can be the lowest cost alternative available for effluent disposal, the lowest cost alternative to advanced water treatment technologies, and a cost-effective alternative to depleting precious underground water sources. Conversion of existing water customers to reuse will help forestall costly future supply and treatment expansions, thus helping reduce future cost increases.

Q. PLEASE PROVIDE AN OVERVIEW OF SSU'S RATE DESIGN PROPOSAL IN THIS FILING, AND EXPLAIN HOW THAT PROPOSAL IS CONSISTENT WITH YOUR COMPANY'S CONSERVATION PHILOSOPHY.

A. SSU is proposing a single block gallonage rate with a base facility charge designed to recover 40% of the revenue requirement. In addition, a reverse osmosis water treatment class of service has been added to the conventional water treatment service classification to recognize the permanent cost differential between facilities designed to treat brackish as opposed to freshwater supplies. Finally, we are proposing a revenue adjustment mechanism in the form of a weather normalization clause or "WNC", similar to fuel and weather adjustment clauses employed by electric and natural gas utilities. The WNC is proposed to mitigate the high degree of consumption variability displayed by SSU's predominantly residential customer base. The testimony of John B. Whitcomb, Ph.D. confirms that SSU's vulnerability to variations in consumption is such that a WNC will benefit SSU, its customers, shareholders and Florida's environment. SSU and its advisors consider the rate design and rate mechanisms we are proposing to be a balanced approach to achieving the three primary rate design objectives of (1) encouraging conservation, (2) promoting full recovery of revenue requirements, and (3) stabilizing inter-period financial performance. SSU's proposal is consistent with SSU's conservation philosophy as it meets the criteria deemed necessary by the Southwest Florida Water Management District to provide an economic incentive for our customers to conserve water.

Q. **WHAT RETURN ON EQUITY IS SSU REQUESTING IN THIS**

PROCEEDING?

A. SSU is requesting a return on equity of 11.19% and a 9.84% overall rate of return for interim rates. The requested equity return for interim rates equals the lower boundary of the approved range for SSU's Marco Island application in FPSC Order No. PSC-93-1070-FOF-WS issued on December 3, 1993. For final rates, SSU is requesting a 12.25% return on equity, and a 10.32% overall return. The testimony of SSU witness Roger A. Morin, Ph.D. verifies that although this return on equity is higher than the return suggested by the FPSC leverage formula in effect at the time of this application, it is a return that more accurately reflects the risk profile of SSU.

Q. CAN YOU PROVIDE A PROFILE OF SSU'S DEBT AND DESCRIBE HOW THAT PROFILE HAS CHANGED SINCE THE LAST SERIES OF RATE FILINGS?

A. SSU has been continually striving to minimize consolidated interest expense, without obligating itself and its customers to undue risk or excessively restrictive covenants. SSU has made effective use of such vehicles as private activity bonds, fixed vs. variable rate blending, parent company credit support, letters of credit, aggressive competitive bidding and staggered maturities to achieve these goals. The weighted average cost of debt reflected in SSU's 1992 consolidated application (Docket No. 920199-WS) was 11.16%. In the instant docket, SSU is requesting recovery of a 9.06% debt cost, a drop of over 200 basis points. At the same time, SSU has been able to increase its average maturity to 15 years under less restrictive terms. As of December 31, 1994, SSU's leverage was 57.8% debt, with 16% of its interest cost subject to market variation. SSU's improving capital configuration has contributed to its favorable debt picture, however its current revenue deficiency still disqualifies it as an investment grade credit (based on Standard and Poor's benchmark ratios) and therefore use of credit support has still been necessary. Relief granted in this docket will position SSU to negotiate ever improving relative rates and terms on an unsupported basis in future financings.

Q. DOES SSU CURRENTLY FINANCE INVESTMENTS IN EACH OF ITS FACILITIES THROUGHOUT FLORIDA INDEPENDENTLY?

A. No. Although some individual debt has been incurred for specific large projects (i.e., Marco Island Industrial Development Bonds and Hernando County/Volusia County Private Activity Bonds), the lion's share of debt and all equity financing are done on a utility wide basis. In each of Southern States' recent rate applications, the Commission has approved the consolidation of all debt into a combined capital structure.

