REBUTTAL TESTIMONY OF SCOTT W. VIERIMA

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

ON BEHALF OF

SOUTHERN STATES UTILITIES, INC.

DOCKET NO. 950495-WS

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND OCCUPATION FOR THE RECORD.

A. My name is Scott W. Vierima. My business address is 1000 Color Place, Apopka, FL. I am currently employed as SSU's Vice President and Chief Financial Officer.

Q. ARE YOU THE SAME SCOTT VIERIMA WHO HAS PROVIDED DIRECT TESTIMONY INCLUDING A STATEMENT OF QUALIFICATIONS IN THIS CASE?

A. Yes, I am.

Q. WOULD YOU BRIEFLY DESCRIBE THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. Yes. The purpose of my rebuttal testimony is to controvert positions taken by the Office of Public Counsel and the Marco Island Civic Association on three general categories of service costs incurred by SSU on behalf of its customers: 1) shareholder service expenses, 2) original investment carrying costs (exclusive of acquisition adjustments), and 3) the cost of invested/loaned funds. In their direct testimony these intervenors have suggested that SSU has requested recovery of amounts in excess of those considered reasonable or necessary to provide water/wastewater service; assertions I will disprove. Additionally, I will discuss the

supplemental testimony of OPC's witness Kim Dismukes in which she proposes imputation of CIAC on assets acquired from Lehigh Corporation. Finally, I will address concerns expressed by Marco Island customers as to the price paid by SSU for the Collier lakes.

Q. REGARDING SHAREHOLDER SERVICE EXPENSES, MS. DISMUKES CLAIMS THAT SSU HAS PROVIDED NO SUPPORT FOR THESE COSTS OR HOW THEY BENEFIT RATEPAYERS. IS THIS ACCURATE?

A. No. As part of the minimum filing requirements, SSU submitted line-item detail of the seventeen components of shareholder costs including such items as rating agency appraisal fees and stock exchange registration fees. In addition, SSU filed two discovery responses relating to apportionment methodologies and parent company costs (OPC Nos. 42, 79 and 105), responded to deposition inquiries, and provided late filed Exhibit No. 4 which again detailed the make-up of shareholder related expenses. Finally, in response to PSC Audit Request No. 74, SSU gave a specific explanation of the benefits realized by SSU customers from Minnesota Power's equity investment in SSU. Copies of each of these discovery responses are provided

in Exhibit ____ (SWV-3). Briefly, the customer benefits include the attraction of debt capital at lower rates and the maintenance of a balanced capital structure.

Q. MS. DISMUKES ALSO SUGGESTS THAT IT IS COMMISSION POLICY TO DISALLOW EXPENSES RELATED TO IMAGE BUILDING AND GOOD WILL. ARE ANY OF THE COSTS OF THAT NATURE REIMBURSED TO SSU'S PARENT?

A. No. It is important to recognize that the shareholder costs apportioned to SSU are in many ways the same type of costs incurred directly by SSU in support of its debt capital. The Company provides recurring financial reports, officer certifications and other operating information to its lenders. Staff and management hold regular meetings with existing and prospective creditors and frequently are required to negotiate and process term amendments and/or covenant waivers. All of these costs are recovered as necessary to a successful capital program. Some of the equity support costs charged to SSU by Minnesota Power are undeniably "communication" related; however, a distinction must be drawn between communication of essential financial and operating data to existing and prospective investors, and image enhancement

activities that do not improve the issuer's access to capital at reasonable prices and under acceptable terms. All of the apportioned parent company communication costs are of the former type. They represent costs associated with SEC filings, production of annual and quarterly reports, conduct of annual meetings, presentations to investor groups/rating agencies/securities analysts, responding to investor inquiries and so forth. None of the costs were incurred with any objective other than to attract and maintain equity capital. Investors are unlikely to purchase equity in a firm that does not communicate performance and results after the initial investment. Consequently, as recurring costs necessary for obtaining equity financing, recovery of the full $209,000 (which represents 3/10ths of 1% of SSU's total equity) should be allowed.

Q. WITNESS MICHAEL WOELFFER ARGUES ON BEHALF OF THE MARCO ISLAND CIVIC ASSOCIATION THAT SHAREHOLDER COSTS SHOULD BE DISALLOWED FOR TWO REASONS: (1) THAT SSU IS NOT A PUBLICLY TRADED COMPANY, AND (2) THAT RECOVERY OF SHAREHOLDER COSTS INCREASES THE RETURN EARNED BY INVESTORS BEYOND THAT PROVIDED THROUGH DIVIDENDS AND SHARE VALUE APPRECIATION. DO

YOU AGREE?

A. Clearly no. The fact that SSU's shares are not publicly held, but instead are held by a firm that in turn is publicly owned, does not eliminate the cost of servicing equity capital providers. The acid test of whether or not SSU ratepayers benefit from the incurrence of these costs is to theorize what would happen if MP decided to discontinue all shareholder services. SEC violations, stock exchange delisting, devaluation of share price and the resulting flight of investors attempting to sell their positions would require SSU to seek other sources of equity capital at no doubt higher cost and in lesser quantities. Debt costs would be negatively effected and the Company would directly incur shareholder service costs if SSU was forced to access equity capital in the public markets, both of which would have to be recovered from SSU customers. There would be no assurance that sufficient equity would be available in view of SSU's inability to pay regular dividends.

Regarding the effect of shareholder cost recovery on equity investors yield, recovery of these expenses is not directly yield related, but a legitimate cost of doing business. These costs are

a necessary and prudent element of a successful utility financing program. If these costs were disallowed, and the Company continued to require equity capital for operations and plant improvements, SSU investors would be denied the opportunity to earn a fair and reasonable return as defined by the Public Service Commission, since a segment of costs necessary for the provision of utility service would go unrecovered.

Q. THE ISSUE OF RECOGNIZING ACQUISITION ADJUSTMENTS SURFACES AGAIN IN THIS CASE THROUGH THE TESTIMONY OF OPC WITNESSES LARKIN AND DERONNE. BEFORE ADDRESSING THEIR SPECIFIC CONCERNS, WOULD YOU AGAIN STATE THE COMPANY'S POSITION ON ACQUISITION ADJUSTMENTS, AND STATE HOW ACQUISITION ADJUSTMENTS IMPACT THIS CASE?

A. Yes. The Company agrees with the Public Service Commission's long standing policy since 1983 that "..... absent extraordinary circumstances, the purchase of a utility system at a premium or discount shall not effect rate base", as quoted from Order No. 25729 issued by the Commission on February 17, 1992. As I see it, the Commission has two main objectives in mind with its continuing policy: (1) to provide a needed incentive for

larger, qualified utility operators to purchase assets from less efficient and less capable owners, thus allowing the effected customers to receive the benefits of ownership transfer, and (2) to ensure that under normal circumstances, neither the acquiring company nor the customers are adversely impacted by the numerous factors that can produce a purchase price discount or premium in an arms length transaction. SSU believes that the incurrence of acquisition adjustments, both negative and positive, is inevitable in any active acquisition program. Rarely will utility assets sell for exactly their original cost (depreciated), and therefore a composite, long-term view of net purchase price must be taken. The consolidated net acquisition adjustment on SSU's books as of December 31, 1995 was less than $1 million, which represents one third of one percent of SSU's total assets and is the sum result of all acquisitions made by SSU since its incorporation in 1961. Included in this proceeding is a net $350,000 in negative acquisition adjustments that had been imposed in prior rate proceedings. No new amounts negative or positive have been requested in this case.

Q. WITNESS LARKIN CONCEDES THAT SSU'S ACQUISITIONS WERE ARMS LENGTH TRANSACTIONS AND THAT THEY DO NOT APPEAR TO BE ABUSIVE TRANSFERS. IN LIGHT OF PUBLIC COUNSEL'S TESTIMONY, DO YOU BELIEVE THAT ANY EXTRAORDINARY CIRCUMSTANCE EXISTS THAT WARRANTS A REDUCED RATE BASE?

A. No. Public Counsel witnesses do not provide evidence of any such extraordinary circumstances despite inferences to the contrary by OPC in testimony and at customer hearings. The overwhelming majority of the assets exhibiting acquisition adjustments on SSU's books have already withstood FPSC review of the issue without Commission conclusion that rate base reductions are warranted. In fact, in Order No. PSC-93-0423-FOF-WS issued in 1993 which included 127 of SSU's plants, the Commission stated that "No such [extraordinary] circumstances were shown." Similarly, in Order No. PSC-93-0301-FOF-WS, the Commission stated that in the case of the Lehigh Utilities acquisition, "Because this was a stock transaction, there was no change in rate base. Therefore no acquisition adjustment resulted."

Q. CAN YOU ELABORATE ON THE DIFFERENCE BETWEEN A STOCK TRANSFER AND AN ASSET PURCHASE, AND WHY THE

COMMISSION NOTED THE STOCK ASPECT OF THE LEHIGH ACQUISITION IN THEIR ORDER?

A. Yes. Just as the value of stock in publicly traded firms varies daily on public exchanges due to a wide variety of factors often not directly related to the value of utility assets owned by the firm, the value of stock in privately held utilities is influenced by negotiated issues and buyer/seller circumstances which cannot be quantified as a rate base adjustment. For example, a large utility buys the stock of a smaller utility which has a history of environmental non-compliance, and the acquirer is therefore able to negotiate a purchase discount related to that history.

Since the discount represents the perceived present value of recovery lag on needed plant improvements and potential transitional fines, imputation of a negative adjustment would create a double penalty for the buyer and make the risk of acquisition unacceptable. The stock can change owners numerous times at varying values during the life of the plant assets, without necessarily effecting the cost or value of those original assets to ratepayers.

Q. WHICH OF SSU'S MAJOR PLANT ACQUISITIONS WERE STOCK

TRANSACTIONS?

A. The purchases of Lehigh Utilities, Inc., Deltona Utilities, Inc., and United Florida Utilities Corporation were all stock acquisitions. These acquisitions included the following facilities in this docket: Marco Island, Marco Shores, Pine Ridge, Lehigh, Citrus Springs, Deltona Lakes, Sunny Hills and Marion Oaks.

Q. WOULD YOU PLEASE COMMENT ON THE REASONS SUGGESTED BY PUBLIC COUNSEL WITNESSES AS THE JUSTIFICATION FOR NEGATIVE ACQUISITION ADJUSTMENTS?

A. Yes. Mr. Larkin and Ms. Deronne argue that negative acquisition adjustments are appropriate because of the amount of rate increase being requested in this application, and the assumption that assets acquired at a discount typically have been poorly maintained which they suggest results in plant deterioration at a pace in excess of the approved depreciation rate(s). These opinions are inaccurate. First of all, the amount of the overall revenue requirement increase, whether large or small, cannot be tied back to any single issue. Each factor must be assessed by the PSC on its own merits and prudency. Then the Commission should step back and evaluate the larger picture for less

tangible issues such as quality of service provided, the financial health of the utility, the period of time that ratepayers have been paying less than the true cost of service, the appropriate rate design and its impact on the Company and its customers, and so forth. To argue that a sizable rate request justifies negative acquisition adjustments would suggest that a nominal increase request is justification for positive acquisition adjustments. Neither argument would have any merit.

With respect to the position that a purchase price discount evidences the purchase of facilities that have been poorly maintained and therefore original installed cost (depreciated) is no longer a good measure of used and useful rate base, is again a one-sided over-simplification. While it may sometimes be true, as Mr. Larkin points out in his testimony, that ".....previous owners were motivated generally by the desire to market real estate and did not maintain facilities in order to provide reasonable and adequate service.....", it does not automatically follow that such practices resulted in a material devaluation of assets or that the owner's maintenance record was the

principal consideration in pricing the purchase. Inefficient operating and maintenance practices can also lead to increased service costs and poor customer service, both of which can be remedied by a qualified acquirer. Pricing factors can range from financial market conditions at the time of negotiations to the seller's inability to comply with increasing environmental and economic regulations. The conclusion that can be drawn from SSU's acquisition program over the years is that SSU has acquired plants in varying condition, for varying reasons and at differing prices. This is evidenced by the low combined book acquisition adjustment relative to net plant assets as shown on the Company's audited financial statements; a netting effect, if you will, between discounts and premiums. The question of whether Mr. Larkin extends his poor maintenance discount theory to a superior maintenance premium for life extension goes unanswered in his testimony. It also must be noted that none of Public Counsel's witness identify facts which would classify any of SSU's plant or facilities in this category. To conclude, the fundamental issue remains unchanged from the Commission's original 1992 analysis: Is it

desirable for qualified, proven service providers to acquire plants owned by individuals or firms who are unwilling or unable to provide the level of investment, compliance and service needed by the various constituents of a water/wastewater utility? The answer is yes, and imposition of a negative acquisition adjustment in the absence of extraordinary circumstances would discourage such transfers.

Q. WHAT ARE SOME OF THE EXPECTED CUSTOMER BENEFITS THAT RESULT FROM ACQUISITION OF SMALL UTILITIES BY LARGE UTILITIES?

A. The FPSC has generally recognized, and SSU has specifically demonstrated, the following benefits:

1) improved service;

2) ability to attract capital;

3) a lower cost of capital;

4) the ability to make improvements;

5) more professional and experienced managerial, financial, technical and operational resources; and

6) compliance with regulatory requirements.

Q. WOULD YOU FURTHER DESCRIBE THESE BENEFITS?

A. Small utilities which are acquired by larger utilities usually have some typical characteristics, often traceable simply to the size

of the utility. They are unable to attract outside capital on their own financial strength. Where small utilities can attract capital, often because of personal guarantees and other commitments of the stockholders, the nominal cost rate for the capital is high due to the associated risk of the investment, and the effective cost of undertaking the financing is high in relation to the amount of the financing. A large utility, such as SSU, is able to attract capital in economically efficient quantities, and at a lower effective cost.

The cost of operations, in absolute dollars and on a per customer basis, for small utilities is high because they lack economies of scale. Large utilities, such as SSU, are often able to operate the smaller plants at a lower cost because they are able to take advantage of economies of scale as well as spread costs over a larger customer base. These economies of scale also enable larger utilities to employ highly trained and experienced people, usually not available to smaller utilities.

It is obvious that small utilities find it difficult and in many cases impossible to make service improvements. The larger utilities, such as SSU, have been able to make service improvements.

Moreover, to the extent that the larger utilities are continually expanding their customer base, the economies of scale continually improve to the benefit of all of their customers.

Q. HAS THE FPSC ACKNOWLEDGED THE ABOVE DESCRIBED BENEFITS?

A. I believe that it has. I believe it is fair to say that every time the FPSC approves the acquisition of a small utility by a large utility, it does so because that acquisition was found in to be in the public interest which we believe is in the best interest of the utilities and customers involved and, perhaps, the environment. In fact, in the past the FPSC has specifically noted the improvements the customers of small plants experience from the acquisition of the facilities serving them by SSU. This also applies to the acquisition of larger facilities owned by financially unstable entities. For example, in FPSC's Order transferring control of Deltona Corporation's utility subsidiaries to SSU's parent, the Commission stated: "The Topeka Group, Inc. has the technical and financial capability to operate the Deltona Corporation's utility subsidiaries." This was at a time when Deltona was under severe

financial pressures and its "financial capability" was in serious question.

Q. ARE YOU AWARE OF ANY ACTIVITIES OF OTHER STATE REGULATORY COMMISSIONS RELATING TO ACQUISITION ADJUSTMENTS?

A. Yes. The New York Public Service Commission ("NYPSC") concluded an investigation into "Acquisition Incentive Mechanisms" ("AIMs") for the acquisition of small utilities by larger utilities. The NYPSC's "Order Instituting Proceeding and Soliciting Comments" which I will refer to as the "Order Instituting Proceeding" was issued on November 10, 1993 as well as the NYPSC's Statement of Policy on Acquisition Incentive Mechanisms For Small Water Companies, which was issued on August 8, 1994 are attached hereto as Exhibit _____ (SWV-4). Reference to the Order Instituting Proceeding reveals that prior to the proceeding the NYPSC policy was to impose negative acquisition adjustments. The Staff memorandum supporting the Order Instituting Proceeding indicates that the result of such a policy is to discourage acquisitions. I know that such a policy in Florida would have a significantly adverse impact on SSU's prospective acquisitions. With the changes

occurring in the water industry, i.e., privatization, large utility sales, regionalization of water supplies, consolidation of small service providers, etc., there are a number of opportunities available to SSU and similarly situated utilities, both inside and outside of Florida, which offer SSU and our customers growth and the benefits resulting therefrom. To date, Southern States has acquired utilities of all sizes. Our expertise with owning and operating plants and maximizing efficiencies in such operations has been proven.

Q. ARE THERE ANY OTHER STATES THAT DISCOURAGE NEGATIVE ACQUISITION ADJUSTMENTS?

A. Yes. Attached as Exhibit _____ (SWV-5) is a copy of an article entitled, "The PUC Role in Assuring Viable Water Service In Small Communities" by John E. Cromwell, III and Wade Miller Associates, Inc. which discusses the broader issue of large utility acquisitions of small utilities. Of particular note in this article are the findings on page 13 of 17 of the exhibit, wherein the authors state:

"In many states, there are large investor-owned water companies that own and operate a number of large and small systems throughout the state or

within certain regions of the state. In some cases, this takes the form of a privatized approach to regionalization. In some cases, PUCs have approved single tariff rates for such situations which allows the company to incorporate systems that might not be economically viable within a regionalized scheme and which also reduces the burden of rate case filings to one unified application for the entire regional operation.

