

STATE OF NEW YORK  
PUBLIC SERVICE COMMISSION

CASE 11-W-0200 - Proceeding on Motion of the Commission as to  
the Rates, Charges, Rules and Regulations of  
Long Island Water Corporation d/b/a Long  
Island American Water for Water Service.

STATEMENT OF THE STAFF OF THE  
NEW YORK STATE DEPARTMENT OF PUBLIC SERVICE  
IN SUPPORT OF THE JOINT PROPOSAL

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**I. INTRODUCTION**

This document presents the argument of the Department of Public Service Staff (Staff) in favor of the Joint Proposal (JP) filed on November 29, 2011 in Case 11-W-0200.

Staff believes that the JP is the best resolution of the current Long Island Water Corporation d/b/a Long Island American Water (LIAW) rate case. The JP balances the interests of the company and the ratepayers by ensuring rate stability for ratepayers over the three years of the JP while providing the company with funds needed to ensure system integrity and improvement.

**II. STATEMENT IN SUPPORT**

**A. Background**

On April 29, 2011, LIAW filed a petition seeking approval of an increase in base rates of \$9,563,146 (19.49%), which when existing Distribution System Improvement Charge (DSIC) and System Improvement Charge (SIC) surcharges were rolled into base rates would have overall bill impacts of \$8,010,140 (15.83%), to become effective on May 31, 2011.

By Order dated May 11, 2011, the Commission suspended the effective date of LIAW's proposed tariff Schedule until

September 27, 2011. Subsequently, by Order dated August 10, 2011, the Commission further suspended the proposed tariff schedule's effective date until March 27, 2012.

From the end of April through September, 2011, Staff investigated the company's filing, reviewed its testimony and submitted 177 information requests to the company. During that time, the Village of Lynbrook (Lynbrook) and the New York Department of State Utility Intervention Unit (UIU) become active parties to the proceeding. On September 12, 2011, Staff filed its testimony supporting an increase in annual revenues of \$493,747 (1.0%). On October 5, 2011, this figure was adjusted to \$987,668 (2.01%) after an error in Staff's calculations was discovered.

On September 15, 2011, LIAW filed a notice of impending settlement negotiations, as required by 16 NYCRR §3.9. Settlement talks began on September 16, 2011 and continued through November, with the company, Staff and the UIU being the only active parties. The company submitted its rebuttal testimony on October 3, 2011.

In late November, Staff, LIAW and UIU reached a final detailed agreement establishing a three year rate plan. On November 29, 2011, the three parties filed their signed JP with the Commission.

**B. Overview of the Joint Proposal**

The JP covers a period of three years. The parties propose to maintain the company's reconciliation of revenues, production costs and property taxes, with updated target levels. In recognition of the efforts by LIAW to reduce its property tax burden in past years, the company will be allowed to recover 90% of any increase in its property taxes.

Under the JP, the company's System Improvement Charge (SIC) mechanism will continue and will be used to recover carrying costs for the projects specified. The company's Distribution System Improvement Charge (DSIC) will not be continued. Instead, the rate base for each year contains additions of \$7.75 million in capital investment related to distribution system projects. The carrying costs related to any shortfall in capital expenditures will be deferred for the ratepayers' benefit.

The JP authorizes LIAW to calculate its pension and other post-employment expense (OPEBs) on a consolidated basis with its parent company, rather than on the stand-alone basis the Commission generally requires. Staff supports this provision because of savings to the ratepayers.

In light of the proposed acquisition of the New York assets of Aqua Utilities, Inc. by LIAW's parent company, the JP reflects estimated savings from anticipated corporate synergies of \$901,331 over the three year term. This figure is subject to revision as a result of the investigation of the acquisition in Case 11-W-0472.<sup>1</sup> In addition, the JP's earnings sharing mechanism contains a smaller than customary dead band (55 basis points) to ensure that any future synergy savings benefit ratepayers.