Q. LET'S EXAMINE EACH OF THOSE CAPITAL COMPONENTS SEPARATELY. IF SSU WERE TO SEEK SINGULAR EQUITY INVESTMENTS IN EACH OF ITS UTILITY PLANTS, HOW WOULD THE PROCESS COMPARE TO EXISTING INVESTOR

SOLICITATION EFFORTS?

A. As of year-end 1994, SSU had $78 million of equity capital on its books. $73 million, or 93% of that amount, represents funds directly invested by its senior parent corporation, Minnesota Power. The remainder represents net nominal earnings retained from prior years. SSU strives to maintain a prudent balance between its equity capital and its debts; therefore, any incremental funding requirements (beyond those that can be serviced through internal cash flow) are financed with a blend of external equity and debt. When an 'infusion' of equity funds is necessary, SSU provides MP with reasonable advance notice of the need, and MP ultimately wires the funds to SSU in the form of paid-in capital.

In contrast, if our facilities were funded as stand-alone entities, investors of a very different nature, and additional time and expense, would be required. Individuals or corporations willing to tie up large amounts of capital, for long periods on a local level, and who are qualified to comply with the requisites of multiple economic and environmental regulators, represent a relatively narrow spectrum of candidates. In Florida, this group has typically been comprised of residential and commercial real estate developers whose primary focus has been land sales versus utility service. History has shown that the ability of such investors to consistently provide capital has been tied to the fortunes of their often transient development operations. Site specific investors also are disadvantaged in the areas of liquidity and administrative overheads. Minnesota Power is able to draw on its reserves or access national securities markets on relatively short notice to provide equity funds for its affiliated operations. A large public offering to support multiple business purposes is normally more cost effective and efficient than multiple private offerings to local investors. The establishment of separate boards of directors, replication of stock certificates, increased legal fees, separate corporate reporting requirements, are all part of an extensive list of added costs that would be imposed on ratepayers if equity were to be procured for SSU's facilities independently.

Q. IF THE BORROWED PORTION OF SSU'S FINANCING PROGRAM WERE CONDUCTED ON A SITE SPECIFIC BASIS, WOULD THE COST OF, OR ACCESS TO, DEBT BE ANY DIFFERENT THAN UNDER A CONSOLIDATED APPROACH?

A. Yes. The size of a debt obligation, as well as the strength of the borrowing entity, significantly effect the all-in cost of debt and the availability of borrowed funds. As an example, Southern States closed a $45.0 million first mortgage loan with Denver based National Bank for Cooperatives (CoBank) in 1993. I asked CoBank to compare that transaction with the hypothetical alternative of multiple small loans, each supported by the separate credit of a smaller, independent water/wastewater utility. Their response (attached as Exhibit ____(SWV-2) confirms that the pricing and covenants received by SSU were preferential due to the larger size of SSU's combined borrowing needs and the diversity of our combined earnings streams. As a small utility loan benchmark, CoBank used their collaborative loan program with the National Association of Water Companies (NAWC) (described in the promotional brochure which is included in Exhibit ____(SWV-2). Under that program, the typical small loan was priced at 300 basis points over comparable maturity U.S. Treasury obligations and includes an additional one time 100 basis point origination fee. In contrast, SSU's twenty year rate for unified borrowing was fixed at less than 200 basis points over then-prevailing U.S. Treasury rates with no up-front origination fee. These two factors alone will result in $3.5 million in total savings to SSU customers over the life of the obligation, savings which are directly attributable to managing costs on a consolidated basis for the combined good of all SSU customers.

The situation I have just described can be contrasted to the 15.5% Deltona Utilities, Inc. ("DUI") debt which was retired in December 1994. Since the Commission recognized a uniform capital structure in each of the rate proceedings initiated since SSU acquired the Deltona facilities, customers previously served by DUI have benefitted considerably by the spreading of the related interest costs to all customers.

A further example of how customers may be price disadvantaged if it were necessary to disassociate individual facilities' capital costs from those of all other SSU customers can be seen in our current efforts to obtain increasing amounts of tax-exempt financing. This form of debt has proven to be extremely low cost in the past, making it a source of preference in the future. SSU is exploring the feasibility of issuing additional multi-county private activity bonds similar to the Volusia County/Hernando County bonds I referred to earlier to service the construction requirements of numerous facilities. Marketing such bonds on an individual small scale would increase the per-unit overhead costs and limit the sphere of interested investors. Under a master offering, investors can look to more than the cash flow from one facility to service the debt.