A final significant area of PUC involvement is in regulating any transactions involving the transfer of ownership between two private water companies or between a private company and a publicly owned company. Such ownership transfers may be integral to the success of regionalization schemes. There are many situations, such as the municipal/suburban boundary case that we just discussed, in which publicly owned and privately owned systems exist in a contiguous polka-dot pattern. The difference in ownership status can present one of the most formidable barriers to regionalization. Historically, PUCs have applied a complicated set of iron-clad rules to the evaluation of ownership transfers in an effort to protect the public from being charged too much when

depreciated plant and equipment changes hands. This is another area where PUC policies need to be revisited in order to assess whether the benefits of such regulatory protection outweigh the costs of possibly missing the opportunity to put regionalized solutions in-place that will provide a more viable long-term approach to providing quality service. Pennsylvania, Connecticut, and several other states have enacted more liberal merger and acquisition adjustment laws which enable progress in the right direction. Connecticut has enacted laws which permit the PUC to authorize slightly higher rates of return on investments related to certain acquisitions."

The proposal by Public Counsel that the Commission impose negative acquisition adjustments in this proceeding, particularly on the basis of the arguments provided by Public Counsel's witnesses, would make Florida's water services environment a poor contrast to the states mentioned above in matters relating to public benefit from ownership transfers.

Q. WILL SSU RECEIVE A WINDFALL IF RATE BASE IS NOT REDUCED BY NEGATIVE ACQUISITION ADJUSTMENT, AS MR. LARKIN AND MS. DERONNE SUGGEST?

A. No, the perception that Public Counsel is attempting to create that the Commission's policy gives SSU something for nothing is a false perception.

The complexities of the water industry cannot be ignored. SSU is at risk each time that we acquire a plant. The tightening of water quality standards makes compliance with the myriad of water quality rules and standards much more demanding. The fines are at shareholder risk. Additional operating costs and possible capital investment from any violations also are at the expense of the stockholder until a rate case can be prepared, processed and a final order obtained. On the other hand, SSU can offer our existing customers the benefits I previously described.

Q. PLEASE SUMMARIZE YOUR VIEW OF THE PROPOSAL TO IMPOSE NEGATIVE ACQUISITION ADJUSTMENTS WHEN ESTABLISHING RATE BASE.

A. Utilities are entitled to a return on the net investment of the property devoted to public service. The cost of that property is, by definition, the original cost to the person first devoting the property to public service. The term "original cost" is a term of art in the area of

public accounting. James Bonbright in his book on utility ratemaking, Principles of Public Utility Rates (1988), at page 237, defines original cost as the cost of an asset when first devoted to the public service rather than the cost to a transferee utility. SSU agrees with Bonbright at page 240 of his book that while the "purchase price may be considered a cost, it does not represent a contribution of capital to the public service. Instead, it represents a mere purchase by the present company of whatever legal interests in the properties were possessed by the vendor." SSU also agrees with the analysis performed for the Commission by Ms. Denise N. Vandiver, Public Utilities Supervisor, in a paper entitled "Accounting for Acquisition Adjustments" dated November, 1991 wherein Ms. Vandiver recognizes that since many small facilities are purchased for little or no capital investment, a large utility like SSU would have little incentive to purchase and operate the plant if allowed only a return on the investment as limited by the purchase price. In my opinion, ratesetting with respect to this issue is a one-way street. The minimum the acquiring utility is entitled to is a return on the

original cost of the property first devoted to public use and if for the good of the public, in terms of improved service, ultimately lower full-recovery rates or other such circumstances, a positive acquisition adjustment is warranted the regulatory agency may allow that positive acquisition adjustment. On the other hand, a negative acquisition adjustment is simply confiscatory.

Aside from my opinion about regulatory restrictions against negative acquisition adjustments, such adjustments are simply not in the best interest of the customers. The signal to utilities would clearly result in a disincentive for large utilities to acquire small utilities. The customers of small non-viable utilities would continue to experience poorer service and higher rates than would otherwise be the case. In addition, negative acquisition adjustments would continually increase the burden on regulatory agencies including environmental regulators, associated with the resources necessary to cope with the problems caused by more and more aging utilities.

Q. GIVEN YOUR AGREEMENT WITH THE FPSC'S LONG STANDING

POLICY TO EXCLUDE ACQUISITION ADJUSTMENTS FROM RATE BASE DETERMINATION, ARE PUBLIC COUNSEL'S PROPOSED ADJUSTMENTS TO ACCUMULATED AMORTIZATION OF ACQUISITION ADJUSTMENTS AND ANNUAL AMORTIZATION OF ACQUISITION ADJUSTMENTS APPROPRIATE?

A. No. Only the amounts shown in the MFRs as previously approved by the FPSC should be considered.

Q. IN EXHIBIT _____ (HL-1), MR. LARKIN FOCUSES ON TWO OF SSU'S LARGER ACQUISITIONS AND FORMULATES HIS OWN ACQUISITION ADJUSTMENT IN SHARP CONTRAST TO SSU'S AUDITED FINANCIAL STATEMENTS. DO YOU HAVE ANY OBSERVATIONS REGARDING HIS METHODOLOGIES AND CONCLUSIONS?

A. Yes. Beginning with the proposed negative acquisition adjustment to SSU's Lehigh assets, the central premise of OPC witness Larkin, which is later echoed by witness Dismukes, is that in this transaction the purchase discount negotiated by SSU's parent when it simultaneously acquired real estate holdings should benefit utility ratepayers. Raymond James and Associates (RJA), issued an August 8th 1991 opinion concerning the purchase price of the utilities, specifying why the utility acquisition price is separate and distinct from the

real estate component values.

Because of the wide variation in business character and risk existing between the assets purchased from the Resolution Trust Corporation (RTC), RJA was asked by the Board of Topeka Group, Inc. to act as outside advisor on the allocation of the purchase price between those assets. The principal categories of acquired assets were lot sales receivables, real estate related fixed assets, two golf courses, buildings, land, and the utility. Although Mr. Larkin provides no rationale or evidence to support his presumption that all assets acquired in the purchase would command identical discounts or premiums if purchased separately, his proposed negative acquisition adjustment methodology relies solely on that premise. In view of the facts that (1) an outside investment bank opinion has been provided to the contrary, (2) the identical issue was thoroughly reviewed by the Commission in Docket 911188-WS without adjustment in the final order, (3) the assets in question are in totally different industries -- real estate versus water utility -- which demonstrate drastically different risk profiles, (4) the Commission's consistent policy

has been to value assets at original cost, (5)the acquisition of Lehigh Utilities, Inc. was a stock transaction, and (6) that no new evidence has been offered by OPC that suggests the circumstances have somehow changed, Public Counsel's proposed $3.8 million negative adjustment to rate base must be rejected. I also note that had Topeka paid a premium for the Lehigh real estate assets, it is questionable whether Mr. Larkin would be recommending the same price allocation methodology.

Regarding Ms. Dismukes' related adjustment of $11,561 for a parcel of land acquired from Lehigh by SSU subsequent to Topeka's acquisition of Lehigh; just as SSU ensures that all inter-affiliate transactions such as our purchase of services from MP are at arms length and fair market values, Lehigh Corporation is under no obligation to sell real estate to SSU at any price other than fair market. Prudent steps were taken by SSU at the time of parcel acquisition to ensure that prices were competitive.

Q. TURNING TO THE DELTONA ACQUISITION, MR. LARKIN STATES THAT ".....NON-CASH OUTLAYS AND THE SETTLEMENT AMOUNTS SHOULD BE EXCLUDED FROM THE PURCHASE PRICE PAID FOR THE PURPOSE OF CALCULATING

THE ACQUISITION ADJUSTMENT." SHOULD THEY BE EXCLUDED?

A. No. The non-cash outlay referred to in Mr. Larkin's testimony relates to an accrued dividend on convertible preferred stock which was the vehicle for the utilities purchase. In 1985, Topeka Group purchased $22 million of cumulative preferred stock which was convertible into stock of either Deltona Corporation, or the stock of Deltona's utility subsidiaries. The dividend was to accrue between the time of stock issuance and the time of conversion. The value of the original investment, plus the liability of Deltona Corporation for accrued dividends payable at the time of stock conversion, was called the exchange value. That value, along with the $7 million settlement payment and the assumption of $30 million in utility debt made up the underlying purchase price. The non-cash accrued dividend represented the time value of money for the four year period prior to purchase. An analogy would be the accrued interest on a bank loan. If a borrower makes annual interest payments, the bank accrues and books the interest due until the next payment is made. Just because the bank has not received

cash interest in the interim, does not mean that the receivable has no value. Had Topeka structured the transaction such that Deltona were required to pay the dividend in cash at closing, and then had simultaneously turned around and used the cash to purchase the utility stock, the end result would have been the same. Such a structure was unnecessary since conversion was required under the purchase agreement.

Acceptance of the above, in and of itself, totally eliminates the negative acquisition adjustment according to the calculations exhibited by Mr. Larkin. Nevertheless a brief comment on his second adjustment, disallowance of the $7 million settlement payment is warranted. When Topeka exercised its conversion rights, the purchase was challenged by Deltona Corporation. In dispute were a number of issues including intercompany obligations, real estate needed for future utility expansion, and continuing line extension responsibilities relative to outstanding lot sales contracts. The settlement agreement, executed in November of 1989, resolved these issues and others through the payment to Deltona of $7 million as additional compensation for the utility purchase,

including the real estate received by the utilities from the purchase. For these reasons, it would be inappropriate to arbitrarily discount rate base by an equivalent amount.

In both the Lehigh and Deltona cases, the Commission found the transfers of ownership to be in the public interest. In addition, both acquisitions were subsequently viewed by the Commission as including certain amounts of non-used and useful assets. To the extent that these assets are funded by cost capital, they can be viewed as further premiums paid by Topeka for the utilities. SSU has been audited annually by the public accounting firm of Price Waterhouse every year since the acquisition of the Lehigh and Deltona facilities. No acquisition adjustments of the nature proposed by Mr. Larkin have been required or recommended. Finally, as I stated previously, both of these acquisitions were accomplished as stock purchases. For this reason alone, no negative acquisition adjustment would be appropriate.

Q. MS. DISMUKES RELIES ON A DEPOSITION OF SSU VICE PRESIDENT CHARLES SWEAT TO SUPPORT HER PROPOSED DISALLOWANCE OF $186,652 OF EXPENSES INCURRED BY MR. SWEAT'S DEPARTMENT. SHOULD THOSE EXPENSES BE

EXCLUDED FROM THIS CASE?

A. No. Ms. Dismukes was apparently referring to the following exchange from the deposition:

> **Q. (PUBLIC COUNSEL): WHAT PERCENT OF YOUR TIME WOULD YOU SAY IS INVOLVED IN THE ACQUISITION AND POSSIBLE DIVESTITURE OF SYSTEMS FOR SERVICE AREAS?**
>
> A. (Sweat): At the present time about 90%.

From that statement, Ms. Dismukes concludes that Mr. Sweat's department spends 90% of their available time throughout the year on acquisitions and divestitures. At the time of the deposition, Mr. Sweat was actively involved in the Orange Osceola Utilities acquisition. The commitment of resources in his department varies significantly over time, depending on prospective transactions under consideration. As has been the Commission's past practice, time sheets should remain the principal determinant of historic time spent on acquisition activities. It is reasonable to expect that during 1996 Mr. Sweat, Mr. Devore and Ms. Helcher would spend 50% of their time on acquisition related activities.

Q. IN HIS TESTIMONY ON BEHALF OF THE MARCO ISLAND CIVIC ASSOCIATION, MR. MICHAEL WOELFFER PROPOSES THE CALCULATION OF A STAND-ALONE COST OF DEBT FOR THE MARCO ISLAND CUSTOMERS. IS THIS PRACTICAL?

A. No. Mr. Woelffer accurately quotes my position on stand-alone plant capital costs from MICA Interrogatory No. 5, a copy of which is contained in Exhibit _____ (SWV-6). It is not possible to calculate a true stand-alone cost of debt for any SSU service area. Mr. Woelffer's proposal stems from the fact that private activity bonds, such as those issued through the Collier County Industrial Development Authority, are project related. In order to qualify for State allocation of tax-exempt issuing authority, SSU must commit the related funds to site specific projects. What is not understood by Mr. Woelffer is that SSU's ability to secure those funds does not end with the granting of issuance authority. In the case of the two series of bonds referenced in Mr. Woelffer's testimony, credit support was required to ensure marketability through a strong credit rating. That support was provided to SSU, not the Marco assets, in the form of letters of credit from a large regional lending institution. That institution

based its willingness to provide that letter on a credit review of SSU in total, not on the creditworthiness of the assets on Marco Island. In addition, the bank required a guarantee from SSU's parent company, Topeka Group, Inc. Topeka provided that guarantee to SSU, not to assets on Marco. SSU is the legal entity with which all parties to the issuance, including the Collier County Industrial Development Authority, executed documents. None of the parties would enter into an agreement with an asset as opposed to a legal obligor, yet this is what Mr. Woelffer suggests. The parties' willingness to contribute to the successful issuance was predicated on SSU being the obligor. If the Marco assets were to truly 'stand-alone', none of the advantages of affiliation with SSU and its combined operations and customer base could be considered in evaluating what an appropriate debt rate should be. The fundamental question is; if it were possible to issue truly stand-alone debt for the Marco Island assets, would the availability, terms and rates have been the same as those reflected in the 1990 and 1992 Collier Series? The answer is clearly no. The assets owned by SSU on Marco Island do not establish their own debt rates

any more than SSU's statewide vehicle fleet or its Apopka general office facilities do. It should also be noted that the customers on Marco Island benefited from a system-wide capital structure during the years that the 15.5% Deltona Utility First Mortgage bonds were outstanding (1984 - 1994). Those bonds were issued by Deltona Utilities, Inc., the original owner of the Marco Island assets, and therefore, under Mr. Woelffer's theory, should have been dedicated to Marco, Spring Hill and Deltona only, as opposed to all SSU customers, which thereby would have caused an increased weighted debt cost for Marco.

Q. IN HER SUPPLEMENTAL DIRECT TESTIMONY, MS. DISMUKES REFERS TO A LETTER WRITTEN BY MS. LAURA HOLQUIST OF LEHIGH CORPORATION TO THE LAW FIRM OF BRIGGS AND MORGAN IN ST. PAUL, MINNESOTA. THIS LETTER DISCUSSED LEHIGH CORPORATION'S EFFORTS TO ACCESS ESCROWED FUNDS COLLECTED FROM LOT BUYERS IN NEW YORK AND MICHIGAN. ARE THESE THE SAME ESCROW FUNDS THAT WERE REVIEWED IN LEHIGH UTILITIES 1993 RATE CASE?

A. Yes. In that case, the Commission found the escrow funds to be unrelated to rate base since Lehigh Utilities was not a party to the escrow agreements

and did not receive money from the accounts.

Those facts remain unchanged today.

Q. HAS ANYTHING CHANGED SINCE THE COMMISSION LAST REVIEWED THIS ISSUE?

A. Yes. Lehigh Utilities, Inc. was merged into Southern States Utilities, Inc., with SSU as successor to all LUI commitments. Second, SSU, as successor, entered into a modification to the original Lehigh Corporation developers agreement.

Q. CAN YOU DESCRIBE THE TERMS OF THE MODIFICATION AGREEMENT ADDRESSED BY MS. DISMUKES?

A. Yes. The changes to the terms of the original developers agreement addressed by Ms. Dismukes are the segregation of major utility facilities constructed with the use of escrowed funds by Lehigh and the introduction of a utility fee credit to be applied against service availability fees paid by escrow contributors.

Q. DO THESE MODIFICATIONS ALTER THE FACT THAT SSU IS NOT A PARTY TO THE ESCROW AGREEMENTS?

A. No.

Q. CAN SSU NOW ACCESS THE ESCROW FUNDS?

A. No.

Q. WHY THEN IS MS. DISMUKES SUGGESTING THAT CIAC SHOULD NOW BE IMPUTED ON ALL ASSETS CONSTRUCTED

WITH THESE ESCROWED FUNDS WHEN THE COMMISSION DISAGREED IN THE LAST CASE?

A. Ms. Dismukes' repeated premise is that funds drawn from the escrow accounts by Lehigh and invested in utility assets should be considered CIAC. She fails to point out that these assets are already offset in rate base calculations either as refundable advances or, ultimately, as CIAC when the service availability fees are received from the customer and used to refund the developer liability. In addition, at the end of the recoupment period, the advances that remain unfunded automatically revert to developer contributions. The investment cycle is one where the assets are originally transferred to SSU as non-used and useful property funded by "no cost" developer advances, which are then converted to either in-service assets funded by customer contributions, or remain unused assets funded by developer contributions. At no point are the assets included in rate base without the offsetting no-cost funding, either CIAC or advances.

Q. **WHAT ABOUT THOSE CUSTOMERS FROM NEW YORK AND MICHIGAN WHO CONTRIBUTED TO THE ESCROW ACCOUNTS, AREN'T THEY PAYING TWICE FOR UTILITY EXTENSIONS?**

A. No. That's why the utility fee credit provision was included in the modification to the developers agreement. When a New York or Michigan customer connects to assets funded by the escrow funds, SSU has agreed to provide a credit against his normal service availability fee equal to the amount of money s/he paid into the escrow fund, along with interest through March 31, 1994, the date of execution by Lehigh Corporation of supplements to the New York and Michigan Escrow Agreements. SSU in turn will invoice Lehigh Corporation for the credit amount. If Lehigh is unable to reimburse SSU, SSU and Lehigh's common parent has agreed to reimburse SSU. The credit attaches to and runs with the title to the homesite, even though Lehigh had obtained a legal opinion that no such credit was required.

Q. AT A FORT MYERS SERVICE HEARING, A CUSTOMERS QUESTIONED WHETHER THE STATES OF NEW YORK AND MICHIGAN APPROVED THESE ARRANGEMENTS. DID THEY?

