

BEFORE THE
STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

In the Matter of
Long Island American Water
Case 11-W-0200
September 2011

Prepared Testimony of:

Andrew Leung
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State of New York
Department of Public Service
Three Empire State Plaza
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1 Q. Please state your name and business address.

2 A. My name is Andrew Leung. My business address is
3 Three Empire State Plaza, Albany, New York,
4 12223.

5 Q. By whom are you employed and in what capacity?

6 A. I am employed by the Department of Public
7 Service as a Senior Auditor in the Office of
8 Accounting and Finance.

9 Q. Please summarize your educational background and
10 professional experience.

11 A. I am a graduate of Siena College in 2006 with a
12 Bachelor's Degree in Accounting. I joined the
13 staff of the Department of Public Service in
14 January 2007.

15 Q. Have you previously testified before the Public
16 Service Commission?

17 A. Yes. I testified before the Commission in Case
18 07-W-0508 regarding Long Island American Water's
19 (LIAW or the Company) rate year forecasts of
20 Audit Fees, Village Taxes and Working Capital.

21 Q. What is the scope of your testimony in this
22 proceeding?

23 A. My testimony will address the following items in
24 LIAW's rate case filing: 1) the operating and

1 maintenance expense cost components referred to
2 as Payroll, Incentive Compensation, 401(k)
3 Expense, Defined Contribution, the Employee
4 Stock Purchase Plan (ESPP) and Payroll Taxes, 2)
5 the Company's Federal and State Income Tax
6 calculations and 3) how LIAW calculated rate
7 base and the Earnings Base/Capitalization
8 adjustment component of rate base. In addition,
9 I am responsible for Staff's revenue requirement
10 calculation.

11 Q. Are you sponsoring any exhibits?

12 A. Yes. I am sponsoring several exhibits. They
13 are Exhibit___(ACL-1), Exhibit___(ACL-2),
14 Exhibit___(ACL-3), Exhibit___(ACL-4),
15 Exhibit___(ACL-5), Exhibit___(ACL-6),
16 Exhibit___(ACL-7), Exhibit___(ACL-8),
17 Exhibit___(ACL-9), Exhibit___(ACL-10),
18 Exhibit___(ACL-11), Exhibit___(ACL-12),
19 Exhibit___(ACL-13), Exhibit___(ACL-14),
20 Exhibit___(ACL-15).

21 Q. Please describe Exhibit___(ACL-1).

22 A. Exhibit___(ACL-1), provides the calculation of
23 Staff's proposed revenue requirement for the
24 rate year ending March 31, 2013 and consists of

1 the following nine schedules:
2 Schedule 1 - Statement of Operating Income;
3 Schedule 2 - Operating and Maintenance
4 (O&M) Expenses;
5 Schedule 3 - State Income Taxes;
6 Schedule 4 - Federal Income Taxes;
7 Schedule 5 - Rate Base;
8 Schedule 6 - Cash Working Capital;
9 Schedule 7 - Capital Structure;
10 Schedule 8 - Calculation of Revenue
11 Requirement; and
12 Schedule 9 - Explanation of Staff
13 Adjustments

14 Q. Are you proposing any adjustments to the
15 Company's rate year forecast in this proceeding?

16 A. Yes.

17 Q. Please summarize your proposed adjustments.

18 A. I propose a decrease of \$617,231 to Payroll
19 expense; a \$9,853 decrease to 401(k) expense; an
20 \$11,042 decrease to Defined Contribution Plan
21 expense; the removal of \$3,163 in ESPP expense;
22 a \$38,638 decrease to Payroll Taxes; a \$507,890
23 increase to State Income Taxes; a \$1,714,695
24 increase to Federal Income Taxes; and a

1 \$3,366,552 increase to the Earnings Base vs.
2 Capitalization Adjustment. I also make a
3 recommendation regarding how the Company
4 calculated its average rate base.

5 **OPERATING & MAINTENANCE (O&M) EXPENSES**

6 **PAYROLL**

7 Q. How did LIAW forecast union payroll costs
8 included in rate year O&M expenses?

9 A. The Company started with 65 full-time equivalent
10 (FTE) employees for the historic test year (HTY)
11 ended December 31, 2010, and then added 5.5
12 additional FTE employees to increase the level
13 to 70.5 which are maintained through the rate
14 year. The forecast also includes 2.5 FTE summer
15 help employees and three vacancies that have
16 existed since January 2011. Staff Witness Kevin
17 Manz addresses the Company's need for the
18 additional 5.5 FTE in his testimony.

19 Q. Please continue.

20 A. Using 2011 hourly rates contained in the current
21 labor contract, the Company priced out each
22 position for a standard 40-hour work week. It
23 then priced out shift premiums by position,
24 calculated pay differentials when a union

1 employee works above his/her current pay rate,
2 then added meals and mileage reimbursements.

3 Q. How was union overtime (OT) calculated?

4 A. Union OT was priced out by using the three-year
5 average of overtime hours and salaries for the
6 calendar years ended 2008, 2009 and 2010. The
7 Company's next step was to apply a 3.50%
8 projected wage increase effective January 1,
9 2010 and 2011 based on the union contract
10 currently in effect; a forecasted 3.50%
11 projected wage increase effective January 1,
12 2012; and a forecasted 3.50% projected wage
13 increase effective January 1, 2013.