Creditors value and reward risk diversity. Asset backed securities such as first mortgage loans are more favorably priced if the collateral is not concentrated in one location and subject to single site risks (fire, storm, catastrophic failure, etc.). Diversity of income available for debt service is favored by creditors since it dampens the impact of localized economic events that may effect the borrower's ability to repay the loan. Creditors also value accessibility of information. Large utilities such as SSU maintain and distribute extensive and accurate financial data on a regular basis which is independently audited once a year. Investment bankers involved in larger debt placements are regulated by the SEC and NASD providing reassurance that financial data and offering representations are accurate.

Q. ARE THERE OTHER BENEFITS TO SSU CUSTOMERS FROM UNIFIED CAPITAL FUNDING BEYOND PRICING?

A. Yes. As mentioned earlier, market recognition, administration of funds, access to credit support, availability of longer maturities, less restrictive loan covenants, and access to public markets as well as private markets, are all promoted by unified financing programs. These attributes all facilitate a flexible, least cost financing program that would not be available if SSU attempted to fund its investment in individual facilities separately. It would be difficult to justify the abandonment of unified capital funding on the premise that customers do not benefit from a coalition of all SSU facilities.

Q. SSU IS USING PROJECTED CAPITAL STRUCTURES AND COSTS FOR BOTH INTERIM AND FINAL RATES. PLEASE EXPLAIN THE PRIMARY ASSUMPTIONS BEHIND THOSE PROJECTIONS.

A. In projecting capital structure and costs for test years 1995 and 1996, SSU used the following assumptions:

<u>STRUCTURE</u>

1. Retained earnings of $2.8 million and $5.0 million for 1995 and 1996, respectively.
2. No dividends or additional paid in capital in either year.
3. Repayment of existing debt obligations in accordance with

covenants.

4. Constant investment in LP gas operations.

5. All 1995 capital requirements funded internally. $20.0 million of incremental capital needs funded with long-term debt in 1996.

COST

1. Fixed rate obligations continuing at covenanted rates.

2. Incremental long-term debt issued at an all-in cost of 9.29%.

3. Variable rate private activity bond all-in cost constant at 7.5%.

4. Interest on customer deposits at the regulated rate of 6.0%.

Q. IN PRIOR FILINGS SSU INCLUDED A HYPOTHETICAL BALANCE FOR A SERIES OF NO-COST PREFERRED STOCK ISSUED IN 1988, AND REDEEMED IN 1991. WHY IS THIS CAPITAL COMPONENT EXCLUDED FROM THIS FILING?

A. In December of 1988, SSU purchased the Burnt Store, Deep Creek and Sugarmill Woods water and wastewater plants in Charlotte, Lee and Citrus counties from Punta Gorda Developers. Since the asset base included facilities which at that time were considered non-used and useful, the purchase price of $7.5 million was divided into two components: $3.3 million in cash and $4.2 million in no-cost preferred stock, redeemable as a function of new connections at the rate of $550 per ERC. The concept was simply to match no-cost capital with non-earning assets on the balance sheet until customer growth allowed the conversion of the preferred stock into contributions or debt/equity funds supporting used and useful assets. Assuming the stock was still outstanding, the appropriate rate treatment would be the exclusion of any non-used and useful assets at those plants from rate base, and the simultaneous exclusion of the preferred stock from the capital structure. Inclusion of the preferred stock results in the reduction of capital costs applied to all SSU assets, in essence defeating the original intent of the transaction, and causing investors to incur a penalty for the purchase. In PSC Order No. 23511 issued in 1990 on SSU's Seminole County application, the Commission took the position that since the preferred stock was redeemed early at a negotiated discount in March of 1990, ratepayers suffered through the replacement of no-cost capital with the cost bearing funds needed to redeem the stock. To the contrary, the effect on ratepayers was neutral. SSU's embedded capital cost applied to the $2.1 million redemption price, minus the amortization of a deferred credit booked to recognize the discount, represents the income statement impact of the transaction. Ratepayers, however, remain unaffected since rate base has not changed nor has the cost of capital reconciled to rate base changed by the inclusion of the $2.1 million in incremental funds. The deferred credit and the amortization thereof continues to be excluded from capital for rate purposes since it, just as the preferred stock, is attributable solely to unregulated (non used/useful) funding activities. The stock has not been carried on SSU's books since its redemption in March of 1990.