A. Yes. Lehigh Corporation was required to get the approval of New York and Michigan and did so.

Q. WHAT ARE THE CURRENT BALANCES IN THE ESCROW ACCOUNTS, HOW MUCH HAS SSU REFUNDED TO LEHIGH, AND HOW MUCH HAS SSU PROVIDED IN UTILITY FEE CREDITS AS

OF YEAR END 1995?

A. As of December 31, 1995, the combined New York and Michigan escrow balances were $4,573,000. No escrow funded assets had been transferred to SSU and therefore no advance refunds or utility fee credits had been issued. It is expected that escrow asset transfers will begin in 1996.

Q. MS. DISMUKES ALLEGES THAT THERE IS NO BENEFIT TO SSU CUSTOMERS THROUGH UTILIZATION OF THE ESCROWED FUNDS WHILE THERE IS A SIGNIFICANT BENEFIT TO MINNESOTA POWER'S UNREGULATED OPERATIONS. IS THAT TRUE?

A. No. It is SSU's responsibility to ensure that in the case of Lehigh Corporation's development activities, customers are not harmed economically or in quality of service, and that any assets accepted from the developer as part of the original developer agreement, as modified, meet required engineering standards. The extent to which a developer's plans and activities benefit lot and home owners, or the development corporation for that matter, through changes in real estate values, community character, etc., is relevant to the utility only with respect to the increased customer base over which the cost(s) of service are spread,

helping keep per customer costs low.

Q. MS. DISMUKES IMPLIES THAT AS THESE FUNDS ARE INVESTED IN COLLECTION AND DISTRIBUTION FACILITIES, SSU WILL CONSTRUCT OVERSIZED CENTRAL PLANT TO SERVICE THESE NEW CUSTOMERS. CAN YOU COMMENT ON THAT ASSERTION?

A. The addition of new customers typically places increased demands on central plant. The appropriate sizing of plants and the amount of those additions eligible for inclusion as used and useful facilities is a question which is thoroughly reviewed by qualified engineering experts in each rate proceeding. Lehigh Corporation's use in the future of escrow funds for utility construction has minimal, if any, relevance to the issue.

Q. DO YOU AGREE WITH THE CONCLUSIONS OF MS. DISMUKES THAT THE ESCROW FUNDS SHOULD BE A CONSIDERATION IN THE PSC'S DELIBERATIONS ON NEGATIVE ACQUISITION ADJUSTMENTS?

A. No. As stated earlier in my testimony, the Commission policy that acquisition adjustments are inappropriate unless extraordinary circumstances exist still applies. Since the customers are not harmed by Lehigh Corporation's use of escrow funds, as confirmed by the fact that the States of New

York and Michigan approved the arrangement, and customers may indeed benefit from customer growth generated from the use of those funds, no extraordinary circumstances exist.

Q. WERE YOU INVOLVED ON BEHALF OF SSU IN THE PURCHASE OF THE COLLIER LAKES LOCATED ON COLLIER COUNTY?

A. Yes. At the time of the condemnation, I was the acting President of SSU with primary responsibility for the settlement of the condemnation action which SSU was forced to initiate to secure the property.

Q. COULD YOU DISCUSS THE TERMS OF THE SETTLEMENT OF THE CONDEMNATION ACTION BETWEEN THE PROPERTY OWNER AND SSU?

A. Yes. SSU and the owners of the property, who I will refer to as the Colliers, agreed that SSU would purchase the property at a wrap around cost of $8 million. By wrap around cost I mean that the $8 million represented payment for a <u>total</u> settlement of all issues relating to the condemnation and use of the lakes, after acquisition, as a source of public water supply. As the commission may be aware, the condemnor in a condemnation action, in this situation, SSU, is obligated to pay court costs, witness fees and attorneys fees of both the condemnee as well as its

own costs. The $8 million represented payment in full of all costs which could then or ever after be claimed by the Colliers.

Q. DOES SSU BELIEVE THAT IT PAID A FAIR AND REASONABLE PRICE FOR THE COLLIER LAKES?

A. Yes. Confusion over the price we paid for the lakes may have arisen in part through unfamiliarity with the process. In addition to SSU being required to pay the Colliers' court costs, interest, witness fees and attorneys fees, SSU had to pay the Colliers a value equal to what a willing buyer and a willing seller would pay for the property at arms length if all pertinent facts were known to the parties. SSU originally had to pay the Colliers a good faith deposit of $4.1 million to continue using the property as a continued water supply source after December 31, 1994 - the date our water lease with the Colliers expired. SSU's appraisers and experts did not have access at that time to the property owned by the Colliers which adjoins the property we condemned, known as the parent tract, or to other information necessary for the determination of severance value which the Colliers and the market might place on the property.

As is typical in condemnation actions, it was only after the condemnation action was begun that SSU's experts and appraisers obtained the information necessary to determine the market value of the property we were taking based on the Collier's intended use.

Q. COULD YOU DESCRIBE THE DIFFERENCES IN VALUE ASSIGNED BETWEEN SSU'S EXPERTS AND APPRAISERS AND THOSE USED BY THE COLLIERS?

A. For this purpose I refer primarily to the testimony of SSU witnesses Robert Dilg, Esq. of the law firm of Gray, Harris & Robinson, a condemnation expert and SSU's legal expert in the case, and Gerald C. Hartman, P.E., SSU's engineering expert in this case with experience in numerous utility condemnation actions in several states. Also, attached as Exhibit _____(SWV-7) is a copy of the letter SSU received from our land appraiser, Hanson Appraisal Company, Inc., which discusses the value difference between the experts for both sides and recommends that SSU settle the case for a wrap around price of $8 million. I also note that Mr. Dilg and Mr. Hartman also are presenting the Commission with copies of their respective analyses of the case and their opinions and recommendations

to SSU with respect to price.

Q. ARE YOU AWARE OF ANY CIRCUMSTANCES WHICH LEAD YOU TO BELIEVE THAT A WRAPAROUND SETTLEMENT OF $8 MILLION WAS PRUDENT AND REASONABLE?

A. Yes. In addition to the independent expert opinions mentioned above, SSU has been involved in condemnation actions in the past as a condemnee. Therefore, we have experience in these matters, particularly regarding the magnitude of the court costs, witness fees, attorneys fees, interest and other costs which the condemnor has to reimburse to the condemnee. We also are aware of the risks involved in pursuing the case through trial. For instance, in February 1996, a condemnation action filed by Sarasota County against Atlantic Utilities, Inc. went to jury trial. Sarasota County, the condemnor, offered evidence that the property was worth approximately $9 million. The utility presented evidence that the property was worth at least $22 million. The jury award was $17.5 million -- nearly twice the value suggested by the County. Since the case was not settled and went to trial, the utility/condemnee' fees and costs, which must be paid by the condemnor/county, are estimated to be in the neighborhood of $2

million. The County's fees and costs have been indicated to be more than $2.0 million. Therefore, the County's costs of pursuing the condemnation through trial was at least $21.5 million -- almost 2.5 times the County's believed value of the property. Settlement of the case was available to the County, but the County chose to go to trial.

SSU also keeps abreast of other condemnation actions across the state and nation, such as the price paid by Charlotte County to condemn the General Development Utilities facilities in that county. There, the County was forced to pay GDU approximately twice the value the County originally placed on the property.

Based on these facts, SSU's experience in condemnation actions in the past, SSU's knowledge of the facts and circumstances in this case, and the opinions and recommendations of SSU's experts and counsel, SSU determined that settling the case at a wrap around price of $8 million was prudent and reasonable.

Q. DOES THAT COMPLETE YOUR REBUTTAL TESTIMONY?

A. Yes it does.

Company: Southern States Utilities, Inc.

Supplemental Schedule B-12
Page 1 of 2
Preparer: Scott W. Vierima

Docket No.: 950495-WS
Test Years Ended: 1994, 1995, 1996

Explanation: In addition to costs reported on Schedule B-12, provide information on costs allocated or charged to the Company from a parent, affiliate, or related party.

Line No.	Account No.	Description	Charging Entity	Direct or Apportioned	Apportionment Method	Total Cost if Apport.(1995)	> 1% of Revenues	Actual 1994	Budgeted 1995	Projected 1996	
1	1620-2000	*Prepaid Insurance*	TG (2)	*Apportioned*	Broker Assigned	992,774	No	120,408	106,956	109,042	(1)
2	6328-0000	*Contractual Services - Acctng*	TG (2)	Direct	////////////	////////////	No	47,237	77,940	79,460	(1)
3	6358-0000	*Contractual Services - Other*	TG (2)	Direct	////////////	////////////	No	313,124	33,671	34,328	(1)
4	6358-0000	*Shareholder Services*	TG (2)	*Apportioned*	Invested Equity	995,892	No	232,379	204,783	208,776	(1)
5		*Subtotal (6358)*						545,503	238,454	243,104	
6	1861-0000	*Deferred Rate Case Costs*	TG (2)	Direct	////////////	////////////	No	16,224	30,000	30,000	(3)
7	4280-0000	*Credit Support Fees*	TG (2)	Direct	////////////	////////////	No	92,753	136,450	121,931	
								822,125	589,800	583,536	
		One percent (1%) of audited\budgeted total Company revenues :						546,619	557,642	////////////	

1003

(1) All affiliate charges for 1996 indexed from 1995 budget at the rate of 1.95%, the general index rate approved by the FPSC in Order No. PSC-95-0202-FOF-WS (Issued 2-10-95).
(2) TG = Topeka Group Incorporated, owner of 100% of Southern States Utilities, Inc. common stock.
(3) Estimate for instant docket spread between 1995 and 1996.

Attachments per FAC 25-30.436 (4)(h):
h4) apportionment method workpapers
h5) direct charge workpapers
h6) organizational chart
h7) copies of existing interaffiliate agreements

EXHIBIT (SWV-3)
PAGE 1 OF 16

SOUTHERN STATES UTILITIES, INC.
DOCKET NO.: 950495-WS
RESPONSE TO INTERROGATORIES

REQUESTED BY:	OPC
SET NO:	1
INTERROGATORY NO:	42
ISSUE DATE:	07/18/95
WITNESS:	SCOTT W. VIERIMA
RESPONDENT:	Scott Vierima

INTERROGATORY NO: 42

For costs from MPL which are charged or allocated costs to the Company, state the annual amount of such costs charged to the Company, by account, for each of the past four years and as budgeted for 1995 and 1996.

RESPONSE: 42

Attached as Appendix 42-A is Supplemental Schedule PC-1, reproduced from Volume II, Book 2 of 4 in the MFR's for Docket #950495-WS. This schedule shows amounts billed to SSU by its parent(s) Minnesota Power and Topeka for services rendered during 1994, and projected billings for 1995 and 1996. Also attached as Appendix 42-B is a listing of total annual billings from MP/Topeka for the retrospective years of 1991, 1992 and 1993, sorted by account to which the billings were charged.

PARENT COMPANY CHARGES - Summary

Company: Southern States Utilities, Inc.

Docket No.: 950495-WS
Test Years Ended: 1994, 1995, 1996

Explanation: In addition to costs reported on Schedule B-12, provide information on costs allocated or charged to the Company from a parent, affiliate, or related party.

FPSC

Supplemental Schedule PC-1
Page 1 of 2
Preparer: Scott W. Vierima

Line No.	Account No.	*Description*	Charging Entity	Direct or Apportioned	Apportionment Method	Total Cost If Apport (1995)	> 1% of Revenues	*Actual 1994*	*Budgeted 1995*	*Projected 1996*
1	1620-2000	*Prepaid Insurance*	TG (2)	*Apportioned*	Broker Assigned	992,774	No	120,408	106,956	109,042 (1)
2	6328-0000	*Contractual Services - Acctng*	TG (2)	Direct	////////////////////	////////////////////	No	47,237	77,940	79,480 (1)
3	6358-0000	*Contractual Services - Other*	TG (2)	Direct	////////////////////	////////////////////	No	313,124	33,671	34,328 (1)
4	6358-0000	*Shareholder Services*	TG (2)	*Apportioned*	Invested Equity	995,892	No	232,379	204,783	208,776 (1)
5		*Subtotal (6358)*						545,503	238,454	243,104
6	1861-0000	*Deferred Rate Case Costs*	TG (2)	Direct	////////////////////	////////////////////	No	16,224	30,000	30,000 (3)
7	4280-0000	*Credit Support Fees*	TG (2)	Direct	////////////////////	////////////////////	No	92,753	136,450	121,931
								822,125	589,800	583,536
					One percent (1%) of audited\budgeted total Company revenues :			546,619	557,642	////////////////

(1) All affiliate charges for 1996 indexed from 1995 budget at the rate of 1.95%, the general index rate approved by the FPSC in Order No. PSC-95-0202-FOF-WS (Issued 2-10-95).
(2) TG = Topeka Group Incorporated, owner of 100% of Southern States Utilities, Inc. common stock.
(3) Estimate for instant docket spread between 1995 and 1996.

Attachments per FAC 25-30.436 (4)(h):
- h4) apportionment method workpapers
- h5) direct charge workpapers
- h6) organizational chart
- h7) copies of existing interaffiliate agreements

EXHIBIT (SWV-3)
PAGE 3 OF 16

Parent Company Charges - Detail
Company: Southern States Utilities, Inc.
Docket No.: 950495-WS

FPSC

Supplemental Schedule PC-1
Page 2 of 2

Incurred Cost	*Actual 1994*	*Budget 1995*	*Projected 1996*	*Comments*
Board & Officer Costs	177,418	20,000	20,390	Labor and benefits for SSU CEO billed by MP in 1994.
Investment & Analysis	9,194	0	0	Budgeted in 1995 as offset to yield on MP portfolio.
Corporate Finance & Admin.	5,380	6,000	6,117	Forecasting, financing and credit support work.
Corporate Accounting	11,051	10,997	11,211	Recurring services for budgeting, general and property accounting.
Internal Audit	16,303	49,169	50,128	Two operational audits rescheduled from 1994 to 1995.
Tax	19,883	17,774	18,121	Includes Federal and State return preparation.
Environmental Services	15,887	7,671	7,821	Reduced needs due to improved on site audit/lab capabilities
Organizational Development	5,541	0	0	No OD projects scheduled for 1995,1996.
Corporate Development	87,845	0	0	Acquisition related costs, normally capitalized, inestimable.
Shareholder Services	232,379	204,783	208,776	Changed allocation factors as a function of equity invested.
Prepaid Insurance	120,408	106,956	109,042	Improved market conditions and modified primary coverage.
Rate Case Assistance	16,224	30,000	30,000	Cost estimate for 1995 consolidated filing divided 95-96.
Other (IS, Legal, HR)	11,859	0	0	Reduced needs due to improving internal capabilities.
SUBTOTAL	*729,372*	*453,350*	*461,605*	
Credit Support Fees	92,753	136,450	121,931	Increase due to LOC guaranty for $10.3MM Volusia Cty Bond.
TOTAL BILLINGS	*822,125*	*589,800*	*583,536*	

EXHIBIT (SCW-3)
PAGE 4 OF 12

SOUTHERN STATES UTILITIES, INC.
RESPONSE TO REQUEST FOR PRODUCTION OF DOCUMENTS
DOCKET NO.: 950495-WS

REQUESTED BY:	OPC
SET NO:	1
DOCUMENT REQUEST NO:	79
ISSUE DATE:	07/18/95
WITNESS:	SCOTT W. VIERIMA
RESPONDENT:	Scott Vierima

DOCUMENT REQUEST: 79

Provide a copy of any documentation and/or policy and procedures manual which addresses how costs are allocated between the Company and its parent companies, affiliates, and/or subsidiaries.

RESPONSE: 79

In compliance with FAC 25-30.435 (Revised), SSU included in its Application for Rate Increase the following information:

1) Apportionment workpapers for parent company insurance charges.
2) Apportionment workpapers for parent shareholder services charges.
3) Corporate organizational chart.
4) Tax Sharing agreement.
5) Credit support agreements.
6) Sample invoice summary.
7) Parent company payroll overhead rate schedule.

This information is included in Book 2 of 4, Volume II, of SSU's application, and details all charges from the parent company for calendar year 1994, as well as projected charges for test years 1995 and 1996. The methods used for apportioning service related charges are described therein.

EXHIBIT (SWV-3)

PAGE 6 OF 16

SOUTHERN STATES UTILITIES, INC.
RESPONSE TO REQUEST FOR PRODUCTION OF DOCUMENTS
DOCKET NO.: 950495-WS

REQUESTED BY:	OPC
SET NO:	1
DOCUMENT REQUEST NO:	105
ISSUE DATE:	07/18/95
WITNESS:	SCOTT W. VIERIMA
RESPONDENT:	Scott Vierima

DOCUMENT REQUEST: 105

Provide a copy of workpapers and source documents that show how MPL's costs were allocated or charged to the Company for the budget years 1995 and 1996.

RESPONSE: 105

Please refer to the response to Office of Public Counsel's Document Request No. 79, First Set, for explanations and workpapers concerning parent company charges. Only insurance and shareholder expenses are apportioned to SSU based on the formulas described in Document Request No. 79. Direct costs for 1995 reflects amounts agreed to by SSU for services required from TGI parent. 1996 projections are 1995 budgeted amounts, escalated by 1.95%.

EXHIBIT (SWV-3)
PAGE 7 OF 16

Late Filed Exhibit
Number 4

Schedule Reflecting What is Included in the $209,000 for Communication Costs for 1996.

Attached are MP supporting budget schedules for shareholder costs which could be considered ` communication ' related. SSU was apportioned 9.5% of the charges shown for the budget year (1995), therefore the corresponding amounts escalated into the 1996 test year, and included in the total of $209,000 equal $78,170.