**C. Compliance with the Commission's Settlement Guidelines**

In the Settlement Guidelines, the Commission identified the criteria for judging whether a JP is in the public interest. The Commission explained that in considering a JP, it reviews the extent to which that proposal is supported by generally adverse parties, and it also determines whether the

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<sup>1</sup> Case 11-W-0472, Aqua Utilities, Inc. et al. - Acquisition, (commenced September 1, 2011).

record for the decision to adopt a JP is adequate. To be approved, a JP must be consistent with law and public policy, have a rational basis, balance the interests of customers and shareholders, and compare favorably with the probable outcome of litigation. This JP satisfies these criteria and should, therefore, be adopted.

All parties to this proceeding received reasonable and sufficient notice of settlement negotiations as required by 16 NYCRR §3.9(a). LIAW circulated e-mails to all active parties advising them of upcoming dates for negotiating sessions. Moreover, telephone conferencing was made available to all parties for every negotiating session. No interested party was denied an opportunity to participate in the negotiations. Additionally, the record is adequate to justify adoption of the JP. The testimony and exhibits filed by the company and Staff explain the rationale and basis for many of the elements of the JP. The issues that have been resolved in the JP have been thoroughly vetted through the foregoing processes, and, for every issue, Staff believes the resolutions are both reasonable and cost-justified.

The Commission's remaining criteria for judging whether a JP is reasonable is whether the JP's terms are in the public interest. For the reasons discussed below, the current JP offered here meets that standard.

**D. The Joint Proposal is in the Public Interest**

Staff believes that the JP is in the public interest. Because of the change from a one-year rate plan to a three-year negotiated agreement, some terms differ from Staff's filed testimony, but the resulting agreement is a reasonable accommodation of the various parties' interests.

In executing and submitting the JP to the Commission, Staff is aware that it is only a series of recommendations to the Commission and is not a contract.<sup>2</sup> The Commission may accept, reject, or modify, in whole or in part, any recommendation contained therein. Moreover, the Commission's adoption of such represents only the Commission's execution of its statutory responsibility and duty to determine the rates and rules applicable to LIAW for the duration of the rate plan. Any belief that the JP is a binding agreement on the Commission or that it gives rise to contractual claims against the Commission is erroneous as a matter of law.<sup>3</sup>

### **III. TERMS OF THE JOINT PROPOSAL**

#### **A. Rate Plan Term**

The rate plan contained in the JP covers the three year period commencing April 1, 2012 and ending March 31, 2015. The three-year term of the JP is consistent with LIAW's last negotiated rate case.<sup>4</sup>

#### **B. Base Rate Increases**

LIAW's initial filing called for a base rate increase of \$9,563,146 or 19.49%. The increase included the roll-in of the company's existing capital improvement surcharges (i.e., DSIC and SIC). Excluding the annual revenues from the current DSIC and SIC surcharges, the increase would be \$8,010,140 or 15.83%. Staff's pre-filed testimony, after correction of an

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<sup>2</sup> MCI Telecommunications Corp. v. Public Serv. Comm'n, 231 A.D.2d 284, 291 (3d Dep't 1997).

<sup>3</sup> See, e. g., United Water New York, Inc. v. Public Serv. Comm'n, 252 A.D.2d 810, 811 (3d Dep't 1988).

<sup>4</sup> Case 07-W-0508 et al., Long Island Water Corporation - Rates, Order Determining Revenue Requirement and Rate Design (issued March 5, 2008).

error, called for a base rate increase of \$987,668 or 2.01%. Excluding the annual revenues from the current DSIC and SIC surcharges, Staff's position would be a decrease of \$565,318 or -1.12%.