Q. DOES THE FACT THAT SOUTHERN STATES IS REQUESTING UNIFORM RATES IN THIS PROCEEDING HAVE ANY IMPACT ON SOUTHERN STATES' ABILITY TO ATTRACT CAPITAL AND THE COST OF THAT CAPITAL?

A. Yes. Capital providers consider elasticity of demand, or the ability and willingness of a utility's customers to pay their bills, as a component of risk when reviewing debt or equity requests. Uniform rates promote affordability for all customers and ensure that capital costs which are incurred universally, are recovered similarly. Also, capital provided to a utility with uniform rates, will more likely be applied to discretionary projects using uniform capital budgeting standards, as opposed to standards that vary from plant to plant as a function of affordability. Differing and contrary elasticities, construction standards, and cost recovery cycles between facilities owned by one utility lead to increased uncertainty, which is interpreted as increased risk by capital providers, which ultimately translates to higher capital costs.

Q. IS REVENUE STABILITY AN ISSUE OR A CONCERN FOR SSU AND ITS CAPITAL PROVIDERS?

A. Yes. In excess of 85% of SSU's customer base is single family residential, and 45% of their usage varies significantly as a function of weather. In addition, regional consumption can also be affected by tourism patterns. If seasonal trends were consistent year after year, SSU would be able to manage its financial affairs to accommodate the annual variations. Unfortunately, weather and tourism do not exhibit a consistent predictable nature. Consequently, customer monthly water consumption ranged from a high of 1.424 billion gallons to as low as 846 million gallons during the 12 month period ending December 31, 1994, a spread of over 40%. These swings have caused commensurate cash flow and operating income variations which are directly interpreted as increased risk by investors and lenders. SSU witness Arend J. Sandbulte's testimony describes the sensitivity of the investment community to uncertainty and inconsistency in equity yields.

The instability has been further magnified by SSU's narrow operating margins over the past few years, and will continue to exert a meaningful influence over financial results even as returns approach approved levels in the years to come. It is for this reason that SSU has requested the institution of a revenue adjustment mechanism in the form of a WNC to dampen the effects of consumption volatility.

Q. PLEASE EXPLAIN SPECIFICALLY THE ROLE OR RESPONSIBILITY OF THE APOPKA OFFICE IN PLANNING AND OBTAINING FINANCING FOR SOUTHERN STATES.

A. Personnel located in the Apopka office are responsible for procurement of all forms of third party financing at Southern States. Southern States serves customers in approximately 110 separate water/wastewater service areas located in 25 Florida counties; however, meeting the financial needs of the facilities serving these areas is centralized in Apopka for the following reasons:

(a) debt rates obtained and closing costs incurred are substantially lowered by combining borrowing needs into larger offerings. See Exhibit _____ (SWV-2), a letter dated December 14, 1993 from CoBank confirming the financing cost savings by consolidating our financing needs;

(b) Southern States is one corporate entity, thereby becoming the sole legal obligor on all debts;

(c) equity funding is obtained from one shareholder class through the issuance of singular corporate common equity securities;

(d) credit enhancement (guarantees, bond insurance, letters of credit, etc.) is more readily available to one large, recognized borrower;

(e) access to institutional markets is facilitated by combined offerings;

(f) financial records and audits, which provide the foundation for lender credit analyses, are most effectively performed at the corporate level;

(g) administration of, and compliance with, numerous and often complex debt covenants, as well as timely payment of interest, is best assured through a centralized monitoring process by qualified/experienced analysts; and

(h) pooling of asset collateral and supporting cash flows diversifies lender risk, further lowering costs.