	1995 MP Amount	*x .095 (SSU Amount)*	*x 1.0195 (SSU 1996)*
Financial Mailing List	$67,900	$6,451	$6,576
Annual Shareholder Meeting	$103,400	$9,823	$10,015
Investor Relations	$166,500	$15,818	$16,126
SEC Financial Reports	$154,800	$14,706	$14,993
Corp.Communications - Financial	$260,300	$24,729	$25,211
Utility Investors Group	$54,200	$5,149	$5,249
	$807,100	$76,675	**$78,170**

01/20/95 MAINTENANCE OPERATION REQUISITION
RESPONSIBILITY CENTER - 966 YEAR - 95

TITLE - FINANCIAL MAILING LIST

EXPECTED START DATE - 01/01/95 EXPECTED COMPLETION DATE - 12/31/95
TRANSFER CHARGES TO ACCOUNT(S) - ALL CC11 53.5% - 92000000 46.5% - NON-UTIL
ALL OTE- 53.5% - 93020000 46.5% - NON-UTIL
PROJECT OR NONPROJECT (P OR N) - N

	(IN THOUSANDS) PRIOR YEARS	BUDGET YEAR	AFTER YEARS
COMPANY LABOR	3.1	3.2	0.0
COSTS OTHER THAN LABOR	70.1	64.7	0.0
TOTAL COST	73.2	67.9	0.0

DESCRIPTION

ACCUMULATE COSTS ASSOCIATED WITH COORDINATING THE MAILING OF REPORTS AND PERIODIC INFORMATION TO THE FINANCIAL COMMUNITY.

PURPOSE & NECESSITY

TO ACCUMULATE COSTS OF FINANCIAL COMMUNITY CORRESPONDENCE, I.E., FINANCIAL FORECAST, ANNUAL REPORTS, REGULATORY ACTIONS, ETC. IT IS NECESSARY TO INFORM THE FINANCIAL COMMUNITY (INVESTMENT BANKS, COMMERCIAL BANKS, RATING AGENCIES, SECURITY ANALYSTS, AND OTHER INTERESTED PARTIES) OF THE COMPANY'S FINANCIAL CONDITION. IT IS EXPECTED THAT THE DEVELOPMENT OF THE INVESTOR RELATIONS FUNCTION WILL IMPACT THIS PROJECT.

BASIS OF ALLOCATION TO NONUTILITY

46.5% OF THIS M/OR IS ALLOCATED TO NONUTILITY. THIS PERCENTAGE IS BASED ON THE CORPORATE UTILITY/NONUTILITY ALLOCATION DEVELOPED BY THE RATE DEPARTMENT.

PREPARED BY - T. J. THORP

01/20/95 MAINTENANCE OPERATION REQUISITION
RESPONSIBILITY CENTER - 731 YEAR - 95

TITLE - ANNUAL SHAREHOLDER MEETING

EXPECTED START DATE - 01/01/95 EXPECTED COMPLETION DATE - 12/31/95
TRANSFER CHARGES TO ACCOUNT(S) - ALL CC11 53.5% - 92000000 46.5% - NON-UTIL
ALL OTH- 53.5% - 93020000 46.5% - NON-UTIL
PROJECT OR NONPROJECT (P OR N) - N

	(IN THOUSANDS) PRIOR YEARS	BUDGET YEAR	AFTER YEARS
COMPANY LABOR	16.6	24.7	0.0
COSTS OTHER THAN LABOR	62.6	67.7	0.0
TOTAL COST	79.2	92.4	0.0

DESCRIPTION

ACCUMULATE ALL CHARGES ASSOCIATED WITH THE ANNUAL MEETING, TOURS AND LUNCHEON.

PURPOSE & NECESSITY

THE ANNUAL MEETING OF SHAREHOLDERS IS SCHEDULED FOR THE SECOND TUESDAY IN MAY. SHAREHOLDER PARTICIPATION HAS BEEN INCREASING ANNUALLY AND IS EXPECTED TO INCREASE BASED ON REGIONAL MEETING DISCUSSIONS AND EMPHASIS PLACED ON SHAREHOLDER SATISFACTION IN KRA GOALS.

BASIS OF ALLOCATION TO NONUTILITY

46.5% OF THIS M/OR IS ALLOCATED TO NONUTILITY. THIS PERCENTAGE IS BASED ON THE CORPORATE UTILITY/NONUTILITY ALLOCATION AS DEVELOPED BY THE RATE DEPARTMENT. THE NONUTILITY PORTION OF LABOR CHARGES IS FULLY OVERHEADED.

PREPARED BY - V. M. HANSEN

01/20/95 MAINTENANCE OPERATION REQUISITION M,
RESPONSIBILITY CENTER - 190 YEAR - 95

TITLE - COST OF ANNUAL SHAREHLDRS MTG-OPERATIONS

EXPECTED START DATE - 01/01/95 EXPECTED COMPLETION DATE - 12/31/95
TRANSFER CHARGES TO ACCOUNT(S) - ALL CC11 53.5% - 92000000 46.5% - NON-UTIL
ALL OTH- 53.5% - 93020000 46.5% - NON-UTIL
PROJECT OR NONPROJECT (P OR N) - N

	(IN THOUSANDS) PRIOR YEARS	BUDGET YEAR	AFTER YEARS
COMPANY LABOR	8.7	8.4	0.0
COSTS OTHER THAN LABOR	1.2	2.6	0.0
TOTAL COST	9.9	11.0	0.0

DESCRIPTION

PROVIDE 3 EACH CLASS 6 VEHICLES, 3 EACH CLASS 3 VEHICLES AND THE COMPANY HELICOPTER FOR VIEWING AT THE MAY 1995 ANNUAL SHAREHOLDERS' MEETING.

PURPOSE & NECESSITY

PARTICIPATE IN THE MAY 1995 SHAREHOLDERS' MEETING.

BASIS FOR ALLOCATION TO NONUTILITY

46.5% OF THIS M/OR IS ALLOCATED TO NONUTILITY. THIS PERCENTAGE IS BASED ON THE CORPORATE UTILITY/NONUTILITY ALLOCATION AS DEVELOPED BY THE RATE DEPARTMENT.

PREPARED BY - K. R. MICKELSON

01/20/95 MAINTENANCE OPERATION REQUISITION M/OR NO. 18629611
RESPONSIBILITY CENTER - 966 YEAR - 95

TITLE - INVESTOR RELATIONS

EXPECTED START DATE - 01/01/95 EXPECTED COMPLETION DATE - 12/31/95
TRANSFER CHARGES TO ACCOUNT(S) - ALL CC11 53.5% - 92000000 46.5% - NON-UTIL
ALL OTH- 53.5% - 93020000 46.5% - NON-UTIL
PROJECT OR NONPROJECT (P OR N) - N

	(IN THOUSANDS) PRIOR YEARS	BUDGET YEAR	AFTER YEARS
COMPANY LABOR	78.0	109.7	0.0
COSTS OTHER THAN LABOR	35.7	56.8	0.0
TOTAL COST	113.7	166.5	0.0

DESCRIPTION

MEETINGS WITH ANALYSTS, RATING AGENCIES, INVESTMENT BANKERS, TRUST OFFICERS, INSTITUTIONAL INVESTORS, ETC.

PURPOSE & NECESSITY

THE COMPANY MEETS ANNUALLY WITH THE VARIOUS RATING AGENCIES TO KEEP THEM CURRENT REGARDING THE FINANCIAL POSITION OF THE COMPANY AS WELL AS OTHER COMPANY ACTIVITIES. ALSO, PERIODIC MEETINGS WITH OTHER INVESTOR GROUPS ARE REQUIRED TO MAINTAIN A WELL-INFORMED FINANCIAL COMMUNITY.

BASIS OF ALLOCATION TO NONUTILITY

46.5% OF THIS M/OR IS ALLOCATED TO NONUTILITY. THIS PERCENTAGE IS BASED ON THE CORPORATE UTILITY/NONUTILITY ALLOCATION DEVELOPED BY THE RATE DEPARTMENT.

PREPARED BY - T. J. THORP

01/20/95 MAINTENANCE OPERATION REQUISITION M/OR NO. 18629536
RESPONSIBILITY CENTER - 900 YEAR - 95

TITLE - SEC FINANCIAL REPORTS

EXPECTED START DATE - 01/01/95 EXPECTED COMPLETION DATE - 12/31/95
TRANSFER CHARGES TO ACCOUNT(S) - ALL CC11 53.5% - 92000000 46.5% - NON-UTIL
ALL OTH- 53.5% - 92100000 46.5% - NON-UTIL
PROJECT OR NONPROJECT (P OR N) - N

	(IN THOUSANDS) PRIOR YEARS	BUDGET YEAR	AFTER YEARS
COMPANY LABOR	103.7	94.5	0.0
COSTS OTHER THAN LABOR	66.9	60.3	0.0
TOTAL COST	170.6	154.8	0.0

DESCRIPTION

. PREPARE, EDGARIZE, PRINT AND FILE THE ANNUAL REPORT ON FORM 10-K WITH THE SECURITIES AND EXCHANGE COMMISSION (SEC), INCLUDING THE FINANCIAL SECTION OF THE ANNUAL REPORT TO SHAREHOLDERS. PREPARE, EDGARIZE, PRINT AND FILE FORMS 10-Q, 11-K, 8-K AND OTHER MISCELLANEOUS FILINGS (U-3A-2 AND 13-D) PERIODICALLY OR AS REQUIRED WITH THE SEC. COORDINATE THE REVIEW OF THE ABOVE DOCUMENTS WITH OUTSIDE LEGAL COUNSEL AND INDEPENDENT ACCOUNTANTS. MAINTAIN EXPERTISE THROUGH PROFESSIONAL DEVELOPMENT.

PURPOSE & NECESSITY

AS A PUBLICLY TRADED COMPANY LISTED ON THE NEW YORK AND AMERICAN STOCK EXCHANGES, MINNESOTA POWER IS REQUIRED TO FILE CERTAIN PERIODIC REPORTS WITH THE SEC. THIS PROJECT IS SET UP TO ACCUMULATE INTERNAL AND EXTERNAL COSTS ASSOCIATED WITH THESE FILINGS AND THEN ALLOCATE TO ALL BUSINESS UNITS.

ASSUMPTIONS:
. TYPING DONE IN OFFICE SYSTEMS & SUPPORT.
. PRINTING AND EDGARIZING DONE IN OFFICE SERVICES.
. FILING FEES
. LABOR ESTIMATE BASED ON HISTORICAL HOURS

BASIS OF ALLOCATION TO NONUTILITY

46.5% OF THIS M/OR IS ALLOCATED TO NONUTILITY. THIS PER-

01/20/95 MAINTENANCE OPERATION REQUISITION M/OR NO. 18628006
RESPONSIBILITY CENTER - 731 YEAR - 95

TITLE - CORPORATE COMMUNICATION - FINANCIAL

EXPECTED START DATE - 01/01/95 EXPECTED COMPLETION DATE - 12/31/95
TRANSFER CHARGES TO ACCOUNT(S) - 53.5% 93020000 46.5% NON-UTIL

PROJECT OR NONPROJECT (P OR N) - N

	(IN THOUSANDS) PRIOR YEARS	BUDGET YEAR	AFTER YEARS
COMPANY LABOR	0.0	67.1	0.0
COSTS OTHER THAN LABOR	0.0	193.2	0.0
TOTAL COST	0.0	260.3	0.0

DESCRIPTION:

PREPARE THE FOLLOWING COMMUNICATIONS:
* QUARTERLY SHAREHOLDER REPORTS
* ANNUAL REPORT
* FINANCIAL ADVERTISING
* OTHER SHAREHOLDER INFORMATION

PROJECTS INCLUDE PLANNING, WRITING, DESIGNING, TYPESETTING, PHOTOGRAPHY, PRINTING AND/OR VIDEOGRAPHY, EDITING, POSTING AND DUPLICATING.

PREPARE AND PRESENT FINANCIAL PUBLIC INFORMATION WHICH INCLUDES NEWS RELEASES AND DISTRIBUTION.

PURCHASING FREELANCE WRITING AND ART-RELATED SERVICES ON AN AS NEEDED BASIS.

PURPOSE & NECESSITY:

TO PRODUCE AND/OR PRESENT INFORMATION ABOUT THE CORPORATION THAT PROVIDES A REGULAR FORUM TO COMMUNICATE WITH SHAREHOLDERS.

BASIS OF ALLOCATION TO NON-UTILITY

46.5% OF THIS M/OR IS ALLOCATED TO NON-UTILITY. THIS PERCENTAGE IS BASED ON THE CORPORATE UTILITY/NON-UTILITY ALLOCATION AS DEVELOPED BY THE RATE DEPARTMENT.

PREPARED BY - COMMUNICATION TEAM

EXHIBIT (SUV-3)

PAGE 15 OF 16

01/20/95 MAINTENANCE OPERATION REQUISITION M/OR NO. 18620402
RESPONSIBILITY CENTER - 966 YEAR - 95

TITLE - MINNESOTA UTILITIES INVESTORS GROUP

EXPECTED START DATE - 01/01/95 EXPECTED COMPLETION DATE - 12/31/95
TRANSFER CHARGES TO ACCOUNT(S) - 53.5% - 93020000 46.5% - NON-UTIL

PROJECT OR NONPROJECT (P OR N) - N

	(IN THOUSANDS) PRIOR YEARS	BUDGET YEAR	AFTER YEARS
COMPANY LABOR	0.4	0.0	0.0
COSTS OTHER THAN LABOR	66.2	54.2	0.0
TOTAL COST	66.6	54.2	0.0

DESCRIPTION

ACCUMULATE COSTS AND ASSESSMENTS ASSOCIATED WITH MINNESOTA POWER'S SPONSORSHIP OF MINNESOTA UTILITY INVESTORS INC.

PURPOSE & NECESSITY

WORKING WITH OTHER MINNESOTA UTILITIES, AN AD HOC COMMITTEE HAS BEEN FORMED TO DEVELOP A UTILITY INVESTOR GROUP WITHIN THE STATE. ITS MISSION INCLUDES PROVIDING AN INDEPENDENT VOICE FOR UTILITY INVESTORS, REPRESENTATION WITH REGULATORY AUTHORITIES, AND PROMOTION AND PROTECTION OF THE FREE ENTERPRISE SYSTEM. THE COMPANY HAS MADE A COMMITMENT TO THIS EFFORT.

BASIS OF ALLOCATION TO NONUTILITY

46.5% OF THIS M/OR IS ALLOCATED TO NONUTILITY. THIS PERCENTAGE IS BASED ON THE CORPORATE UTILITY/NONUTILITY ALLOCATION DEVELOPED BY THE RATE DEPARTMENT.

PREPARED BY - T. J. THORP

FPSC AUDIT REQUEST #74

SHAREHOLDER SERVICES

1. The sources of SSU's equity capital are twofold: 1) retained earnings and 2) paid-in capital from its first tier parent Minnesota Power (MP). In order for MP to attract and retain equity capital for reinvestment in subsidiary corporations, it must incur continuing expenses associated with the issuance of securities, payment of dividends, compliance with SEC regulations, payment of registration and rating agency fees and shareholder communications. These costs are apportioned to recipient subsidiaries as a function of their equity balance relative to MP's consolidated equity.

2. The following types of services are included:
1) Labor and payroll overheads for operation of a shareholder services department, 2) proxy and annual meeting noticing, 3) utility investor group assessment, 4) annual stockholder meetings, 5) annual and quarterly shareholder reports, 6) DRIP and stock purchase plans, 7) NY and AMEX assessments, 8) rating agency fees, 9) SEC financial reports (10-K, 8-K, etc.), 10) registrar and transfer agent services, 11) meetings with trust officers and institutional investors, 12) certificate printing, 13) board fees and 14) mailings to the financial community.

3. All privately held utilities endeavor to maintain a balanced capital structure which typically includes some form of equity capital. In addition to directly funding a utilities operations and capital improvements, the presence of equity capital promotes the attraction of debt capital at lower rates and under reasonable covenants.

4. See attached Schedule PE-1.

5. See attached Schedule PE-1.

EXHIBIT (SWV-4)

PAGE 1 OF 24

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

CASE 93-W-0962 - Proceeding on Motion of the Commission to establish a Policy to Provide Incentives for the Acquisition and Merger of Small Water Utilities.

NOTICE

(Issued November 10, 1993)

The Commission's Order Instituting Proceeding invites interested persons to submit comments and/or consider proposals regarding a possible Commission policy concerning acquisition incentive mechanisms (AIMs).

NOTICE is hereby given that any interested person may submit comments in response to the issues set forth in the Order by filing 15 copies of such comments or proposals with John J. Kelliher, Secretary, State of New York Public Service Commission, Three Empire State Plaza, Albany, New York 12223, by February 21, 1994. Persons with substantially similar interests are invited to submit jointly-filed comments.

JOHN J. KELLIHER
Secretary

Talked to Jim Perry
-NAAC- activity
N.Y.
Spring Valley
NY Water
Long Island

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

At a Session of the Public Service Commission held in the City of New York on October 20, 1993

COMMISSIONERS PRESENT:

Peter Bradford, Chairman
Lisa Rosenblum
Harold A. Jerry, Jr.
William D. Cotter
Raymond J. O'Connor

CASE 93-W-0962 - Proceeding on Motion of the Commission to establish a Policy to Provide Incentives for the Acquisition and Merger of Small Water Utilities.

ORDER INSTITUTING PROCEEDING
AND SOLICITING COMMENTS

(Issued and Effective November 10, 1993)

BY THE COMMISSION:

This Order institutes a proceeding to solicit comments and consider proposals regarding a possible Commission policy concerning acquisition incentive mechanisms (AIMs) intended to foster acquisition of small water companies. The concept of an AIM was developed as part of an initiative to design regulatory/rate making procedures and state-wide initiatives to deal with small water company problems.[1]

---

[1] Other initiatives arising out of that collaborative process are being developed separately.

have less than 100 customers. Approximately 200 companies have 50 customers or less.