The JP calls for an unlevelized annual base rate increase of \$2,955,218 (6.02%), \$1,375,826 (2.64%), and 1,160,601 (2.17%) in rate years one through three respectively. Excluding the annual revenues from the current DSIC and SIC surcharges, the increase in revenues supported by the JP would be \$1,402,212 (2.77%), \$1,375,826 (2.64%), and \$1,160,602 (2.17%) for rate years one through three, respectively. The annual bill for a residential customer with a 5/8" meter and using 72,000 gallons per year would increase from \$382.37 to \$391.73 (2.45% increase) in the first rate year, \$402.05 (2.63%) in the second rate year, and \$410.78 (2.17%) in the third rate year.

The main driver for the initial rate year increase is the company's prior capital investments being added to rate base and related depreciation expense. The increases in rate years two and three are caused by projected distribution related plant additions and inflation on operating expenses and property taxes.

**C. Rate of Return**

The JP basically adopts Staff's methodology regarding the calculation of the rate of rate of return for LIAW. The figures have been updated to reflect current market conditions.

On April 29, 2011, LIAW submitted testimony requesting an 8.37% after-tax rate of return and an 11.67% pre-tax return. Staff filed testimony on September 12, 2011 recommending an after-tax rate of return of 7.09% and a corresponding pre-tax

rate of return of 9.65%. The difference between Staff's recommendation and the Company's request resulted from:

1. A staff recommended 8.9% return on common equity versus LIAW's request for an 11.5% allowance,
2. A Staff recommended capital structure utilizing a 43.76% common equity ratio versus LIAW's proposed 43.38% equity ratio, and
3. A recommended 5.68% cost of debt as opposed to LIAW's estimate of 6.0%

Staff's recommended 8.9% return on equity was calculated based upon the Commission's well established cost of equity methodology of employing a two-third/one third weighting of the discounted cash flow model and the capital pricing model applied to a surrogate group of companies. An update of Staff's cost of equity analysis produces a current cost of equity of 9.1% for LIAW.

While Staff's recommended equity ratio of 43.76% is very similar to LIAW's requested ratio of 43.38%, Staff's estimation methodology is quite different from the Company's proposal. LIAW requested equity ratio was based upon an estimate of its stand-alone rate year capital structure. Due to inadequate ring-fencing between the Company's parent American Water Works Company, Inc. (American Water Works) and LIAW, Staff rejected the Company's approach. In such circumstances, the Commission generally uses either the parent company's capital structure or a hypothetical capital structure to estimate the subsidiary's cost of capital. Due to the high level of goodwill contained in American Water Works capital structure, and the refusal of LIAW to provide a rate year estimate of the parent's capital structure, Staff chose to use a hypothetical capital structure to establish LIAW's overall cost rate. Staff proposed

an equity ratio consistent with a surrogate group of companies with bond ratings consistent with American Water Works BBB+/Baa2 Standard and Poor's and Moody's bond ratings.

The difference between Staff and LIAW's rate year cost of debt resulted from a lower forecast of the interest rate for planned debt issuances. LIAW proposed using a forward interest rate calculation to estimate a 6.6% cost estimate for the 2011 and a 7.0% for the 2012 issuances. Consistent with Commission's precedent, Staff rejected the use of forward interest rates and recommended that the current interest rate levels are the most accurate estimate of rate year interest rates. As a result, Staff recommended a 5.68% interest cost rate estimate (base on 5.63% cost of BBB+/Baa2 -rated long-term debt plus 5 basis points for issuance expenses) be used for embedded cost of long-term debt. Staff subsequently revised the estimated cost rate to 5.92% in the October 2011 filing. The 5.92% embedded cost of long-term debt was later updated downward to 5.81% for the negotiation.

The JP reflects Staff's pre-filed positions regarding the capital structure and cost of debt. Regarding the return on equity, the JP incorporates Staff's cost estimation methodology updated to reflect current market conditions. In addition, a 30 basis points stay-out premium was added to the 9.1% updated cost figure to arrive at an overall cost rate 9.4%. The stay-out premium is similar to that found in recent past rate cases and follows the Commission's overall methodology for awarding stay-out premiums of one-half the historic spread between one and three-year treasury rates for a five-year period. The resulting overall pre-tax rate of return for LIAW is 10.14%. Finally, the JP lowers the equity ratio from 43.76% to 42.0% and raises the equity cost rate to 9.65%. Staff agreed to the change in equity

ratio and cost rate since it does not have an impact upon the awarded pre-tax cost of capital of 10.14% and, hence, the overall revenue requirement for LIAW.