Southern State's Apopka based personnel:

1) conduct impact simulations and analyses of capital financing transactions on the Company's capital structure to promote an appropriate balance of maturities, type (debt vs. equity), and fixed versus variable rates;

2) negotiate credit enhancement fees, loan covenants and closing fees to ensure all are competitively priced;

3) plan financing needs by developing cash flow forecasts and analyzing which of the myriad of financing vehicles/sources are the optimal alternative(s) for Southern States and its customers;

4) review the capital requirements and consolidation impacts of potential acquisitions;

5) administer changes (additions, exclusions, substitutions) to pledged assets which require officer certification(s);

6) respond to lender information requests and negotiate/execute inevitable supplements and amendments;

7) continually monitor financial markets for refinancing or prefinancing opportunities;

8) analyze financial results for continuing compliance with loan

covenants;

9) set uniformity standards for loan documentation;

10) manage reserve, construction or other restricted cash accounts mandated by loan agreements; and

11) prepare testimony and various schedules for rate applications, TEFRA hearings, board meetings, etc.

Examples of recent financings which resulted in substantial customer benefits include:

1) consolidation of multiple short-term, variable rate obligations into a master fixed rate, twenty year, first mortgage debt secured by Southern States' unencumbered assets statewide;

2) issuance of multiple county, credit enhanced "low floater" private activity bonds; and

3) securing a competitively bid line of credit available for the short term general operating requirements of all Southern States' facilities.

None of the above would have been achievable without centralized financial planning and administration.

In addition, due to SSU's hiring of professional staff experienced in the water and wastewater industry, we have successfully obtained matching funding from two of Florida's water management districts and have ensured that future funding from the districts will be made available to SSU, as well as other investor-owned utilities, in the future. SSU witness Kowalsky will provide further details in this regard.

In summary, it would be costly and impractical to maintain the financial expertise required to administer capital for a $300 million (assets) corporation at individual plant sites. The strategy of centralized planning and procurement of debt and equity has saved Southern States and its customers millions of dollars over the years, and has enhanced capital availability dramatically over that which could be obtained using an individualized facility approach.

Q. DOES SSU OBTAIN INSURANCE ON AN INDIVIDUAL FACILITY OR STATEWIDE BASIS?

A. Except as noted below, general liability, excess liability, director and officer, property damage, automobile and workers' compensation policies are issued singularly to Southern States for statewide coverage.

Q. SPECIFICALLY FOR PROPERTY DAMAGE INSURANCE, HOW DOES A STATEWIDE POLICY REDUCE COSTS WHEN COMPARED TO SITE SPECIFIC POLICIES?

A. The best possible pricing typically results when risk is spread over a larger asset and operational base, which is why Southern States purchases liability insurance for all systems on a statewide basis. Each year, because of its combined size, Southern States is in a position to negotiate advantageous premiums relative to the alternative summation of premiums for 110 separate site-specific policies. Southern States periodically conducts a full-scale market test, inviting competing proposals from carriers who know and understand Southern States' business and who are comfortable with underwriting Southern States' total property coverage. The only location which has separate coverage is Marco Island because it exhibits unique risks from a property damage standpoint (increased hurricane exposure). Southern States purchases property damage insurance from a specialty carrier for Marco Island.

Q. WHAT IS THE CORPORATE RELATIONSHIP BETWEEN SOUTHERN STATES, MINNESOTA POWER AND TOPEKA?

A. Minnesota Power, a publicly traded (NYSE) company, owns 100% of the equity securities of Topeka, which in turn owns 100% of the common stock of Southern States.

Q. WHAT TYPES OF CHARGES DOES SOUTHERN STATES ROUTINELY RECEIVE FROM ITS PARENT COMPANIES?

A. The majority of payments made by Southern States to Topeka and/or Minnesota Power can be classified into five types: (1) compensation and expense reimbursements paid for professional services rendered; (2) premiums paid for insurance coverages provided; (3) tax payments made under tax sharing agreements; (4) apportioned shareholder costs associated with equity funds and (5) fees for credit support. Other types of billings also are occasionally received for inter-affiliate activities of lesser financial significance (e.g.: computer time-sharing for special projects).