Any policy concerning AIMs must satisfy broad economic goals while maintaining a proper balance between ratepayers and investors. As a starting point for a dialogue with interested parties, staff has identified several broad goals and factors for consideration in establishing an AIM policy.[1] Also, parties are invited to comment on the following proposed guidelines for development of any AIM policy that have been proposed by staff:

1. The proposal must be in the general public interest.

2. The acquiring company should demonstrate that it will have the capacity to serve and manage the acquired company efficiently and adequately, and has the ability to achieve compliance with the SDWA and other regulatory requirements, including the ability to finance improvements.

3. The level of any incentives provided should be reasonable and commensurate with the magnitude of overall benefits to customers in terms of improved service quality, rate stability and long term ability to repair and replace equipment and meet SDWA mandates as economically as possible.

4. The terms of an acquisition should not preclude the occurrence of beneficial future alternatives for system ownership and management, such as municipal or water authority take over.

5. The impacts on the acquired company customers should be measured against the

---

[1] The specific goals and factors are set forth in the attached memorandum.

2. Initial comments and reply comments of interested persons shall be submitted in accordance with a schedule to be issued by the Secretary of the Public Service Commission.

3. This proceeding is continued.

By the Commission,

(SIGNED)

JOHN J. KELLIHER
Secretary

EXHIBIT (SWV-4)

PAGE 5 OF 24

FILED-SESSION OF OCT 20 1993

STATE OF NEW YORK
DEPARTMENT OF PUBLIC SERVICE

October 12, 1993

TO: THE COMMISSION

FROM: ENERGY AND WATER DIVISION
CONSUMER SERVICES DIVISION
OFFICE OF ACCOUNTING AND UTILITY FINANCE

SUBJECT: CASE 93-W-0962
Proceeding on Motion of the Commission to establish a Policy to Provide Incentives for the Acquisition and Merger of Small Water Utilities.

SUMMARY OF PROPOSED ACTION: It is proposed that - A proceeding be instituted to establish a policy for Acquisition Incentive Mechanisms (AIM), and that this memorandum and its concepts be issued for comment and become the subject for discussions with industry, consumers, other state agencies, municipalities, and other interested parties. Comments and the results of discussions should be submitted by February 21, 1994, and then used in formulating a Commission policy.

** *** **

Summary

The Department has recently identified three initiatives to improve regulation in the water industry:

(1) development of long-term planning processes for the seven largest water companies;

(2) design of regulatory/ratemaking procedures and statewide initiatives to deal with small water company problems; and

(3) increase our activity at national levels and improve our presence with the federal government on water industry matters, and communicate positions on the Safe Drinking Water Act (SDWA).

This memorandum recommends that a proceeding be instituted to establish a Commission policy for acquisition incentive mechanisms (AIM) to foster acquisition of small water companies.

a long-term basis. The problems that occur in finance, service, and management (including poor records) stem from a fundamental cause: the company is simply too small to function efficiently as a public utility.[1] The new financial and operating demands created by the SDWA are expected to be beyond small company capabilities in many cases.

Historically, the amount of staff and Commission time spent on the service and rates of small water companies has been disproportionate to the revenues and number of people involved. Looking to the future, this disproportionate effort could become worse in light of the new SDWA mandates. In New York State there are approximately 350 investor owned waterworks subject to Commission regulation. Of these, about 300 have less than 100 customers. Approximately 200 companies have 50 customers or less.

Because of the many public benefits to be derived from acquisition/mergers, especially the absorption of small water utilities into larger entities, staff believes the Commission should actively engage the private water industry and other interested parties in achieving this goal. To this end we believe that a clearly articulated policy on mergers and acquisitions should be developed. By developing such a policy statement it is hoped that more applications will be brought to the Commission for consideration and approval. Safe and

1/ supra p. 26

original cost less depreciation unless the applicant will amortize immediately said excess through charges to surplus. That is, the purchase price that exceeds book value (or the "purchase premium") may not be recouped or be added to the acquiring company's rate base. In addition, the Commission in past decisions has often allowed a rate base no more than the purchase price, where the book value has been greater than the purchase price.

Staff believes these past decisions, while not stated policy, were designed to protect the ratepayers from excessive charges, but may have had the effect of acting as a significant disincentive to small water company acquisitions. Over the four year period 1989-1992, there were 23 transfers of utility water systems or property approved by the Commission. Over half of these were system transfers to municipalities, and only three could be termed consolidations/mergers. Given New York's large number of water companies, it would appear there is significant room for improvement in this activity and that an effective Commission incentives policy would provide that improvement.

Elements of an Acquisition Incentive Mechanisms Policy (AIM)

To be effective, an AIM policy should satisfy broad economic goals while maintaining a proper balance between ratepayers and investors, and use a few well understood implementation guidelines to foster mergers and acquisitions that provide maximum customer benefit. In regulating utilities, the Commission is constantly balancing consumer and investor

- Moderate the rate impacts of the costs[1] facing the water industry, specifically those imposed by the SDWA.
- Promote small water company acquisitions/mergers.
- Improve the economic efficiency of small water companies.
- Provide regulatory flexibility and openness to a wide range of alternatives, thereby stimulating creative and economic solutions.
- Fairly balance acquisition incentives with service and rate impacts to promote acquisitions/mergers that are in the public interest.
- Provide meaningful and clear guidelines which encourage exploration of acquisition opportunities and facilitate the development and approval of acceptable proposals.
- Ensure public participation.

Factors for Consideration

Staff has identified a number of factors that should be considered in the evaluation of any AIM proposal. They include the following:

- Purchase price
- Realized economies
- Rate impact on customers of both systems
- Service history
- Rate equalization considerations
- Customer service
- Long term benefits[2] to customers
- Customer satisfaction with the proposal
- Access to capital
- Operational and capital improvement
- Economic viability
- Management

1/ Aging infrastructure replacement, and the monitoring, treatment and plant addition requirements of the SDWA.

2/ Lower rates and better service resulting from economies of scale, better operation and management, and access to financing for improvements.

- Operating ratios in lieu of rate base treatment
  Where rate base of the acquired company is very low relative to construction cost, relate net income and revenue requirement to a ratio of operating costs.

- Incentive returns
  Allow a higher than normal rate of return for certain acquisition and improvement costs.

* Depreciation allowances
  Reflecting increased annual depreciation in rates provides additional cash flow and incentive. This can be accomplished by allowing depreciation on contributed plant where little or no rate base exists, or by allowing accelerated depreciation where rate base does exist.

* Amortization of acquisition costs
  Where there is a purchase premium, reflect all or part of the premium in rates.

- Delayed recovery of costs
  In some cases, the use of certain economic incentives may be initially unacceptable for various reasons, such as rate shock; however, their use may be necessary to attain the acquisition. A possible mechanism in this situation would be to delay the recovery of any of the above mechanism costs to mitigate customer impact.

* Lease buyout plans
  Where companies, the Commission, or customers are uncertain about the benefits of an acquisition, the acquiring company may lease a system before acquisition, allowing time to evaluate the acquisition benefits.

As discussed in the Staff Guidelines section that follows, staff believes that, in general, rates should be equalized between the two merging companies. Rate equalization can also be an incentive for acquisition, and the speed at which rates are equalized relevant to how great this incentive is.

Staff Guidelines

Staff's views on some important issues are as follows:

- The proposal must be in the general public interest.

be issued for comment, with special focus on the questions set forth in Appendix A. Notice of the proceeding should be served on a broad range of potentially interested parties, and the Commission should direct that all comments be submitted by February 21, 1994. It is further recommended that staff, industry, concerned consumers, and other interested parties be encouraged to immediately establish dialog and convene focused groups, as well as use other means of communication to explore the concepts contained in this memorandum. The results of these discussions and comments would then be used in formulating the policy.

Respectfully submitted,

BRIAN M. SUMMMERS
Associate Utility Financial Analyst
Office of Accounting and Finance

ROY W. LAMBERTON
Associate Hydraulic Engineer
Energy & Water Division

DENISE C. WAXMAN
Supervisor of Utility Hearings
Consumer Services Division

APPROVED BY:

THOMAS G. DVORSKY
Deputy Director, Cost Performance
Energy and Water Division

KATHRYN C. BROWN
Director, Consumer Services Division

FRANCIS M. HERBERT
Director, Office of Accounting & Finance

APPENDIX A

QUESTIONS FOR PUBLIC COMMENT

1. Are the policy goals articulated correct? Are there others? If so, identify and elaborate.

2. Are the factors identified for consideration all relevant? Are there other factors that should be considered? What relative weight should be given to the different factors?

3. Are the incentive mechanisms identified complete, or are there others that should be considered for inclusion? Should any of the identified incentives be rejected? Are any of the incentives to be preferred over others? Generally? In particular situations? Elaborate on any guidelines that might be appropriate for weighing or prioritizing the use of different incentives, informing the use of multiple incentives, etc.

4. Are the guidelines set forth reasonable? If not, explain how they should be modified or why they should be rejected. Are there other guidelines that should be applied?

   a. Purchase price
      Comment on the guidelines set forth in Appendix D. Are there alternative ways of determining a fair purchase price? Other information that should be considered? How should the need for objective evidence of a fair price be balanced against the desire for a streamlined process? To what extent, if at all should the standards of valuation in eminent domain law be used? To what extent should the estimated costs of immediately needed capital improvements be a factor in evaluating the fair purchase price?

   b. Application of incentives
      Is it possible to articulate more concrete guidelines for the application of incentives in a particular case, that is, to evaluating the magnitude of the benefits that will result from the transfer and in determining the commensurate incentive? If so, explain and provide details.

   c. Rate equalization
      Are the guidelines described in appendix E proper? If not, explain how they should be modified or why they should be rejected. Are there other guidelines or factors that should be considered in the context of setting forth a rate equalization plan? If so, identify them and describe their applicability. Are there any circumstances where rates should not be equalized? If so, explain.

EXHIBIT (SWV-4)

PAGE 12 OF 24

APPENDIX B

ESSENTIAL ELEMENTS OF AN AIM PETITION

Existing Requirements of 16 NYCRR, Part 31

- Copy of Certificate of Incorporation and any modifications. (17.2)
- Copy of the proposed contract [31.1 (d)]
- Description of the property to be transferred. [31.1(b)]
- Copy of franchises, consents, and rights to be transferred, with details (31.1 (c)) (including DEC Certificate of Convenience and Necessity and any modifications).
- Municipal approvals, if required [31.1 (d)]
- Inventory of Water Plant being transferred [31.3 (f)], in accordance with applicable system of accounts [31.1 (g)].
- Accrued depreciation in property to be transferred with methodology [31.1 (h)]
- Cost of property to be transferred, per books [31.1(i)].
- Depreciation and amortization reserves applicable to the property to be transferred. [31.1 (j)]
- Statement of contribution toward construction of property, showing those subject to refund. [31.1 (k)]
- Statement of operating revenue, expenses, and taxes for each of the 3 preceeding years. [31.1 (l)]
- Most recent balance sheet for both transferee and transferor. [31.1 (l)]
- The company's proposal for financing the acquisition, and if this involves the issuance of stocks, bonds, notes or other evidences of indebtedness, details as required in Part 37.

APPENDIX D

PURCHASE PRICE EVALUATION

As stated in the Staff Guidelines section of this memo, the AIM policy, by its very nature could affect the negotiated purchase price. If sellers and buyers can reasonably expect that the price paid will be recouped, that fact may encourage a price higher than might be attained otherwise. That said, we should recognize that most of the small water companies that might be acquisition targets have no rate base or one that represents a very small amount of the utility assets. Since the market may value some of these properties differently, any acquisition policy that desires to encourage economic transfers conflicts with the present policy, which has been that when one utility purchases another for a price higher than book value, only the book value of the purchased entity may be recouped.

It is also clear that any acquisition policy should not discourage purchases below book value, where appropriate. From a public benefit standpoint, encouraging a purchase price below net book value through an AIM policy would be desirable. The incentive in this instance could be to allow all or a portion of the difference between the lower price and book value to be reflected in rates. This would be in contrast to current policy which has replaced the existing rate base with the lower purchase price for ratemaking.

The AIM policy should endeavor to allow economic forces and each unique situation set the price. The Commission can best do this by retaining its discretion and its position as an economic arbiter, subjecting each transaction to serious economic review. That review would evaluate the transaction with respect to the Commission's broad goals, its guidelines, and to the peculiar economic circumstances presented.

Staff would offer the following proposed broad guidelines relating to the purchase price:

- The purchase price should be determined to represent an exchange value that, in the totality of the circumstances, is fair and reasonable.

- The burden of demonstrating that the proposed purchase price is fair and reasonable is on the petitioners.

7. Delayed recovery of cost.
While not strictly an incentive, delayed recovery is a tool that could be used in creating an acceptable acquisition proposal. For any of the above mechanisms, where a cost is to be allowed as an incentive, its effect on ratepayers may be mitigated by delaying its inclusion in rates.

8. Lease buyout plans.
These plans generally provide that the acquiring company will lease the system for some specified period, with an option to buy at the end of that time. This mechanism can allow the companies, customers, and Commission to observe the advantages and disadvantages of the acquisition before it becomes irreversible.

As previously indicated, the amount of incentives to induce an acquisition is likely to be related to the viability and liabilities associated with the acquired company. Other possible factors are the proximity of the acquirer, system age, quality of system installation and design, number of customers, RB/customer, construction cost/customer, cost of needed improvements, viability of acquirer, volatility of O & M and earnings, and ability of customers to pay.

APPENDIX E

RATE EQUALIZATION

Staff believes that in a merger or acquisition, except where there are very unusual circumstances, the rates of the merged companies should be equalized. While it is impossible to lay down specific rules for how rate equalization should be handled in each case, staff believes that it is important to have some principled basis for judging the rate equalization proposals that are presented to assure that, on a statewide basis, customers are being treated fairly. Accordingly, we have endeavored to articulate several general guidelines or principles that we believe should guide the rate equalization proposal that is put forth in a petition.

An AIM petition should contain a proposal for the equalization of rates, including a schedule for a planned phase-in, if applicable, and an estimate of the rate impacts for typical customers. Where the engineer's report indicates that the acquired company will require a major infusion of capital expenditures in the near term, and/or other causes make it likely that a rate increase will result from the acquisition, the petition should include projections of the increase, and any phase-in of equalization. The petition should justify the plan proposed in the light of these guidelines.

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

CASE 93-W-0962 - Proceeding on Motion of the Commission to Establish a Policy to Provide Incentives for the Acquisition and Merger of Small Water Utilities.

STATEMENT OF POLICY ON ACQUISITION INCENTIVE MECHANISMS FOR SMALL WATER COMPANIES

Issued and Effective: August 8, 1994

Case 93-W-0962

TABLE OF CONTENTS

EXHIBIT (SWV-4)

PAGE 18 OF 24

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

COMMISSIONERS:

Peter Bradford, Chairman
Lisa Rosenblum
Harold A. Jerry, Jr.
William D. Cotter

CASE 93-W-0962 - Proceeding on Motion of the Commission to Establish a Policy to Provide Incentives for Acquisition and Merger of Small Water Utilit

STATEMENT OF POLICY ON ACQUISITION INCENTIVE MECHANISMS FOR SMALL WATER COMPANIES

(Issued and Effective August 8, 1994)

BY THE COMMISSION:

GUIDELINES FOR WATER COMPANY ACQUISITIONS

PREAMBLE

On October 20, 1993, we instituted Case 93-W-0962 to consider the provision of incentives for the acquisition of small water companies by, and therein merger into, larger entities. Public comment was invited, and on the basis of that comment and the recommendations of Department staff, we are establishing goals and guidelines that will apply to proposals to consolidate small water companies through acquisitions and mergers.

Small water companies typically cannot attract capital and often have small cash reserves, or none at all. Frequently, these companies are run by part-time managers possessing little technical training. In addition, their small customer base

limits their ability to incur significant expenditures for regulatory compliance and other purposes. As a result, these small companies frequently fail to comply with new, or even existing, health and safety regulations. In particular, the requirements of the Safe Drinking Water Act are expected to impose requirements that many systems will be unable to meet. Consolidation of water companies through acquisition or merger may serve as a solution in these situations.

GOALS

This policy is intended to foster acquisitions and mergers that will: (1) improve the ability of small water companies to provide service; (2) improve customer service; (3) make it easier to comply with current and future regulations; (4) avoid drastic rate increases; (5) bring the rates of merged systems into parity; (6) improve and consolidate management and operation; and (7) promote conservation.

GUIDELINES

The guiding principal in granting acquisition incentives will be to increase customer benefit. An acquirer must be able to show that it can continue to exist in the long term and will be able to provide its customers with safe and adequate service at just and reasonable rates. To foster a

transformation of small non-viable water companies into entities better able to serve, acquisition incentives may be provided in certain cases, where the following factors so suggest:

1. Whether the acquiring company has the ability to adequately manage the business, serve customers, comply with regulations, and finance capital improvements.

2. Whether the impact on customers resulting from the acquisition is at least as beneficial as the impact of realistic alternatives.

3. Whether the terms of the acquisition will permit future beneficial solutions, such as municipalization.

4. Whether benefits to customers are expected to be commensurate with the cost of the incentives for the acquisition or merger.

5. Whether meaningful customer participation has been obtained through effective public involvement.

We will also consider additional incentives where proposals are made to consolidate several water systems at once.

INCENTIVES

Because each small water company will present unique circumstances, incentive plans will have to be tailored case-by-case. The following incentive mechanisms are provided as examples of those that may be considered. They will not be appropriate in each instance, nor do they constitute an

exhaustive list of measures that can be entertained. As a general matter, however, any significant rate increases that may be needed should be phased in, in order to avoid unduly harsh effects on customers.

