STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

At a session of the Public Service Commission held in the City of Albany on October 21, 1998

COMMISSIONERS PRESENT:

Maureen O. Helmer, Chairman
John B. Daly
Thomas J. Dunleavy
James D. Bennett

CASE 98-W-0475 - Petition of Long Island Water Corporation for Approval, Pursuant to Public Service Law Section 113(2), of a Proposed Allocation of a $2,211,000 Tax Refund from Nassau County.

# ORDER ALLOCATING PROPERTY TAX REFUNDS AND ESTABLISHING RATE PLAN

(Issued and Effective October 28, 1998)

BY THE COMMISSION:

In this order, we shall adopt the terms of a proposed settlement agreement (the Settlement). We thereby establish a refund and rate plan effective now through March 2002, and other provisions, concerning water service provided by Long Island Water Corporation (Long Island Water).[1]

## BACKGROUND

### The Parties' Agreement and its Terms

Long Island Water serves about 74,000 customers in the Town of Hempstead. Its most recent base rate increase occurred in April 1996, pursuant to a three-year rate plan that expired in March 1997. The Settlement was filed September 23, 1998 with the support of all parties active in this proceeding, namely Long Island Water, staff of the Department of Public Service (Staff), and the Consumer Protection Board (CPB). The Settlement recites that, upon our approval, its provisions for one-time credits and

---

[1] The Settlement accompanies this order as the Appendix.

a rate reduction would take effect immediately; that is, the credit and rate reduction would be reflected in the first bill a customer received after tariffs were filed in compliance with today's order. Other provisions, such as the calculation of excess earnings subject to sharing with customers, would take effect at the beginning of the first full rate year on April 1, 1999. The third and final rate year would end March 31, 2002. Adoption of the Settlement would allow the company to file a rate application in 2001, to seek new rates that would take effect no sooner than April 1, 2002.

The Settlement's terms include (1) a one-time credit of $12.64 per customer, or $15.06 per hydrant or connection in the case of fire protection customers, within the first billing cycle following today's decision, for a total of $1.0 million in credits; (2) a 1.37% reduction in per-gallon charges, so that the current $368 annual bill for a typical residential customer using about 102,000 gallons per year would decline by 1% (approximately $4); and (3) a base rate freeze at that reduced level, through the end of the Settlement period. As a result, residential customers from now through March 2002 would be paying annual charges about $4 lower than in April 1996, except in the unlikely event that extraordinary weather caused a revenue adjustment clause (RAC) surcharge that would offset the $4 decrease.

The credits, reduction, and freeze would be funded primarily from three sources. First, to achieve the equity return targeted in the Settlement, the company would have to meet certain productivity goals. In the first full rate year, the company's labor expense would be subject to the 1% productivity offset that we typically impose. In the second and third years, however, the 1% imputation would be extended to all types of expense. Moreover, the company's expenditures for new data processing and telephone systems would be subject to either a 25% productivity offset or, in one instance, an imputed 20% reduction in the parent company's charges to Long Island Water for data processing services.

Second, the company has realized approximately $2.7 million in property tax savings. These consist partly of $2.2 million in refunds resulting from a settlement of the company's judicial proceedings against Nassau County concerning tax assessments for 1979-85. The other $0.5 million is owed to customers as a result of a reconciliation between actual and projected property taxes for the third year of the most recent rate plan, ending March 31, 1997. Of the $2.7 million, the parties to the Settlement propose that $1.0 million be flowed through to customers immediately as the one-time credit described above. The remainder would be used to offset a projected three-year revenue requirement increase of $1.8 million cumulatively over the Settlement period. The balance available for this purpose would be $1.6 million, after deducting a $31,797 allowance for the company's legal fees related to the tax challenges and deducting 10% of the refund (net of legal fees) for incentive purposes in recognition of the company's efforts to minimize property tax expense. In principle, the difference between the $1.8 million revenue requirement increase and the $1.6 million offset would be a revenue shortfall of $0.2 million; but in fact the company has volunteered to absorb this deficiency as a "settlement adjustment."

Third, the cost of electricity used to operate the company's wells has decreased 20.9% as a result of electric rate reductions made possible through the Long Island Power Authority's takeover of former Long Island Lighting Company operations. This decrease translates into the 1.37% reduction in per-gallon charges noted above. The 1.37% base rate reduction would produce a 1% bill reduction, as noted above, because customers' bills include not only per-gallon charges but also fixed charges.