Q. DO MINNESOTA POWER AND TOPEKA BILL SOUTHERN STATES FOR ALL THE SERVICES THEY RENDER?

A. No. An often unrecognized element in the cost/benefit assessment of services afforded Southern States through its ownership by Minnesota Power is the fact that most services are provided at rates lower than those that would otherwise be available to Southern States, or at no cost. Examples of services rendered for which the parent has not invoiced Southern States include: (a) access to tested and fully developed programs such as job evaluation, sex discrimination/harassment training, safety, fleet management, financial and environmental audit procedures and information systems development; (b) use of Minnesota Power's licensed software and its membership in used data processing equipment brokerage organizations; (c) advice and experience with equipment purchases such as PCs, copiers, printers, bulk postage units, telephone systems and cash processors; and (d) continuous availability of business professionals and data for spot research on a wide variety of subjects from evolving Federal tax legislation to wage and salary surveys. Such assistance promotes effective economic decision-making and translates into a lower cost of service for Southern States' customers.

Q. WHAT IN YOUR OPINION CONSTITUTES A DIRECT CHARGE VERSUS AN ALLOCATED COST?

A. The Company still maintains its definition of an allocated cost as "... one for which the associated benefit <u>cannot be subjectively segregated from the benefits provided in total; or, for which a meaningful competitive price cannot be obtained</u> from an alternative supplier." The maintenance cost of Minnesota Power facilities, from which administrative duties are conducted for multiple business units (including the Florida water/wastewater systems), would be an example of an allocated cost, if such costs were divided among and billed to each business unit. Such costs are not currently being allocated or billed by Minnesota Power or Topeka to Southern States.

Shareholder costs and certain insurance coverages are apportioned or allocated to SSU at the present time. The apportionment methodologies are based on invested equity and insurance underwriters recommendations which we believe to be reasonable measures of value received. Insurance costs are benchmarked against outside quotes for comparable coverage, and MP's premiums have consistently proven to be the lowest.

Direct charges for requested services are billed at an hourly rate plus incidentals such as travel and lodging. The all-in cost for personnel experienced in SSU matters typically runs between $40 - $50 an hour, which compares favorably with local consultants.

Q. **HOW CAN SOUTHERN STATES BE SURE THAT INVOICES RECEIVED FROM ITS PARENT ORGANIZATION(S) REPRESENT**

PRUDENTLY INCURRED COSTS, AND DO NOT INCLUDE AMOUNTS THAT WOULD NOT OTHERWISE BE NECESSARY, OR COULD BE OBTAINED AT A LOWER RATE, IF SOUTHERN STATES WERE NOT AFFILIATED WITH THE MINNESOTA POWER GROUP OF COMPANIES?

A. Southern States is given discretionary authority by its parent(s) regarding the utilization of resources. Minnesota Power/Topeka are viewed by Southern States as competing outside vendors for billable services rendered. Therefore, Southern States only solicits those services from Minnesota Power/Topeka for which they offer a distinct quality or cost advantage. Southern States reviews an annual proposed budget from Minnesota Power/Topeka, reviews each invoice for accuracy and authorization, and rejects disputed amounts. In addition, Volume 11, Book 2 of the MFRs contains a composite schedule relating to the specific amounts paid and methodologies employed in apportioning directors and officers (D&O) and excess liability insurance premiums between members of the Minnesota Power affiliated group. As I previously indicated, the real issue is the "reasonable and prudent" test, which the Company has consistently endeavored to meet. The indicators and methods selected for assessing apportioned insurance risk will always be as debatable as risk levels themselves. Southern States has, and will continue to focus its attention on the issue of relative cost and value, and not on the methodology used by competing vendors in developing bids for services such as insurance coverage.