1. Rate Base

   a. Where the purchase price is less than the rate base of the company being acquired, rates may nevertheless reflect the full rate base of the acquired company.

   b. Where the purchase price is greater than rate base, rates may reflect the purchase price premium if warranted. For example, a premium might be justified by improved service, realized cost efficiencies, or economies of scale.

   c. Where capital expenditures are required for service improvements or to comply with health and safety regulations, projected improvement costs may be reflected in rates immediately, subject to verification that the expenditures are made.

   d. Where the company being acquired has little or no rate base, a proxy rate base may be allowed, equivalent to the rate base per customer of the acquiring company.

2. Depreciation

   Where circumstances warrant, depreciation may be allowed at accelerated rates, or depreciation on projected improvement costs may be allowed subject to subsequent adjustment.

3. Amortization

The reasonable costs of acquisition may be recovered by amortization. Under certain conditions, amortization may also be considered for recovery of a purchase price premium. The term of an amortization should be chosen to minimize adverse effects on customers.

The four incentives described below will be considered only in special cases for good cause shown. They represent a departure from traditional rate-making practice and are meant to facilitate consolidation that may otherwise not be possible.

4. Operating Ratio

Where rate base incentive mechanisms are less practicable, a ratio of revenues to operation and maintenance costs may be used to determine revenue requirement.

5. Rate of Return

Where it can be shown to benefit customers, a premium on the overall rate of return may be allowed.

6. Delayed Recovery

Where the costs of acquisition or improvements, or the effects of rate equalization, would cause unduly harsh effects on customers, proposals to delay or phase in

recovery of costs, rather than lose the opportunity for consolidation, may be considered.

7. Lease/Buyout

Where there is uncertainty regarding the overall benefit of an acquisition, and it would appear beneficial for ownership, management, and operation to occur for a trial period, operation of the company under a lease with an option to by may be considered as a mechanism for providing incentives.

REQUIRED INFORMATION

The following information should be submitted with any request for our approval of an acquisition or merger.

- With respect to both companies involved in the merger or acquisition:
  - The current extent of compliance with regulatory agency requirements and directives (Departments of Health, Environmental Conservation, and Public Service, and local authorities).
  - The prospects for future compliance with regulatory requirements.
  - The number of customers.
  - Comparative income statements for the three most recent years.
  - A current balance sheet.
  - Estimate of rates needed to comply with SDWA or other service requirements.

- Evaluation of customer benefits and economies of scale.
- Information and data on the rate impact on all customers (acquiring and acquired companies), and the rate plan to achieve parity.
- A report on the public involvement effort and customer input.[1]

o With respect to the acquired company:

- Identification of ownership of all transferred water plant.
- Inventory of plant being transferred.
- The location of the acquired company relative to the acquiring company and to nearby systems, both municipal and private.

o With respect to the acquiring company:

- A copy of the proposed purchase contract.
- Identification of municipal approvals, if required.
- The proposal for financing the acquisition, if appropriate, including applicable information in compliance with 16 NYCRR Part 37.

By the Commission,

(Signed) JOHN J. KELLIHER
Secretary

[1]In reviewing any acquisitions, we will focus on the results of the company's public involvement and information efforts.

The PUC Role in Assuring Viable Water Service In Small Communities

John E. Cromwell, III
Richard F. Albani
Wade Miller Associates, Inc.

Introduction/Overview

Regulation of water systems in small communities has been a long-standing problem for both state public utility commissions and state public health regulators. Though many potential solutions have been suggested, progress has been very slow due to a lack of stimulus. The inertia of the status quo may finally be broken by the catalytic effect of tougher new compliance requirements under the Safe Drinking Water Act (SDWA). However, a significant restructuring of the small community segment of the water supply industry is needed if SDWA compliance requirements are to be met in a manner which is sustainable.

The inherent incrementalism of the SDWA regulatory program could introduce tremendous inefficiencies into the restructuring process. Restructuring should be approached within the context of a long-term planning horizon. A process resembling ***integrated resource planning*** is required in order to provide assurance that the restructuring process will reflect ***least cost*** principles. If the motive force provided by near-term SDWA compliance pressures is allowed to be the only force at work, the result will most certainly not be ***least cost*** and the problem of assuring reliable water service to small communities will grow worse.

The threat runs deeper than a mere concern for economic efficiency. The concern for ***viability*** stems from a growing concern over ***non-viable*** small water systems. There are presently many thousands of small water systems that are regarded by regulators as "basket cases." These are cases where the institution responsible for providing water service is essentially in default; where the utility management has effectively failed, as manifest in violations of current SDWA standards which represent very genuine public health problems. These are systems which cannot respond to an order. They are unable to cope with problems such as pollution of wells, maintenance and replacement of deteriorated infrastructure and equipment, inadequate pumping, poor water quality, and even breakdowns and wells running dry.

The threat is that there are many thousands of additional "marginal systems" that will become "basket cases" under pressure of SDWA compliance. In addition, many potentially viable solutions may be by-passed due to SDWA-induced incremental decisionmaking, undertaken in the absence of a long-term planning process.

Ultimately, state government will have to intervene to impose a planning discipline and promote efficient restructuring, or to take over and direct restructuring after failure has occurred. The issue is not SDWA compliance; the issue is the long-term reliability and cost of the water supply infrastructure systems serving small communities. If the broader public interest is to be served, there is a clear mandate here for broader forms of intervention by state public utility commissions (PUCs).

Several states have begun to lead the way. This paper draws examples from the experiences in Pennsylvania[1] and Connecticut[2] where the authors have had substantial experience in the development of coordinated interagency strategies to once-and-for-all confront the small water system problem. The Pennsylvania example is more modest, illustrating key first steps towards broader intervention. Connecticut is an example of sweeping reform. The paper uses these two examples to define and characterize the generic components of a coordinated state strategy to enhance the viability of water service in small communities and to highlight the major elements of the PUC role.

The Need for Restructuring

Although large urban water systems serve 90 percent of the population, they account for only 10 percent of the total number of community water supplies. The overwhelming majority of water systems nation-wide are very small systems serving less than 3300 persons.

These proportions result in some very unfavorable economics. While having only 10 percent of the total customer base, small water systems will account for roughly half of the total capital demands imposed by the SDWA and over half of the total annualized cost of compliance.[3] Moreover, infrastructure rehabilitation and replacement requirements exposed by tougher SDWA performance levels will likely entail a comparable level of capital investment needs merely to maintain the existing facilities serving small systems.

Historically, the major cost element in water system construction was the distribution system. Source development and treatment costs were trivially small; all that was required in many circumstances was a well, a pump, a tank, and a chlorinator. The result was a vast proliferation of small independent water systems, often operated by a developer or by a homeowner's association. This configuration evolved in the historical cost environment in-part because it was the *least cost* solution within that environment.

Small water systems are thus a product of the low-cost environment in which they were created. With the capital and operating costs of water service being historically very low, and the effects of inadequate maintenance and replacement being so lagged as to be invisible in the short run, there were no significant cost pressures in the environment in which many small systems were formed. In the absence of significant cost pressures, the institutions originally devised for the purpose of running small water systems evolved without the types of management and financial mechanisms needed to cope with more demanding economic realities becoming apparent today. In the face of the SDWA-induced changes in the cost environment, it is becoming clear that the current configuration involving thousands of small systems is no longer the *least cost* solution.

---

1 Cromwell, J., Harner, W. Africa, J. and Schmidt, J.S., "Small Water Systems At A Crossroads," *Journal of The American Water Works Association*, May 1992.

2 Albani, R., "Connecticut Legislation And Experience In Acquiring Small Systems," Annual Conference of the American Water Works Association, Philadelphia, PA, 1991.

3 Schnare, D. and Cromwell, J., "Capital Requirements for Drinking Water Infrastructure," Sunday Seminar on Capital Financing, Annual Conference of the American Water Works Association, Cincinnati, OH. June 1990.

The small system problem has been described for much of the past two decades. A fundamental theme repeated in many of the prescriptions that have been written is the simple notion that small communities will have to adapt to paying much higher water rates. While it is true that higher rates will have to be a part of any solution, a more fundamental requirement is that institutional mechanisms be put in place that are capable of responding more broadly to the challenges of today's cost environment in the water supply industry -- capable, for example, of raising additional capital, of prudent husbandry of the capital stock over the long term, and of sustaining a much more demanding O&M regime on a daily basis. Raising rates is an insufficient solution if it is unaccompanied by other institutional reforms.

The Imperative Need for Planning

SDWA regulatory requirements are a source of significant change in the small system segment of the water supply industry just as they are for the industry as a whole. But the resulting changes in financial risk characteristics could have much more ominous consequences for some small systems, involving more pain than that embodied in a higher water bill.

Without deliberate efforts to the contrary, a well-intentioned approach to meeting SDWA compliance requirements could become a trap for some systems. SDWA regulations will be phased-in incrementally the next decade. As a result, systems may be lured into thinking they are capable of meeting all the new performance requirements when they, in fact, are not. The realization of the true extent of SDWA compliance and infrastructure rehabilitation liabilities could become apparent only after taking on substantial new debt and passing up better options. Satisfaction of SDWA capital demands could also result in further deferral of infrastructure maintenance and rehabilitation needs, creating additional liabilities.

Ironically, as a "break" to small systems, they are allowed more time to comply than larger systems. As a result, however, the larger systems that might be the keystone of a regionalization strategy are making commitments, sizing facilities, and putting concrete in the ground already. Many logical opportunities may be lost forever (e.g., main extension possibilities for the 50 percent of small systems located within suburban areas).

The financial risks involved extend past the owners of the water system to the individual residential customers. If the water system serving a residence becomes incapable of meeting either its financial or its SDWA compliance liabilities, the default could have a negative effect on the values of properties connected to the system. Thus, there is an imperative need for risk management through a planning process.

The fact that there is risk which could convey to individual homeowners provides a potentially strong motivation that can be used to build support for a planning process and for plan recommendations. Under the status quo, there may be no desire to become entangled in a purchased water arrangement with the town down the road, for example. But, a planning process may reveal that doing business with the town down the road is the least objectionable alternative available.

Another equally compelling reason to plan is that there are many thousands of situations where the results will be quite positive. Water supplies are not, for the most part, heavily contaminated; SDWA compliance burdens will therefore be relatively light in many instances. Documentation of compliance liabilities in a plan can help a small system obtain more attractive financing by distinguishing such relatively light burdens from those of other riskier systems. Moreover, a planning process provides a

means of assuring that even more attractive possibilities are not missed. For example, it may be advantageous to expand the customer base by becoming "the town down the road" and selling water to the neighbors.

Viability and Restructuring

In nature, environmental change induces animal and plant species to adapt in order to survive. A parallel exists in economic institutions. Changes in the business environment must be met with appropriate *restructuring* of economic institutions in order to assure the long-term *viability* of the enterprise.

A viable water system is one which has a sustainable ability to meet performance requirements over the long-term. An alternative, and simpler, definition of viability is: ***the ability to cope with change.***

There are many different strategies that can be adopted in approaching the restructuring of institutional arrangements for providing water service. They are classified here into two categories: external and internal.

- *External* strategies involve active collaboration with other adjacent water systems to attain the advantages of operating at a larger scale-- this amounts to various different forms of regionalization.

- *Hard* regionalization implies structural consolidation -- extending a main to enable hooking up to, or purchasing water from, the town down the road. This is often infeasible in remote rural areas, but approximately half of all small water systems are within the Census Bureau's Standard Metropolitan Statistical Areas; i.e., within suburban rings of major metropolitan areas.

- *Soft* regionalization encompasses an array of strategies for obtaining large scale economies in management, operations, and finance through various sharing arrangements. A popular model is contract provision of operation and maintenance services on a rotating, circuit-rider basis. Another successful example is formation of a county or regional authority to provide not only circuit-rider operation and maintenance services, but also centralized management and pooled access to the capital markets. Finally, there is also an array of *"soft" soft* regionalization strategies, involving such loose linkages as equipment sharing and joint procurement to pool buying power.

- *Internal* restructuring strategies involve changes in management and finance sufficient to produce a "turnaround" in the likely fate of the small system. Not all small systems are basket cases. There are many that may be able to handle the changes ahead if they make the right management and financial adjustments. In some cases, such changes might be accomplished through a simple change of ownership.

There will always be some areas where remoteness or other aspects of geography dictate the provision of water service independently at small scale. It may not be possible to involve every small system in *hard* or *soft* regionalization schemes. Moreover, there are many small systems that are presently viable, and that can continue to be viable. There is, however, a danger that in undertaking measures to assist small systems in maintaining their independence, the state would inevitably become involved, to some degree, in supporting, or propping up, systems that would not be viable in the absence of state assistance. Neither forcing regionalization and consolidation nor sustaining non-viable systems through

subsidies should be objectives of state viability policy. Rather, the objective of state viability policy should be to help owners and customers of small water systems identify the most viable strategies for provision of water service while, at the same time, adjusting state-controlled barriers and incentives in a manner that will promote the widest possible range of choices.

Framework for A State Viability Initiative

The comprehensive state viability initiatives launched in Pennsylvania and Connecticut have two major parts. The first part is a systematic ***viability screening process*** to generate and review the information needed to assess the viability status of both newly proposed and existing small water systems. The screening process is intended to directly involve water system owners, managers, customers, homeowners, tenants, creditors, and local public officials in confronting the issue of institutional capability in the context of two main strategic questions: 1) is the present system configuration viable over the long-term; and 2) are there any better options available for providing service at larger scale?

To enable individual water systems to make a complete assessment of the most viable strategies for provision of water service, there must be complementary state action to adjust barriers and incentives that affect the range of options available. The existing legal and regulatory setting at the state level has co-evolved with small water system institutions in the historical low-cost environment. There are, as a result, many types of inadvertent barriers to efficient restructuring which have developed over time in the absence of any opposing influences. The objective of the second half of a state viability program, therefore, is the launching of a number of ***sympathetic initiatives*** designed to remove barriers to viability enhancement and/or provide additional incentives and assistance to systems striving to attain viability, including provision of a safety net to handle restructuring of failed systems.

Viability Screening Processes

In its simplest form a viability screening process consists of measures to get small systems engaged in taking ***The viability test***. ***The viability test*** is intended to promote a grass-roots awareness of the changes that are coming and of the full range of options that may be available for coping with change. In the viability test, the intent is to engage small system owners, managers, and customers in confronting the facts of their situation in enough depth to answer these three questions:

1. Is the current system configuration viable?
2. Are there better options available at larger scale?
3. What is the best option?

The hope is that by confronting the realities of the situation and making comparisons to the obvious alternatives, the potential benefits of either internal or external restructuring will become evident. Where these options make sense to people, they will be more likely to pursue them.

In applying ***the viability test***, it is important to address the three questions in the proper context -- with a focus on the long-term prospects of the water system. Focusing on the immediate situation is likely to lead to an incorrect conclusion. There are many small systems who would rate themselves as viable, given the operating conditions they are faced with today. But the real question, as implied by our definition of viability, is can they cope as well with the changes that will be upon them over the next few years? If a system bases decisions about the future on the conditions that exist today, it not only runs the

risk of selecting an option that will turn out to be non-viable, but it may also be foreclosing opportunities to adopt other, more viable options.

A common conclusion in the states that have pushed forward with viability screening initiatives is that strategies for intervention can be most effective when they are viewed as a coordinated, interagency effort undertaken on a statewide basis. Several state agencies have means of administering *the viability test* through their unique channels of access to small systems. Implementation of many potential solutions requires legal authority that lies outside the reach of the SDWA, but within (or, conceivably within) the reach of other agencies such as, especially, the PUC.

There are three different types of planning initiatives that have been conceived as means of administering *the viability test*. These are;

1) new system viability screening -- controlling the growth in the number of potentially non-viable small systems by making them pass a version of *the viability test* as a condition of getting a permit.

2) development of system-level business plans -- applying *the viability test* directly to existing small systems through various means.

3) *comprehensive regional water supply planning* -- incorporating *the viability test* into broader comprehensive planning processes.

Viability Screening of New Small Systems

Viability screening of new small systems is an attempt to thrust back upon real estate developers the responsibility for demonstrating that the system will be viable over the long-term before granting the permit to the system. Viability research performed in Pennsylvania produced a useful tool for conducting this type of analysis called, PAWATER.[4] PAWATER is a user-friendly, menu-driven PC-program that enables the user to develop a rough estimate of the *full cost* of building and properly operating and maintaining a water system. It also summarizes results in terms of the capital cost per dwelling unit and the annual household water bill to give the developer a realistic picture of the true cost that will have to be borne.

An additional approach to new system screening is to require financially-backed assurances or guarantees of viability. The concepts being considered include: escrow accounts, an irrevocable letter of credit from a bank, reputable co-signers, and a contract with a reputable contract O&M organization.

Both viability screening tests and assurances and guarantees require specific legal authority which does not always exist. There are a number of different strategies for implementing these measures.

Some states have successfully modified their state SDWA statutes to enable both viability screening of new systems and requiring assurances. Authority for viability screening can be accomplished by simply inserting the word viability at the right place in the law. Viability screening can then be further

[4] Gannett Fleming, Inc. and Wade Miller Associates, Inc., PAWATER: Financial Planning Model for New Small Community Water Systems. Prepared for the Pennsylvania Department of Environmental Resources, July, 1992.

defined through rulemaking. Authority to require assurances might have to be more specifically defined in the statute, but the details can still be left to the rulemaking process. The major drawback of modifying the state SDWA statute to provide authority for viability screening or assurances is that state SDWA primacy agencies are staffed with engineers who are not equipped to implement such authority.