Pre-tax cost of capital is reasonable and similar to recent cases. For instance, it is comparable to the Commission's recent decision in the Orange and Rockland Utilities, Inc. rate case in which the company was granted 10.15% pre-tax rate of return.<sup>5</sup> Moreover, it is comparable to the rate of return outcome in the yet-to-be approved JP in the United Water Owego-Nichols Inc. rate case in which the parties agreed to an ROE of 9.58% and a common equity ratio of 44.35% at a resulting pretax rate of return of 10.46%.<sup>6</sup>

#### **D. Earnings Sharing**

The JP contains an earning sharing mechanism that provides that the company's actual earned return on equity will be calculated on an aggregate basis for the three-year period ending March 31, 2015. The aggregate achieved ROE for the three-year period ending March 31, 2015 will be the average of the achieved ROE for each of the three rate years ending March 31, 2013, March 31, 2014, and March 31, 2015. With respect to the equity ratio for the earning sharing purposes, the JP provides that the lower of the company's actual common equity ratio or a hypothetical 42.0% common equity ratio be used, thereby assuring ratepayers of a greater share of the Company's overearnings. The JP provides that the company will be permitted to retain 100% of

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<sup>5</sup> Case 10-E-0362, Orange and Rockland Utilities, Inc. - Electric Rates, Order Establishing Rates for Electric Service, (issued June 17, 2011). In that litigated one-year case, the Commission authorized an equity return of 9.2% on a 48% equity base, producing a pre-tax equity return of 10.15%.

<sup>6</sup> Case 11-W-0082, United Water Owego-Nichols Inc. - Water Rate Case, Joint Proposal (filed on September 30, 2011) and Staff Statement In Support (filed on October 25, 2011).

earnings attributable to an achieved return up to and including 10.2% ROE, thus a dead band of 55 basis points. The 55 basis points is less than the traditional 100 basis points dead band in order to capture potential synergy savings. Earnings above 10.2% threshold and up to and including 10.7% ROE will be shared equally between customers and the Company. Earnings above 10.7% ROE are to be shared 75%/25% between customers and the Company. The provision for the Earnings Sharing Mechanism will continue beyond March 31, 2015 until the Company's rates are reset in the subsequent rate proceeding, thus assuring customers of any merger savings beyond the rate year. During the years that the Earnings Sharing Mechanism is in effect subsequent to March 31, 2015 the 10.2% threshold will continue to be in effect and earnings beyond the threshold will be shared between LIAW and customers will be continued to be shared in according to the methodology described above.

In the event that earnings are at a level to be shared with ratepayers, the amount would be applied to reduce the company's revenue requirement in the next general rate case or as may be directed by the Commission.

These earnings sharing proposals provide three distinct benefits. The first tiered dead band whereby the company is permitted to retain 100% of earnings based on ROE not exceeding 10.2% provides an effective incentive for the company to manage its costs and seek efficiencies. The second tiered dead band whereby earnings are shared equally provides incentive to the utility while providing an opportunity for ratepayers to further share in efficiency gains. The final tiered dead band, where 75% of earnings are credited to ratepayers provides a safeguard for the Commission and ratepayers against overearnings by the utility.

**E. Revenue, Production Costs and Property Tax Reconciliation (RPCRC) Mechanism**

The existing reconciliation mechanisms will be continued with minor modifications and as updated in the JP. As described in Section III, Subsection B of the JP, the parties agree that metered revenues, production costs (fuel, power and chemicals) and property taxes will be reconciled on an annual rate year basis. The target levels will be updated each rate year and are set forth in the JP for each year. The RPCRC mechanism is designed to continue beyond the term of the rate plan using the Year Three target levels until they are reset by the Commission in the next rate proceeding for LIAW.