The projected return on equity resulting from adoption of the Settlement terms, computed for Continental Water Corporation (Long Island Water's parent) on a consolidated basis, is 10.2% (or 10.63% pre-tax). This comprises a basic 9.9% allowance representing the cost of equity, determined on the basis of the approach endorsed in the recommended decision for water companies in the Generic Finance case;[1] plus a 0.3% premium to reflect the risk of the Settlement's proposed multi-year rate freeze, inferred from market-based return differentials for short- and longer-term debt. The projected consolidated equity return of 10.2%, applied to a stand-alone capital structure for Long Island Water, equates to a company-specific fallout equity return of 9.6%.

As an incentive to control costs and thus maximize earnings, the parties propose that the company retain all earnings in the initial equity return band from 9.6% through 10.4%. Adoption of the Settlement's earnings sharing provisions would assign customers 50% of earnings exceeding a 10.4% common equity return, and 75% of excesses over an 11.4% return. The earned return would be determined on a three-year composite basis at the end of the third full rate year in April 2002, and any sharing of excesses would be implemented thereafter. While held by the company, the customers' share of any excess earnings would accrue interest.

The parties would have us assume that present property tax expense, which accounts for nearly a third of the company's revenue requirement, will increase at the general inflation rate as projected by the GDP Implicit Price Deflator. If, however, actual expense exceeded the forecast, the company would be allowed to defer and recover 80% of the excess through the RAC. If actual expense fell short of the forecast, the entire shortfall would be deferred and applied for customers' benefit through the RAC.

Other noteworthy Settlement terms include an allowance of only $30,000 for rate case expense related to this expedited proceeding, to recognize that adoption of the stay-out provision would minimize such expense in the future; a freeze in the assumed number of employees, to capture for customers the savings

---

[1] Case 91-M-0509, Financial Regulatory Policies for New York State Utilities, Recommended Decision (issued July 19, 1994).

resulting from approximately an 8% headcount reduction over the past five years; disallowance of about 62% of the company's projected cost of deferred compensation plans for management; an assumed reduction in chemicals expense, despite price increases, because of savings achieved through more efficient delivery methods; deferral (rather than capitalization) of expenditures related to an office renovation project, for recovery through the RAC as the expenses are incurred if they are reasonable and prudent; and a requirement that the company give advance notice if it intends to impose a surcharge to recover a deficiency in the RAC balance, so that interested parties can confer on possible alternatives.[1]

Procedural History

This case began with the company's filing of a petition, on March 30, 1998, to retain $0.5 million of the $2.7 million tax savings as an incentive and for legal fees. The company proposed to use the other $2.2 million as an offset to revenue requirements, and thereby freeze rates through September 2000. That filing became the subject of discovery and negotiations which led initially to a revised proposal by the company and, ultimately, to the present Settlement.

After filing the Settlement, the parties chose to pursue an expedited process, in preference to a schedule more typical of a conventional rate case. Accordingly, the Administrative Law Judge established procedures that began with

[1] The RAC balance represents the net effect of items recognizable through the RAC. These include revenue and production expense excesses or shortfalls relative to projected levels; and would include, were the Settlement adopted, property tax excesses or shortfalls and costs related to the office renovation project. At the end of each fiscal year, corresponding to the rate years proposed in the Settlement, the company calculates the balance or deficiency, and determines the RAC credit or surcharge that will suffice to flow through or recover one-third of that amount. The newly determined credit or surcharge remains constant for the ensuing four quarterly billing cycles.

the filing of statements supporting the Settlement, including exhibits in some instances, by the company, Staff, and CPB.[1] This was followed by an evidentiary hearing, in which the Judge questioned the three parties' witnesses but no party took the opportunity to cross-examine.[2]

A public statement hearing was scheduled at the same date and location as the evidentiary hearing. Statements were offered by two customers, both of whom said the Settlement's credits and rate reduction are inadequate to reduce disparities between Long Island Water's rates and other, much lower rates assertedly paid by customers in neighboring service territories.[3] CPB also presented a public statement, summarizing the Settlement's benefits for customers. We have received no calls or correspondence from the public about this case.