In many places state Public Utility Commissions may already have sufficient authority to perform viability screening and to require assurances for companies within their jurisdiction. However, the exercise of such authority by PUCs tends to promote formation of non-profit cooperative homeowners associations as a means of escaping PUC scrutiny. The California PUC adopted strict screening criteria over a decade ago. They have not approved a single new system since, but the number of cooperatives has mushroomed.

Connecticut has solved this problem by expanding the reach of the PUC's certification authority to include all types of water systems, regardless of ownership. In applying for a certificate, the proposed owners/operators must pass thirty discrete viability tests to the satisfaction of the state health department and the PUC. Notably, the permitting and certification authorities of the two agencies were formally fused by statutory changes. Joint approval is required. This integration of regulatory authority affords the advantages of the health department's engineering expertise and the PUCs financial expertise. Pennsylvania is attempting to achieve some of the same benefits through closer coordination of SDWA permitting and PUC certification authority, as documented in a formal Memorandum of Understanding (MOU).

The wish of many state regulators is to transfer the responsibility for assuring viability of new systems to the local level. It is reasoned the local authorities responsible for land use decisions should be made to accept the responsibility for taking over any new systems they approve if these systems should later prove to be non-viable. While there is a ring of justice in this idea, it is difficult to accomplish politically. Connecticut has done it by passing a law that holds the municipality responsible if a water system is allowed to be constructed without first being certified by the PUC and the health department.[5]

A final means of accomplishing new system viability screening is to incorporate it into a comprehensive water supply planning process. The essence of such a process is that it attempts to define logical service area boundaries, including logical main extensions to serve new development. This may provide a less threatening way of enlisting the cooperation of local governments responsible for land use decisions.

A non-regulatory means of disciplining developers of new water systems is through education of the home-buying public. If, through newspaper stories or other means, it is possible to elevate SDWA compliance status to the same level of visibility as testing of indoor air for radon, a market pressure to assure viability might be established.

Viability Screening for Existing Small Systems

The development of system-level ***business plans*** for existing systems is the grass-roots approach to applying ***the viability test***. Developing a business plan may sound too sophisticated for many small systems, especially for the basket cases, but the components of the system-level business plan can be quite simple. The key is a simple comparison of the costs of different alternatives. The business plan covers three areas.

---

[5] Section 8-25a of the *General Statutes of Connecticut*.

The facilities plan is developed on the basis of a comprehensive assessment of all the likely improvement needs of the existing system. This should encompass present and future SDWA compliance needs as well as the backlog of unmet infrastructure repair and replacement needs. The bottom line is a realistic estimate of the costs of making these improvements and the required schedule of expenditures.

At the same time, a parallel analysis is performed to develop estimates of the costs of all conceivable alternative schemes for providing water service, including all plausible *hard* and *soft* regionalization strategies.

The combination of these two cost analyses permits a small system to squarely confront the facts of their situation and evaluate the available choices in terms of a clear cost criteria. Obviously, there are many small systems who will need help in developing even so simple a plan as this. That is where various state officials and various members of the army of technical assistance providers can play an important role.

The hope, of course, is that by confronting the facts, many systems will discover more viable options at this grass roots level, resulting in greater acceptance of regionalized solutions. However, if the numbers suggest a stand-alone operation is still the best choice, then the other two components of the business plan provide a means of assuring the same type of grass roots recognition of what it takes to maintain a viable operation.

The management plan is a simple idea that is an important missing piece in many small systems presently. The idea involves nothing more than writing a few things down on paper to make it clear who is responsible for different operating functions and what those functions are. The act of writing these things down makes the need for specific management commitments more clear.

The financial plan is intended to assure sufficient revenue to meet the *full costs*. This is accomplished by simply acknowledging on paper the amount and timing of capital investment required in the system over a multi-year forecast and the annual cost per household, or annual water bill. By committing to these key cost figures on paper, there is an implicit financial commitment to viability.

There is an important side issue to this financial aspect of the business plan as it relates to the integration of SDWA and PUC authority. It has often been suggested that SDWA primacy agencies should be able to develop financial criteria for deciding whether or not a system is viable, as a means of forcing regionalization alternatives. There are many defects in that approach. Primary among them is the fact that only a state public utility commission or municipal government can set water rates. There is also the fact that SDWA primacy agencies are staffed with engineers, not financial analysts. However, if the level of capital and annual revenue needed to operate effectively is defined by the facilities plan, then it can be argued that a system must be willing to commit to that level -- by whatever rate structure they choose, or can get approved -- in order to document their ability to remain viable: to sustain SDWA compliance over the long-term.

Thus, the willingness to make the necessary financial commitment in a business plan can be interpreted in terms of SDWA compliance without invading the rate-making authority of other entities. To the SDWA primacy agency, it is immaterial how high the water rates are, or how they are structured, all that matters is that they reflect a commitment to carry the *full costs* of a sustainable operation. In a state where the word "viability" can be inserted into the state SDWA, this full cost test could conceivably be incorporated into the SDWA regulations in the form of a business plan requirement without contradiction of other rate-making authorities and without the primacy agency having to become involved

in any type of financial analysis; all that is involved is an assessment of the *full costs* of operation on the basis of engineering cost analysis.

In Pennsylvania, a viability criterion was included in the state SDWA regulations implementing the filtration requirement for surface water systems. This provided the state SDWA primacy agency with authority to require the essential elements of a business plan. In Connecticut, the integrated exercise of authority between the PUC and the health department was mandated in the context of a deliberate viability initiative, providing complete authority to require and evaluate a complete range of information. In another expansion of the PUC domain, this process in Connecticut provides a requirement for annual reports from all water systems, regardless of ownership status.

State Public Utility Commissions usually have the authority to explore the full range of viability concerns in the course of routine proceedings such as overall rate hearings or advisory ruling hearings required for approval of SDWA-induced treatment expenditures. PUCs generally have a responsibility to assure that the service being provided is least-cost, safe, adequate and reliable. These principles fit squarely within the concept of long-term viability. Historically, PUCs have been unable to pay much attention to water issues due to their preoccupation with other much larger utilities. That situation is changing, however, as SDWA rate cases begin to appear more frequently on the dockett.

A potentially very effective means of administering a business plan requirement is through the application process for attaining financial assistance. This is a remarkably effective strategy that has been employed in-part by the Farmers Home Administration for many years; they have used the quid pro quo of financial assistance in exchange for financial discipline to help turnaround the fate of many many small rural systems. The key to expanding this strategy is to get other lenders to recognize what the Farmers Home Administration has known for many years -- that the long-term viability of the system is critical to determining whether they will be paid back for their loans. Two avenues of expansion of this mechanism are available:

- State revolving loan funds, bond pools, or other financial assistance mechanisms can be encouraged to incorporate elements of the business plan in their application requirements as a means of assessing their own financial risk.

- The local banking community can be educated to better understand the long-term threats to viability, causing them to require the same type of long-term viability planning in their application requirements.

In Pennsylvania, the existence of PENNVEST, a state revolving loan fund which encompasses water supply as well as wastewater, provided an excellent means of focusing this leverage. The SDWA primacy agency and the PUC are presently negotiating a three-way MOU intended to fully coordinate information and analysis relevant to the viability initiative.

A more direct means of encouraging the development of system-level business plans is through the auspices of technical assistance providers who are in continuous contact with the systems, know the situation, and have the trust of small system owners, managers, and customers. This may present a dilemma for technical asistance providers. If the system may be better off as part of a consolidation or regionalization scheme, technical assistance providers could view this as working themselves out of a job. But, in the final analysis, technical assistance providers must confront this issue and ask whether they are really helping to find long-term solutions, or are they just propping the system up to last a little longer. All their hard work is to no ones' benefit if the system is not viable over the long term.

A final strategy for encouraging the type of system level business planning that is needed to assure viability over the long term is to create a pressure for such planning by educating homeowners/customers regarding the implicit risks to the value of their properties if the system is not viable. The wrong decisions regarding viability choices could result in much higher water bills than might have been possible under potentially available alternative arrangements. At worst, a default on SDWA compliance could become a negative factor in real property transactions. There are cases where this worst case scenario has indeed happened.

Comprehensive Water Supply Planning

All of the strategies discussed above for applying ***the viability test*** have been based on taking a case-by-case approach, developing individual business plans for one water system at a time. An obvious shortcoming of that approach is that these individual planning efforts may or may not be optimally synchronized with those of neighboring systems, presenting an obstacle to consideration of potential strategies for collaboration within the region.

This disjointedness is made worse by the staggered implementation pattern of SDWA regulations. A large or medium-size system that might be the logical hub of a *hard* or *soft* regionalization scheme may be faced with the need to make compliance decisions several years sooner than the surrounding small systems. Similarly, a surface water system may have to make tough decisions regarding compliance with the Surface Water Treatment Rule years before a neighboring groundwater system will have to face decisions under the Groundwater Disinfection Rule.

Without some process for bringing things together within a region, many opportunities to improve the viability of water service through regionalization may be passed by. Human nature suggests that once individual water systems begin to sink money into compliance expenditures, there will be ever greater resistance to giving up on the old system, even if it is not the most rational alternative. Thus, not only will opportunities be lost, but new barriers will be created.

Happily, there is a cure for this that has been demonstrated in a few states that have put regional Comprehensive Water Supply Planning programs in place. Washington and Connecticut have implemented a program of comprehensive planning through the authority of explicit new statutory mandates requiring such planning. The comprehensive planning process achieves considerable economies in that *hard* and *soft* regionalization alternatives can be assessed jointly for all systems within the planning region. The planning process promotes the same type of grass-roots understanding as the business plan process because it implicitly involves all the same steps as the business plan. Moreover, it convenes a formal consensus building process among the systems in the region through which the feasibility of alternatives is jointly discussed and evaluated.

The regional comprehensive planning process is particularly valuable because -- by virtue of its regional scope -- it inherently catches the basket cases that might otherwise have difficulty mounting a planning effort and it automatically encompasses the issue of new system development within the region. The Comprehensive Planning Framework is also ideal for incorporating significant collateral issues such as questions of water allocation and water rights. Water quantity issues were in fact the primary impetus behind the statutory mandates for comprehensive planning in both Washington and Connecticut. With the quantity issue included, the planning framework is essentially identical to that defined in the utility field as *integrated resource planning*.

There are two major obstacles to establishing a regional comprehensive planning approach: 1) politics, and 2) money.

There are many places where planning is either regarded as an exclusively local responsibility or as nobody's business. It is typical to expect lots of resistance to any type of planning mandate handed down from the state level. In both the Washington and the Connecticut programs, final plan approval authority rests with the state and both states intend to use the process in unpopular ways, such as making local officials responsible for guaranteeing the viability of new small systems. In Washington, the establishment of such a strong state planning mandate required persistent, repeated assaults on the legislature over a period of many years. In Connecticut, the unique experience of a severe drought provided the uncommon political momentum sufficient to implement such a program.

The best approach to sweetening the appeal of a planning initiative is to allow significant local control of the planning process and to provide funding to cover the costs of planning. In deference to political and budgetary realities, Pennsylvania has adopted an incentive-based approach. Three demonstration programs have been launched. One offers regionalization feasibility planning grants to any group of two or more municipalities in rural areas. Another provides demonstration grant funding to study the feasibility of establishing county-wide authorities. The third provides demonstration grants to counties interested in launching comprehensive water supply planning initiatives. Such a voluntary approach to initiating comprehensive water supply planning will probably not provide coverage to all parts of the state, but it will encourage planning to go forward in areas where this approach is acceptable and where there is a demonstrated interest expressed by local officials, as manifest by their interest in obtaining the grant funds. These may be just the areas where a planning approach has the greatest chances of succes in any case.

Sympathetic Initiatives to Facilitate Restructuring

As stated above, it is not enough to get small systems involved in long-run planning -- in seriously looking at all their options. The second part of a state viability initiative has to consist of a wide range of what have been called, *sympathetic initiatives*. These are coordinated efforts by different state agencies intended to make the widest possible range of choices available to small systems. This is accomplished by taking a sweeping look at all the ways in which the various agencies of state government can facilitate the possibilities for beneficial restructuring. There are three generic ways in which the state can do this:

1) removing barriers to restructuring solutions;

2) providing incentives to restructuring solutions; and,

3) providing a *last resort* means of accomplishing restructuring under the direction of the state.

Adjusting State Barriers and Incentives to Restructuring

One of the most important things that must be recognized in undertaking measures to promote viability is the need for restructuring not just of small water system institutions, but of various institutions of state government as well.

Just like small system institutions were shaped by the historical low cost environment, institutions of state government are also a product of this historical environment in which small water systems were not a recognized problem. As a result, the pattern of incentives presented by state government programs and policies is in many ways insensitive to concerns over viability and restructuring. There are many instances in which the actions or policies of state agencies present inadvertent barriers to regionalization. There are many ways in which actions or policies of state agencies inadvertently create incentives that work against consideration of long-term viability.

The solution to this problem is to undertake a comprehensive review of barriers and incentives related to the activities of each relevant state agency to explore possibilities for removing barriers and adjusting incentives in a way that will favor the most viable outcomes. The objective is to achieve a coordinated state program wherein all agencies are pulling together in the same direction.[6]

The SDWA primacy agency provides an important incentive in the form of regulatory pressure to comply with SDWA regulations. But it is important to be sensitive to the difference in incentives that may result depending upon how this pressure is applied.

If the primacy agency implements the regulatory program in a strictly incremental -- i.e, one-rule-at-a-time -- fashion, this may encourage incremental thinking rather than long-term planning within the individual water systems. As discussed earlier, this can be combated by finding a means of making systems think through the long-term implications for SDWA compliance before they commit to incremental decisions.

A second area where the SDWA primacy agency has an important role in structuring incentives is in the area of exemption policy. As a general rule, the perception of strong enforcement pressure creates strong incentives to evaluate prospects for long-term viability and to entertain notions of regionalization. The hope of relief through granting of an exemption can take the steam out the enforcement incentive, however. The best approach is to emphasize the temporary nature of exemptions -- that they are merely a time-extension, not a waiver. In keeping with the statutory provisions, the extra time can be granted in exchange for a plan and a schedule to eventually achieve compliance. An acceptable basis for a time extension is time required to pursue regionalization strategies or to obtain financing. This could conceivably be tied into a business plan requirement.

The SDWA primacy agency can also present a barrier to viability and restructuring in the manner in which it approaches the engineering plan review process in considering approval of innovative technologies. In many cases, engineering conservatism and the mere cost of the review process have presented a barrier to the introduction of potential small-scale technological fixes. This area of policy should be reviewed in light of the overall problem of finding lasting solutions to the small system problem. In the operating arena, the SDWA primacy agency determines the stringency of operator certification requirements, within statutory limits. In states where these requirements are strongest, the effect is to create strong market incentives for circuit rider O&M strategies.

Public utility commission procedures and protocols represent another area where the state can exercise its authority in a manner which either helps or hinders progress towards long-term viable solutions. With regard to investor-owned water systems, state public utility commissions can exert regulatory pressure bearing directly on the issue of viability as it relates to the quality of service provided to customers.

---

[6] USEPA. Restructuring Manual. EPA570/9-91-085. December 1991.

But, PUCs also have a significant role in structuring barriers and incentives affecting the feasibility of regionalization and restructuring options involving both publicly and privately owned water systems. PUC regulatory involvement is generally invoked in any situation involving a transaction between public and private entities.

When a municipal system extends service to a suburban area outside the city limits, the PUC often intervenes to regulate rates charged to the suburban customers. In many cases, this has been a significant barrier to logical extensions of service to contiguous suburban areas and the creation of regional water systems. In light of the concern for the long-term viability of the approach to providing water service to such suburban customers, this is one area of PUC policy that might be revisited in the context of a broader concept of the public interest that the PUC is attempting to protect.

In many states, there are large investor-owned water companies that own and operate a number of large and small systems throughout the state or within certain regions of the state. In some cases, this takes the form of a privatized approach to regionalization. In some cases, PUCs have approved *single tariff rates* for such situations which allows the company to incorporate systems that might not be economically viable within a regionalized scheme and which also reduces the burden of rate case filings to one unified application for the entire regional operation.

A final significant area of PUC involvement is in regulating any transactions involving the transfer of ownership between two private water companies or between a private company and a publicly owned company. Such ownership transfers may be integral to the success of regionalization schemes. There are many situations, such as the municipal/suburban boundary case that we just discussed, in which publicly owned and privately owned systems exist in a contiguous polka-dot pattern. The difference in ownership status can present one of the most formidable barriers to regionalization. Historically, PUCs have applied a complicated set of iron-clad rules to the evaluation of ownership transfers in an effort to protect the public from being charged too much when depreciated plant and equipment changes hands. This is another area where PUC policies need to be revisited in order to assess whether the benefits of such regulatory protection outweigh the costs of possibly missing the opportunity to put regionalized solutions in-place that will provide a more viable long-term approach to providing quality service. Pennsylvania, Connecticut, and several other states have enacted more liberal *merger and acquisition adjustment* laws which enable progress in the right direction. Connecticut has enacted laws which permit the PUC to authorize slightly higher rates of return on investments related to certain acquisitions.[7]

Water resources agencies in states afflicted with chronic water resource shortages, may be an extremely significant factor in the incentive strucutre. A potential regionalization scheme that might make compelling economic sense in light of the burden of SDWA compliance and long-term viability, may be totally pre-empted from consideration due to the ramifications that consolidation may have in causing water allocation formulas to be adjusted. As with PUC regulation, water resource allocation policies need to be revisited in light of the broader objective of providing water supply in a manner that will be sustainable over the long-term.

State technical and financial assistance programs are another category of state initiatives that needs to be revisited. The most important change that is needed is to redirect the focus of these initiatives to the long-term. If technical and financial assistance are provided to small systems on an incremental basis, the effect may be simply to prop them up -- get them by today's SDWA requirement -- and preserve them until some inevitable future day of reckoning. The net effect could be quite perverse (i.e., "Pick 'em

[7] Section 16-262r of the General Statutes of Connecticut.

up, so I can hit 'em again.") in contrast to the original good intentions. This can be especially perverse in the case of state-supported financing, such as from a state revolving loan fund -- once the state has invested in a small system, it has a vested interest that may become a barrier to regionalization.