Q. ARE THERE ANY COSTS NOW BEING ASSESSED TO SOUTHERN STATES BY ITS PARENT COMPANIES WHICH WERE NOT PREVIOUSLY ASSESSED?

A. Yes. The MFRs include $209,000 of costs which represents Southern States' portion of costs incurred by Minnesota Power regarding shareholder reporting and communication. These costs have been assessed to the parent and all subsidiaries based on average invested equity as a percent of consolidated common equity. The services provided to shareholders include annual shareholders meetings, SEC filings, stock exchange fees, rating agency fees, registrar and transfer agent expenses, board fees, annual and quarterly reports, proxy statements and the staff assigned to respond to shareholder inquiries. As I indicated previously, Minnesota Power is Southern States' sole equity provider. As I also indicated, Southern States benefits from the financial strength and reputation of Minnesota Power in our financing arrangements, including reduced financing costs as a result of Topeka or Minnesota Power guarantees of our debt. The money invested in Minnesota Power by its shareholders is critical to the financial well-being of Southern States. The cost of keeping shareholders informed, complying with reporting obligations for a publicly-traded company, ensuring acceptable investor relations, etc., should be shared by all affiliated companies benefitting from these activities, including Southern States. In fact, Florida shareholders hold the highest number of shares of Minnesota Power stock of any State other than Minnesota and Wisconsin where Minnesota Power has implemented customer stock purchase plans. Therefore, a significant portion of our shareholder communication efforts are directed toward Florida residents.

Q. COULD YOU DESCRIBE THE METHOD USED BY SOUTHERN STATES TO CALCULATE WORKING CAPITAL?

A. For the 1995 interim year, we used the one-eighth O&M method since that method was used by the Commission in our last three rate proceedings. For the projected 1996 test year we used the balance sheet method as required by Commission Rule.

Q. COULD YOU BRIEFLY DESCRIBE THE PROCESS SSU USED TO DETERMINE WORKING CAPITAL REQUIREMENTS UNDER THE BALANCE SHEET METHOD?

A. Working capital represents SSU's investment in assets, net of liabilities incurred, that enable the utility to meet current obligations as they arise, and to bridge the gap between the time expenditures are required to provide service, and the time collections are received for that service. All accounts that are plant related such as plant in service, accumulated depreciation, CIAC, and all cost of capital accounts such as customer deposits, equity, long and short-term debt, are excluded from working capital. In addition, all deferred tax accounts, interest bearing assets and all non-utility accounts have been excluded from the working capital calculation. The thirteen month average net balance (assets net of liabilities) of the remaining accounts has been included as a component of rate base for the test period ending December 31, 1996.

Q. DOES THAT CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

COBANK
Rural America's Cooperative Bank

Galleria Complex
200 Galleria Parkway N.W
Suite 1900
Atlanta, Georgia 30339
(404) 618-3200

December 14, 1993

EXHIBIT______ (SWV-2)

Capital Cost Comparisons - CoBank

Mr. Scott W. Vierima
Vice President of Finance
and Administration
Southern States Utilities, Inc.
1000 Color Place
Apopka, Florida 32703

Dear Scott:

In response to your inquiry about how borrowing rates and terms are affected by the size of the entity being financed, I submit the following:

CoBank currently finances over 55 water/sewer corporations nationwide. All of these financings have been to non-public body entities (i.e. taxable financings). We have been financing the water and sewer sector of the utility market since 1988. We have financed the electric systems since 1971. To expand our lending in the water and sewer market, we staffed an entire department of ten people in 1993 specifically dedicated to serving the water and sewer market.

With this stepped up market emphasis has come a working relationship with the National Association of Water Companies or "NAWC". Jointly, NAWC and CoBank developed a new lending program specifically designed to meet the needs of small private water companies which have financing needs in the \$50-\$500,000 range. To qualify for participation in this program, the company must meet certain financial criteria (see attached information brochure). Upon qualifying, the loan terms include a fixed interest rate equal to the Treasury yield (matching the maturity of the loan) plus 3%. The loan also carries an up-front fee of 1% of the loan amount being financed.

In comparison, the financing for your organization was completed with more attractive interest rate options due to the size of the financing transaction (\$45 million) and the diversity of your earnings stream from your 150+ systems. In addition to price, the consolidation of many small systems not only brings an interest rate savings flowing through to each system, but also includes a timing efficiency. Closing 150+ loans to separate systems, even with a staff of ten people, would take considerable longer thus delaying implementation of new EPA mandated improvements, or resulting in the slowing of new construction which ultimately affects the economy's ability to grow at a more rapid rate or a utility's ability to grow with it.

In summary, although each credit is somewhat unique, loans to larger utilities typically exhibit certain characteristics and economies of scale that allow CoBank to price such transactions at lower overall interest rates.

Sincerely,

John Cole

John P. Cole
Assistant Vice President
Rural Utility Banking Group

About NAWC

The purpose of the National Association of Water Companies (NAWC) is to strengthen America's investor-owned drinking water supply industry. Through NAWC, water companies can effectively communicate with regulatory agencies, members of Congress, state legislators and others on water policy issues.