The company will be allowed to recover 90% of increases in property taxes above the target levels, for each rate year, as specified in the JP on page 4 and later, in more detail, on pages 14-15. The remaining 10% will be borne by its shareholders. If actual property tax expenses are below the target levels set, then the company will be allowed to retain the 10% of such variance only if it can successfully demonstrate that the reduction in property tax expense was a direct result of the company's intervention and action.

Permitting LIAW to recover 90% of property tax increases above the target levels will allow the company to recover additional revenues needed to cover these escalating expenses while continuing to provide LIAW with a strong incentive to monitor and challenge such property tax increases.

**F. System Improvement Charge (SIC)**

Staff believes that continuing the SIC surcharge mechanism, with modifications, is appropriate. Section III, Subsection E on pages 6-8 highlights the details of the SIC mechanism. The company is authorized to utilize the SIC to recover carrying costs (i.e., return and depreciation expense)

on specific projects that are placed in service during the rate plan and beyond. The use of the SIC mechanism is allowed for the following projects and associated maximum capital expenditures: Iron removal facilities at Plant 15 (\$8,450,000), Storage tank rehabilitation at Plant 13 (\$1,900,000), Phase 2 rehabilitation of Plant 5 common suction wells (\$525,000), and the Enterprise Asset Management and Customer Information System phases of the company's Business Transformation Program (\$4,926,481). The estimated maximum potential incremental SIC surcharge related to each of the projects above would be on the order of: 1.90%, 0.44%, 0.13%, and 1.84%, respectively. The company will provide Staff with detailed project information within 30 calendar days of the project's in-service date. Staff will have 60 days to analyze and verify the data, as well as the surcharge calculation. The SIC surcharge will remain in place until the Commission issues a decision in the Company's next general rate case, at which time all of the costs previously collected via the SIC surcharge will be accounted for and included in base rates.

The SIC surcharge mechanism satisfies the interest of both the ratepayers and LIAW. It allows the company the financial flexibility to do necessary and substantial plant construction beyond the rate year without the need to apply for rate increases. At the same time, the SIC mechanism affords the ratepayers financial protection in that only carrying costs (i.e., return and depreciation expense) of these projects are allowed recovery up to a maximum expenditure level based on the current estimates for the projects. Further, the SIC mechanism accounts for the possibility of project slippage by allowing recovery of carrying costs in a timely manner only after the

respective projects have been placed into service and are used and useful.

**G. Distribution System Improvement Charge (DSIC)**

As described in Section III, Subsection F of the JP, the parties agree that the company's current DSIC surcharge be rolled in to base rates and that the DSIC surcharge mechanism end on the effective date new rates are implemented in the instant proceeding. The company agrees to spend \$7.75 million per rate year on distribution system related projects. If the company does not spend the allocated amounts over the three year rate plan, the carrying costs associated with the variance will be deferred to be used to the ratepayers' benefit.

A final reconciliation between the authorized and actual collections of the current DSIC surcharge will be made via a reconciliation filing for the period ending March 31, 2012. The resulting final DSIC reconciliation amount will be recovered or refunded via a one-time surcharge or credit.

**H. Acquisition Savings**

On September 1, 2011, American Water Works and Aqua Utilities, Inc. (Aqua) petitioned<sup>7</sup> the Commission for approval of a transfer of Aqua's New York holdings<sup>8</sup> to American Water Works. Given the proximity of LIAW and NYWS, the largest of the proposed acquisitions, it is reasonable to expect that, if the acquisition is approved, the two companies will experience operational efficiencies from which the ratepayers should benefit.

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<sup>7</sup> Case 11-W-0472, supra, Joint Petition (filed September 1, 2011).