## CONSIDERATIONS FAVORING ADOPTION OF THE SETTLEMENT TERMS

We find that the Settlement's proponents have satisfied their burden of showing that adoption of its terms would ensure safe and adequate service at just and reasonable rates, in accordance with the Public Service Law (PSL). They also have shown that it complies with our Settlement Guidelines[4] in that its adoption would balance the parties' interests, comply with relevant public policy, approximate a litigated result, and

---

[1] Case 98-W-0475, Procedural Ruling (issued October 1, 1998).

[2] Held in Mineola, October 7, 1998, before Administrative Law Judge Rafael A. Epstein.

[3] The other rates cited by the speakers appear to be those charged by municipal water systems, which tend to be substantially lower than private companies' rates because the latter include an allowance for income taxes, property taxes, and other costs avoidable by the municipalities.

[4] Cases 90-M-0255 et al., Procedures for Settlements and Stipulation Agreements, Opinion No. 92-2 (issued March 24, 1992), Appendix B, p. 8.

implement the terms of an agreement among ordinarily adversarial parties. More specifically, these conclusions are justified by the public benefits inherent in adopting the various Settlement provisions summarized above.[1]

In addition to having won the support of adversaries and having been examined in an evidentiary hearing, the Settlement terms also would serve a variety of objectives consistent with the public interest. The refund, rate reduction, and rate freeze obviously would provide customers a direct economic benefit, and would stabilize rates at a level that would recover only the reasonably necessary cost of service. The basic consolidated equity return (excluding any stay-out premium) of 9.9% would be lower than any comparable equity return we have allowed in recent years for similarly situated companies. And, among multi-year plans we have approved for water companies, the excess earnings mechanism for the "third tier" range above 11.4% is unique in allocating a 75% share to customers.[2]

The Settlement promises other important public benefits as well. By flowing prudent costs of the renovation project through the RAC, we would avoid the need to recognize project expenditures in rates before they actually occur. This would mitigate the company’s revenue requirement; strengthen its incentives to control the project’s costs; and preserve our ability to examine the prudence of such costs. Adoption of the provisions regarding property tax expense shortfalls and excesses would ensure a fair disposition of costs that are highly

---

[1] The proponents’ position statements include comprehensive summaries of the Settlement’s benefits, which illustrate in more detail why its adoption would be in the public interest.

[2] To illustrate these points, the company cites Cases 97-W-1514 et al., New York-American Water Co. - Rates, Opinion No. 98-15 (issued July 20, 1998), projecting a 10.0% stand-alone return with 50% sharing above 10.8%; Case 95-W-1168, United Water New Rochelle, Inc. - Rates, Opinion No. 96-29 (issued October 1, 1996), projecting a 10.7% return with 50% sharing above 11.7%; and Case 97-W-1273, New York Water Service Corp. - Tax Refund, where a proposed settlement provides 50% sharing above 11.0%.

significant for this company and its customers, while creating an effective incentive for the company to reduce its tax liability where possible. Moreover, the Settlement's terms--particularly its productivity imputations, coupled with the company's opportunity to retain all earnings in the initial equity return tier (i.e., up to and including 10.4% on a stand-alone basis)--would provide the company both a reasonable return expectation and a strong incentive to minimize its controllable costs.

Productivity gains are an important element of the Settlement not only because they make possible the reduced base rate level proposed here; but also because the company's management must stay closely focused on the pursuit of additional cost savings and revenue opportunities that are not necessarily recognized in the rate plan. As the company observes in its supporting statement, we should be mindful that the Settlement's proposed rates are predicated on a one-time, $1.6 million tax refund component which would not be available as a rate mitigator after March 2002. The company says this raises the specter of a substantial rate increase at that time.[1] From our perspective, however, one of the reasons the Settlement terms deserve adoption is that the resulting efficiency incentives during the Settlement period should encourage practices and attitudes within the company that will lead to additional cost saving opportunities beyond March 2002. In adopting the Settlement terms, the record on which we rely includes management's testimony that it recognizes its obligation to find and pursue all reasonable means of minimizing a revenue requirement increase at the end of the Settlement term; and Staff's and CPB's testimony that they entered the agreement in reliance on their perception that management would honor that obligation.