NAWC members are dedicated to providing a safe and quality supply of drinking water for all Americans.

For More Information on the NAWC Loan Program:

National Association of Water Companies
1725 K St. N.W., Suite 1212
Washington, D.C. 20006
(202) 833-8383; fax (202) 331-7442

About the Banks for Cooperatives

Funds for the NAWC Loan Program are provided by the Banks for Cooperatives (BCs). The banks provide about 60 rural water and waste disposal systems across the nation with more than $135 million in loans and commitments. The BCs also finance agricultural cooperatives and rural electric and telecommunications systems.

The BCs include CoBank, the Springfield Bank for Cooperatives and St. Paul Bank. CoBank also finances exports for the benefit of U.S. agricultural cooperatives. The banks are part of the $63-billion Farm Credit System. The System's public policy purpose is to finance agriculture and rural America.

BC figures as of June 30, 1993, unaudited

Ronald J. Mire
Assistant Vice President
Rural Utility Banking Group

CoBank
National Bank for Cooperatives

200 Galleria Parkway, N.W.
Suite 1900
Atlanta, GA 30339
Phone: (404) 618-3270
Fax: (404) 618-3202
(800) 255-7429, x3270

The NAWC Loan Program

A program to provide financing for water companies across the nation, brought to you by the National Association of Water Companies and the Banks for Cooperatives.

EXHIBIT ___ (SWV-2)
Page 2 of 3

Q. What is the NAWC Loan Program?
A. The program was developed by the Banks for Cooperatives in cooperation with the National Association of Water Companies (NAWC) to provide financing to the nation's water companies.

Q. Why was the NAWC loan program created?
A. Water companies have a growing need for financing system upgrades and expansion and to meet increasing environmental requirements mandated by the Safe Drinking Water Act and other federal laws. The program was initiated by NAWC's Small Companies Committee to meet these growing needs.

Q. Who can borrow from the program?
A. First, your water company must be a NAWC member. Secondly, you must serve a predominantly unincorporated area or a community of 20,000 or less population. Borrowers must be corporations, cooperatives or other public or private entities.

Q. For what purposes are loans made?
A. Financing is provided for virtually any valid business purpose, including general working capital needs, capital improvements and project financing such as construction and upgrades to systems, operational equipment and refinancing of existing debt.

Q. How much can we borrow?
A. Anywhere from $50,000 to $500,000. A loan may not exceed 80 percent of your rate base.* If your needs go beyond these parameters, the Banks for Cooperatives may be able to help you through their direct lending programs.

Q. Who provides the funds?
A. The NAWC Loan Program is funded by the Banks for Cooperatives (BCs). With approximately $15 billion in assets, the BCs provide financing to rural water and waste disposal systems, rural electric and telecommunications systems, and agricultural cooperatives throughout the U.S.

Q. Are your rates competitive?
A. Yes. Interest rates are fixed and are indexed to U.S. Treasury rates. There is a $250 application fee, plus a one percent origination fee.

Q. What are the repayment terms?
A. Terms range up to 20 years. Loans are payable monthly, or quarterly if your cash stream is less than monthly. There is a penalty for prepayment of fixed-rate loans.

**The BCs may approve a surcharge covering principal and interest payments for the loan in lieu of a reduced net worth requirement and increased loan to rate base.*

Q. How strong do we have to be, financially, to borrow?
A. The Banks for Cooperatives provide financing to creditworthy water companies. Customers must have a minimum net worth level of 20 percent of total assets.* In addition, systems must maintain certain financial and operating conditions.

Q. How do we apply for a loan?
A. Contact the NAWC Loan Program administrator. NAWC will send you an application form and a list of background information which you must provide. They'll also guide you through the application process, which has been streamlined to be as efficient as possible for the customer. Call (202) 833-8383.

Q. How long will it take to receive funds?
A. You will be notified as to the status of your application within two weeks after NAWC and the BC have received your application. Funds can usually be provided within four to eight weeks following notification of approval of your application. The loan closing date will depend largely on how soon you can provide closing documents. The BCs are committed to providing funds in a timely and efficient manner.

EXHIBIT ____ (SWV-2)
Page 3 of 3