<sup>8</sup> Aqua owns three New York water companies: Aqua New York, Inc., New York Water Service Corporation (NYWS) and Aqua New York of Sea Cliff, Inc.

While these synergy savings are reasonably anticipated and will have an effect on LIAW's operating expenses, the parties are unable to determine whether, and to what extent, the savings would be realized over the duration of the JP. In recognition of this, the JP's treatment of the matter is limited. The parties agreed to a reduction of \$901,331 over the JP's three years as a best estimate of savings. This figure is subject to future modification in Case 11-W-0472 as the parties' understanding of the transaction's effects develops. In addition, the earnings sharing section of the JP contains a 55 point dead band, rather than the customary 100 points, which will act to recoup ratepayers' share of any additional synergy savings that emerge before the company's next rate case.

**I. Outreach and Education**

The Company will continue to develop and implement customer outreach and education programs and materials to increase awareness and understanding of water issues, policies, and initiatives such as water quality, cost, system improvements, conservation techniques, customer rights and customer service matters. Within 30 days after the Commission issues an order adopting the terms of the JP, the Company will file a plan with the Director of the Department of Public Service's Office of Consumer Policy ("OCP Director") for Staff review that details the outreach and education program's goals and objectives, target audiences, source of funding, core messages and implementation strategies, methods and schedule for the coming year. The annual plan may be reviewed and updated as appropriate and necessary based on significant changes in company services or programs. The Company will review the plan each year of the rate term and send a letter to the Director within 30 days after the end of the Rate Year stating whether

any change to the plan is warranted, and, if a change is warranted and describing the change.

**J. Pensions and OPEBS**

LIWC's employees participate in the consolidated pension and OPEB<sup>9</sup> plans of the company's parent, American Water Works. The Commission's Pension/OPEB Policy Statement<sup>10</sup> requires utilities to compute Pension/OPEB expense for ratemaking purposes on a stand-alone basis when the employees of the utility participate in a consolidated plan.

The company has requested, pursuant to section N of the Pension/OPEB Policy Statement for permission to calculate its expense on a consolidated basis because continuing to compute pension/OPEB expense on a stand-alone basis would significantly increase the cost to ratepayers and would better align the amount of Pension/OPEB expense allowed in rates with the amount actually funded, which is done on a consolidated basis. Under the JP, the company will be allowed to calculate its expense on a consolidated basis for the three-year term. Staff supports this treatment because the company will continue to perform the stand-alone computations and the Commission may require the company to return to the stand-alone calculations at the end of the three years.

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<sup>9</sup> OPEB are the non pension-benefits received by an employee when he or she begins retirement, including health care and life insurance premiums, and deferred compensation. The cost of health care benefits is generally the dominant component of OPEB expense.

<sup>10</sup> Case 91-M-0890, supra, Statement of Policy and Order Concerning the Accounting and Ratemaking Treatment for Pensions and Post-Retirement Benefits Other Than Pensions (issued September 7, 1993) (Pension/OPEB Policy Statement).

In compliance with a prior Commission Order,<sup>11</sup> the company filed an update regarding its Internal Reserves for Pension and OPEBs on April 1, 2011. As part of that filing, LIAW has requested permission to seek prospective interest accruals or rate base treatment for debit balance on its Pension/OPEBs internal reserves. Staff is reviewing the request, and will submit its recommendation to Commission on the matter, if the review is completed before the Commission addresses this JP.

**III. CONCLUSION**

Staff respectfully requests that the ALJ recommend that the Commission adopt the terms of the JP. The proposed terms are intended to provide predictable rates for the next three years while ensuring that the company be able to continue to provide safe and adequate service.

Respectfully submitted,

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Dated: December 7, 2011  
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<sup>11</sup> Case 05-W-0339 et al., Long Island Water Corporation - Rates, Order Determining Revenue Requirement and Rate Design (issued March 5, 2008)