[1] Company's Statement, pp. 23-24. ("Barring . . . an additional refund, [the company] will have an immediate need for rate relief of approximately $1.8 million (5.0%) at the conclusion of this Agreement [footnote omitted]. Moreover, anticipated cost increases for the period beyond March 31, 2002 will create pressure for additional rate relief.")

Here as in any multi-year rate plan, there inevitably is a trade-off between providing near-term benefits for customers and, on the other hand, prolonging the settlement period. We conclude that the Settlement terms reasonably balance these objectives, assuming that, during the Settlement term, the company will diligently pursue the goal of mitigating its revenue requirement beyond that period.

## CONCLUSION

For the reasons considered above, our adoption of the Settlement's provisions will satisfy our statutory obligation to ensure safe and adequate service at just and reasonable rates and, pursuant to PSL §113(2), just and reasonable dispositions of property tax refunds. Moreover, prompt action is necessary because a delay would postpone the benefits of the refunds and rate reduction contemplated in the Settlement. We therefore find that immediate adoption of the Settlement terms as an emergency measure under §202(6) of the State Administrative Procedure Act (SAPA) is necessary for the preservation of the general welfare of Long Island Water's customers, and that compliance with the additional notice and comment provisions of SAPA §202(1) would be contrary to the public interest.

The Commission orders:

1. Subject to the foregoing discussion, the terms of the Settlement Agreement (Settlement) filed in this proceeding September 23, 1998 are adopted in their entirety and are incorporated as part of this order.

2. This order is adopted on an emergency basis pursuant to §202(6) of the State Administrative Procedure Act because, for the reasons noted above, such action is necessary to preserve the general welfare.

3. Long Island Water Corporation (Long Island Water, the company) is directed to file on one day's notice, to become effective on a temporary basis no later than November 2, 1998, all tariff amendments and other changes necessary to effectuate

the immediate refund, rate reduction, and Revenue Adjustment Clause modifications contemplated in the Settlement.

4. Long Island Water shall serve copies of the filing described in the preceding paragraph upon all parties to this proceeding. Any comments on the filing must be received at the Commission's offices within ten days of service of the company's proposed amendments. The amendments shall not become effective on a permanent basis until approved by the Commission. The requirement of §89-c(10)(b) of the Public Service Law that newspaper publication be completed prior to the effective date of the proposed amendments is waived, provided that Long Island Water shall file with the Commission, no later than December 28, 1998, proof that a notice to the public of the changes proposed by the amendments and their effective date has been published once a week for four successive weeks in a newspaper having general circulation in the area affected by the amendments.

5. Long Island Water is authorized to use the following accounts, as appropriate, to record the principal amount, any required interest cost, and the federal income tax effect of the items for which deferred accounting is specified in the Settlement and approved by this order: Account 186, Miscellaneous Deferred Debits; Account 253, Other Deferred Credits; Account 190, Accumulated Deferred Income Taxes; and Account 283, Accumulated Deferred Income Taxes - Other. The amounts deferred for each such item shall be recorded in a separate subaccount so as to remain readily identifiable, and the company shall maintain proper and easily accessible documentation for each entry made. The disposition or amortization for each item shall be carried out according to the terms of this order and the Settlement, or as otherwise authorized by the Commission.

6. Within 60 days after the end of the rate year ended March 31, 2000, Long Island Water shall file with the Director of the Office of Accounting and Finance financial schedules comparing the projections used for setting rates, as shown in Exhibit 1 of the Settlement, with the actual amounts that materialize. The comparison shall be presented in essentially

the same format and detail as on the first page of that exhibit. In addition, the company is directed to file with the Director of the Office of Accounting and Finance, within 60 days after the end of the second-stage rate year which ends March 31, 2001, financial schedules comparing the projections upon which the second-stage rates are premised with the actual financial data that materializes for the relevant period; the comparisons shall be in the same format and detail as the projections used in establishing the second-stage rate adjustments proposed in the Settlement. Likewise, the company shall file a third comparison within 60 days of the end of the third-stage rate year which ends March 31, 2002. Together with that third comparison, the company shall file a computation of its actual earned return on equity on a composite basis for the three years ending March 31, 2002. Along with the several comparative financial statements and composite earnings computation required to be submitted, the company shall provide work papers adequate to support the actual data reported by the company.

7. This proceeding is continued.

By the Commission,

(SIGNED) DEBRA RENNER
Acting Secretary