The simple solution to this dilemma is to redirect all technical and financial assistance initiatives to operate on a "strings-attached" basis. In this approach, the provision of technical and financial assistance is provided in a manner that promotes progress towards viable long-term strategies. In the financial assistance area, a simple measure adopted by some states, for example, is to give funding priority to applications which involve regionalized solutions. In both Pennsylvania and Connecticut, the state financial assistance programs have been fully incorporated in the state viability initiative in order to achieve this strings-attached feature.

State Takeover Authority And Directed Restructuring

The final essential element of a state strategy to facilitate restructuring is takeover authority -- the ability to direct the restructuring of the "basket case" systems that have defaulted under regulatory pressure. This is a very misunderstood concept. In many people's minds, this should be one of the first instruments of policy. Some believe that states should get substantial new authority and begin to mandate restructuring of the small system segment of the water industry from the start. There is also another school of thought which suggests that this should be the last instrument of policy.

Ultimately, the need for state exercise of takeover authority is inescapable. Such authority can be very expensive to exercise, however, and, on general principles, forced restructuring is likely to be much more troublesome than a restructuring process driven by incentives. Under the incentive-driven approach, the number of basket cases that ultimately have to be restructured by the state is minimized through a process of: 1) incentivizing grass-roots long-term planning to identify options, 2) removing barriers and creating incentives to maximize the range of options available, and 3) applying firm SDWA enforcement pressure to drive the process.

Under this approach the takeover authority is used as a means of following through on SDWA enforcement pressure -- when a system defaults and has no option left but to hand over the keys, the state has to be able to move into the driver's seat in order to sustain the credibility of enforcement. Keeping the pressure on, while opening as many doors to viable restructuring options as possible is the surest means of minimizing the number of basket cases that might have to be taken over in the end.

In the end, the exercise of state takeover authority represents an excursion into a much broader area of public policy than that of the SDWA policy arena. This is important to recognize because takeover of basket case systems will inevitably involve a subsidy from the state. In this respect, the takeover mechanism is a *safety net* -- a reflection of state policy regarding rural poverty, rural infrastructure, and economic development. Development of an effective takeover mechanism must draw on these broader constituencies.

The unavoidable need for a subsidy to deal with the basket cases provides another over-arching reason for adopting an incentive-based approach to the overall restructuring process; it provides a means of minimizing the total amount of subsidy required and a means of assuring that subsidies are directed to the true basket case situations where this type of assistance is truly needed.

The need for a takeover mechanism also provides another compelling reason for expanded involvement by the PUC. The PUC is the only state agency that is staffed and equipped to provide provide the relevant type of administrative process with protection of rights to due process. The PUC has the staff expertise required to evaluate all aspects of a default situation and a charter to weigh all the broader public interests. In Connecticut, the takeover law permits the commission to order takeovers regardless of the ownership of the utilities involved. This expansion of PUC authority beyond the normal realm results in a very complete mechanism for resolving defaults. By Contrast, the takeover law in Pennsylvania is narrower, enabling the commission only to order takeovers of investor owned companies by investor owned companies.

Conclusions

Researchers of the National Regulatory Research Institute have proposed a framework for consideration of alternative approaches to regulation in the water supply field.[5] It is grounded in the recognition that commission regulation need not be viewed as an all-or-nothing monolith. State public utility commissions typically have six discrete types of authority, as follows:

- o issuance of certificates,
- o establishment of rates,
- o approval of short and long-term financing,
- o approval of ownership transfers,
- o resolution of customer complaints, and
- o establishment of reporting requirements.

The NRRI researchers offer the insight that regulation may be made more efficient through the development of strategies that adjust the degree and form of intervention within these discrete areas. The coordinated state viability initiatives launched in Pennsylvania and Connecticut, discussed in this paper, illustrate a number of ways in which the exercise of commission authority in these six areas can be modified to allow the natural expertise and ability of the PUC to be more fully brought to bear on the development of sustainable solutions to small system problems.

In the area of certification, for example, commissions can probably determine that assessment of new system viability is already under their authority for investor owned systems. The Connecticut program illustrates how PUC certification authority can be expanded to encompass all new systems without expanding the other five dimensions of commission regulation. Only one of the six areas of PUC authority needs to be expanded in order to address this aspect of the small system problem. Certification of public convenience and necessity is a fundamental PUC function performed to protect the public interest in the configuration of utility service areas. Expansion of the PUC role to protect the broader public interest, as in Connecticut, is a logical step.

The natural role of the PUC in certification can also be relied upon as a source of authority to promote stronger forms of intervention when the inevitable need arises for the state to direct the takeover of basket case systems in default. Again, the Connecticut example leads the way in pointing to logical reforms. Rather than leave the PUC hobbled in this area by traditional constraints of jurisdiction, the Connecticut legislature expanded the reach of the PUC to permit it to direct takeovers regardless of the

---

[5] Beecher, J. and Mann, P., Deregulation And Regulatory Alternatives for Water Utilities, National Regulatory Research Institute, Columbus, OH, February 1990, NRRI 89-16.

ownership status of the entities involved. Again, the Connecticut PUC is empowered to protect the broader public interest. Over forty takeover orders have been issued so far.

With the right reforms in regulatory practices, the PUC can also play a more active role in promoting healthful forms of restructuring through incentives. In the area of mergers and acquisitions, Pennsylvania and Connecticut have enacted enlightened adjustment mechanisms that can permit variations from rigid accounting rules when the broader public interest favors making some compromises in order to promote efficient restructuring. PUCs can draw on both their certification and rate making authority in this area.

An issue for consideration in the area of rate reform pertains to the rate case treatment of inside-the-city versus outside-the-city transactions. It may be worthwhile to re-evaluate the benefits and costs of traditional regulatory approaches. Is the airtight protection against the evils of monopoly worth the social cost it imposes in the resulting balkanization of nearby suburbs into an inefficient and potentially non-viable patchwork of small entities? One approach, adopted in Connecticut, is to expand the reach of PUC reporting requirements to cover municipals. In this strategy there is the implied threat of expanded PUC rate regulation if municipals stray to far from reasonableness. Conceivably, a commission could also determine to keep the complaint window open as a check on municipals. The threat of PUC regulation of municipals may be as effective as the reality.

As also highlighted in recent NRRI research, the PUC can play a significant role in sponsoring a process of integrated resource planning in the water supply field.[9] Such planning processes are an extremely beneficial means of mobilizing support for efficient restructuring. The Connecticut case represents an example where the PUC is actually the lead entity in spearheading such planning efforts. The substance of the planning process goes to the heart of commission responsibilities for certification and encouragement of *least cost* configurations. The Pennsylvania example illustrates an approach to mobilizing a planning process even in a situation where planning is less widely accepted.

We offer the following conclusions regarding the role of the PUC in assuring viable water service to small communities:

1) Without more significant intervention by state government, the restructuring of the small system segment of the water industry will proceed, under SDWA compliance pressure, in a very inefficient manner. The result is likely to be an increase in the number of "basket cases." That situation will ultimately require a different form of state intervention.

2) It must be recognized that the issue is not SDWA compliance. The issue is state infrastructure policy relevant to water supply. The problem calls for a coordinated interagency approach. The problem calls for legislative expansion of the traditional scope of intervention by the participating agencies and for efficient restructuring of certain institutions of state government.

3) Within the six discrete areas of PUC authority defined by NRRI, there is enormous potential for commissions to selectively expand the reach of the state to take control of the restructuring process. Yet, this can be accomplished without expanding commission regulation as an all-or-nothing monolith.

---

[9] Beecher, J., Landers, J. and Mann, P., Integrated Resource Planning for Water Utilities, National Regulatory Research Institute. Columbus. OH. October 1991, NRRI 91-18.

4) With regard to the broader public interest at stake in the restructuring of this category of infrastructure, the PUC has all the natural types of regulatory authority that are applicable to guiding the process. They require only selective expansion in order to support a very complete framework for attaining sustainable, least cost solutions.

5) The PUC also has the specific expertise and administrative apparatus necessary to the task of restructuring. Unique among state agencies in the water field, commissions have the financial and legal expertise as well as the administrative processes relevant to the types of transactions which may be required. PUCs can usher restructuring solutions into place while maintaining adequate safeguards to assure due process.

6) In sum, there is a clear mandate for broader and more active intervention by state PUCs. PUCs have precisely the forms of authority and the unique expertise that is required. Moreover, without such capable leadership, the outcome will probably be a water supply infrastructure in small communities that is less safe, adequate and reliable. PUCs should not stand by to let this happen, but should seek the legislative authority to fulfill their natural mandate to intervene on behalf of the public interest at stake.

EXHIBIT (SWV-6)

PAGE 1 OF 1

SOUTHERN STATES UTILITIES, INC.
DOCKET NO.: 950495-WS
RESPONSE TO INTERROGATORIES

REQUESTED BY:	Marco Island Civ Assoc
SET NO:	1
INTERROGATORY NO:	5-R
ISSUE DATE:	12/12/95
WITNESS:	Scott W. Vierima
RESPONDENT:	Scott W. Vierima

INTERROGATORY NO: 5-R

If the two Collier County tax exempt bond interest rates were applied directly and solely to the facilities for which they were intended to finance, what would be the weighted cost of debt for SSU's Marco Island facilities on a stand alone basis?

RESPONSE: 5-R

In December the two Collier County tax-exempt bonds were floating rate issues with weekly remarketing. The effective rate on those bonds at year-end 1995, including amortization of debt closing costs, remarketing fees, interest and credit support fees was just over 7%. It is not possible to calculate a true stand alone cost of debt because no stand alone credit analysis or rating exists for the Marco Island plant.

The two Collier issues were sold with a Aa3 Moody's rating on the basis of credit support given to SSU in total, and therefore do not reflect the rates and terms that would be available if the Marco facilities were financed without SSU ownership.

EXHIBIT (SWR-7)

PAGE 1 OF 4

HANSON APPRAISAL COMPANY, INC.

2233 SECOND STREET
FORT MYERS, FLORIDA
33901-3025
941 • 334 • 4430
FAX: 941 • 334 • 0403

W. Stanley Hanson, Jr., MAI
Woodward S. Hanson, MAI
St. Cert. Gen. REA RZ 0001003
Real Estate Appraisers • Realtors

ASSOCIATES:
R. Alan Wilcox, MAI
State Cert. Gen. REA RZ 0000306
Michael D. Doyle
State Cert. Gen. REA RZ 0002048
Kenneth F. Swartz
State Cert. Gen. REA RZ 0001297
Robert A. Kump II
State Reg. REA RI 0000791
Caroline D. Edwards
State Reg. REA RI 0003032

03 May 1995

Via Telefax No. (407) 880-1395
and Regular Mail

CONFIDENTIAL WORK PRODUCT

Brian Armstrong, Esquire
General Counsel
SOUTHERN STATES UTILITIES
1000 Color Place
Apopka, FL 32703

Re: Evaluation of Proposed Settlement Offer
Case Style: SSU, Inc. v. Lynton, et al.
Case No.: 94-0793-CA-01-CTC

Dear Mr. Armstrong:

Pursuant to your request, I submit this correspondence for the purpose of providing you my evaluation of the proposed settlement offer currently being considered by Southern States Utilities, Inc. in regards to the above-referenced matter.

In summary, the compensation estimates in this matter have ranged from $3,723,500 (Hanson) to $12,500,000 (Klusza). The following table is presented as a summary of the compensation estimates as prepared by each of the valuation experts and allocated between the contributing elements of their analysis:

	Land Taken	Interim Benefits	Damages		Total
CALHOUN:	$4,241,000	---	$157,100	=	$4,398,100
HANSON:	$3,606,500	---	$117,000	=	$3,723,500
KLUSZA:	$6,400,000	$1,500,000	$4,600,000	=	$12,500,000
CARROLL:	$4,800,000	$2,400,000	$4,450,000	=	$11,650,000

In evaluating the proposed settlement offer, the appraiser will provide the reader with an analysis and overview of each of the contributing elements to the compensation estimates summarized above. This analysis will lead to a conclusion by the appraiser in regards to the merits of the proposed settlement offer. The following analysis and overview is presented:

1. Value of Land Taken: In summary, the compensation estimates for the value of the land taken range from $3,606,500 to $6,400,000.

The condemnor's experts estimated the value of the land taken to range from $3,606,500 to $4,241,000. The lower end of the value range resulted from a valuation theory which gave less contributory value from the bodies of water associated with the part taken, although Collier County allows residential density credits to be derived from these contributing areas. Each of the value estimates above included contributory values from that portion of the parent tract identified as "Activity Center" on the Collier County Future Land Use Map. This portion of the parent tract was recognized as having a commercial type potential and resulting value estimate.

The condemnee's experts provided value estimates for the land taken ranging from $4,800,000 to $6,400,000. The higher end of the range was arrived at through an analysis which was based on an $8,000 per dwelling unit unit of comparison. The weakness of this approach relates to the physical capacity of the part taken to accommodate 800 residential dwelling units in a product mix consistent with similarly situated residential projects within the Collier County market area. The lower end of the value range was arrived at through an analysis of six sales of large unimproved residential properties which were analyzed in a methodology considered consistent to the valuation analyses presented by John Calhoun (condemnor's expert).

In my experience, I would not expect a jury verdict in regards to the value of the land taken to be less than the higher end of the condemnor's value range ($4,241,000). In all probability, I would expect the jury to reach a decision in this regards midway between Calhoun's value estimate ($4,241,000) and Carroll's estimate ($4,800,000), or approximately $4,500,000. However, there is substantial risk in regards to this issue due to the fact that the condemnee's other expert will testify to a compensation estimate of $6,400,000.

2. Interim Benefits: An additional element of compensation considered by the condemnee's experts related to the valuation of the interim benefits associated with the sale of water rights at the subject property during an interim period of time until which mixed-use residential development of the site would occur.

In summary, the condemnee's experts included compensation estimates for this element of compensation ranging from $1,500,000 to $2,400,000. I have no knowledge as to the admissibility of a claim based upon this type of analysis but I am aware of interim use valuation methodologies as presented by the Appraisal Institute in its various publications (e.g., The Appraisal of Real Estate - Tenth Edition). If this component of the compensation estimate is admissible and is attacked based upon a factual basis (e.g., retail prices versus wholesale prices), it is likely that the jury would include a portion of this compensation estimate in their final verdict. I would expect a jury verdict in regards to this matter between $500,000 and $1,000,000. In any event, this element of compensation presents significant risk to SSU and must be considered in regards to the evaluation of the settlement offer.

3. Severance Damages: In summary, the severance damages were estimated by the four experts to range from $117,000 to $4,600,000.

The condemnor's experts estimated severance damages ranging from $117,000 to $157,100. In general concept, these severance damages were estimated based upon impacts resulting from the partial acquisition to the westerly remainder (e.g., west of Henderson Creek). Neither of the condemnor's experts included a severance damage estimate based upon increased regulatory pressures expected to occur at the remainder property by reason of the proposed use of the partial acquisition area (e.g., public water resource facility).

The condemnee's experts have provided severance damage estimates ranging from $4,450,000 to $4,600,000. In general theory, these damage estimates were predicated upon the belief that significant discounts and penalties would be imposed on the remainder property by the market place as a result of increased regulatory constraints and pressures which would occur as a result of the proximity of the remainder property to the public water resource facility. It is my understanding that Mr. Klusza has considered similar surface water resource facilities throughout the Southwest Florida market area including, but not necessarily limited to the Hillsborough River facility, North Port facility and Lake Manatee, and has reached the conclusion that significant evidence exists in the market to support the deep discount penalty discussed herein.

This single element of compensation presents more risk to SSU than any of the other elements of compensation discussed thus far. The nature of the damage estimates presented herein present the jury with an "either or" decision. The condemnor's experts believe no impact is demonstrative in regards to the increased regulatory

pressures, whereas, the condemnee's experts believe significant impacts can be demonstrated in this regard.

The risk in this regard is so substantial that great consideration most be given thereto. In my best estimate, I feel as though a jury would likely conclude that the severance damages in this regard would total $2,500,000. Keep in mind that there is still $2,000,000 added exposure to this issue in the event the jury completely believes this element of the condemnee's theory of valuation.

4. Fees and Costs: It is my understanding that the condemnee's experts currently have incurred costs totaling $424,000. Furthermore, it is my belief that an additional $250,000 would be incurred by these experts in preparation for and testimony at trial. Therefore, the total budget for condemnee's cost should approximate $675,000. In regards to attorney fees, I would expect the fee to be based upon a reasonable hourly rate together with a 15.0% to 20.0% premium for any benefit produced by opposing counsel for its client. In this regard, I would expect an hourly rate for the attorneys to approximate $350 per hour and a total amount of time and preparation for this trial to support a probable fee on this basis of $200,000. I have outlined above a probable jury verdict which totals $8,000,000. On this basis, the attorneys fee would be increased to reflect a betterment of approximately $3,800,000 for an additional fee of $760,000, for a total attorneys fee of $960,000.

5. Summary and Conclusion: The following summary is presented for the reader's review in regards to the various elements which have been considered in the evaluation settlement offer:

Value of Land Taken:	$4,500,000
Interim Benefits:	1,000,000
Damages:	2,500,000
Fee and Costs:	1,635,000
Total	$9,635,000

In summary, I have delineated what I consider to be a probable verdict in regards to the issues summarized above, which is a probable jury verdict of $8,000,000, with an additional $1,635,000 associated with fees and costs resulting in a total economic impact to SSU of $9,635,000.