14 Q. How did LIAW forecast non-union payroll charges
15 for the rate year?

16 A. The Company started with 24.5 FTE for the HTY
17 2010 and maintained that level throughout the
18 rate year. The Company forecasted non-union
19 salaries by using the actual salaries as of
20 January 1, 2011 and projected a 3% wage increase
21 effective January 1, 2012 and January 1, 2013.

22 Q. How was non-union OT calculated?

23 A. Non-union OT was priced out by using the three-
24 year average of overtime hours and salaries for

1 the calendar years ended 2008, 2009 and 2010.
2 The Company's next step was to apply 2.99% and
3 2.90% projected wage increases effective January
4 1, 2010 and 2011, respectively; a forecasted
5 3.00% projected wage increase effective January
6 1, 2012; and a forecasted 3.00% projected wage
7 increase effective January 1, 2013.

8 Q. Did the company include any incentive
9 compensation in its rate year labor forecast?

10 A. Yes. The Company included \$260,010 for
11 incentive compensation in its rate year labor
12 forecast.

13 Q. How much did LIAW request for total payroll in
14 the rate year ending March 31, 2013?

15 A. Combining the union and non-union payroll
16 forecasts mentioned above, including incentive
17 compensation, results in a total rate year labor
18 forecast of \$8,472,488 for the Company.

19 Q. Did LIAW estimate the portion of the forecasted
20 payroll that will be charged to capital
21 accounts?

22 A. Yes. The Company allocated 16.98% of the total
23 forecasted payroll costs to capital accounts.
24 This reduces total payroll by \$1,438,628 to

1 result in a net amount of \$7,033,860 charged to
2 O&M expenses.

3 Q. How did LIAW develop the Capitalized Payroll
4 Percentage of 16.98%?

5 A. The Company developed the Capitalized Payroll
6 Percentage by using the three-year average of
7 payroll capitalized for the calendar years ended
8 2008, 2009 and 2010.

9 Q. Did LIAW reflect a productivity adjustment to
10 its rate year payroll forecast?

11 A. Yes. The Company reflected a 1% productivity
12 adjustment equal to 1% of total payroll costs
13 charged to O&M expense. Consistent with
14 Commission policy, the 1% was also applied to
15 the rate year O&M expense forecasts for all
16 employee related overheads including Group
17 Insurance, Pension, Other Post-Employment
18 Benefits (OPEBs), 401(k) Savings Plan, Employee
19 Stock Purchase Plan (ESPP), Retiree Medical,
20 Defined Contribution Plan (DCP) and Payroll
21 Taxes.

22 Q. What adjustments are you proposing to the
23 Company's rate year payroll forecast?

24 A. My adjustments can be broken down to the

1 following areas: union payroll, non-union
2 payroll, overtime (OT), incentive compensation
3 and capitalization of payroll.

4 **Union Payroll**

5 Q. How much did LIAW include in rate year O&M
6 expenses for union payroll costs?

7 A. The Company forecasted \$5,092,106 for union
8 payroll.

9 Q. What is your proposed monetary adjustment to
10 union payroll for the rate year forecast?

11 A. I propose a downward adjustment of \$370,418 to
12 union payroll for the rate year.

13 Q. Please explain how you arrived at your
14 adjustment.

15 A. I first removed the three vacant union employee
16 positions that have existed since January 2011.
17 This reduces the rate year payroll forecast by
18 \$211,353. The basis for removing these
19 positions from the rate year workforce is
20 provided in the testimony of Staff Witness Kevin
21 Manz.

22 Q. Please continue.

23 A. I then decreased the Company's 3.5% projected
24 wage increase for 2012 and 2013 to reflect the

1 projected rate of inflation instead.

2 Q. Please explain why you are using general
3 inflation to forecast the wage increase for the
4 rate year.

5 A. The company's current labor contract with the
6 Utility Workers Union of America, A.F.L.-C.I.O.
7 Local 365 is set to expire on December 31, 2011.
8 In the absence of a new labor contract beyond
9 that date, the Company has provided no basis to
10 allow non-contractual pay increases greater than
11 the rate of inflation. The current GDP deflator
12 estimates for 2012 and 2013 are 1.90% and 1.99%,
13 respectively, which I used for my forecast of
14 payroll wage increases. This reduces rate year
15 payroll forecast by \$159,065.

16 Q. Can LIAW update your proposed rates if a new
17 union contract is agreed to?

18 A. Yes, it complies with the rules for such updates
19 provided on pages 8-9 of the Commission's
20 "Statement of Policy on Test Periods in Major
21 Rate Proceedings" (issued November 23, 1997).

22 **Non-union Payroll**

23 Q. What is your proposed monetary adjustment to
24 non-union payroll for the rate year forecast,

1 excluding incentive compensation?

2 A. I made a downward adjustment of \$28,302 to non-
3 union payroll for the rate year.

4 Q. Please explain how you arrived to your
5 adjustment.

6 A. I projected my rate year forecast using the
7 Company's 2011 forecast as the base. This
8 serves to align non-union payroll adjustments
9 with union payroll adjustments.

10 Q. Please continue.

11 A. I decreased the company's 3% projected wage
12 increase for 2012 and 2013. As elaborated
13 above, I recommend the projected wage increase
14 be forecasted using the rate of inflation (1.90%
15 for 2012 and 1.99% for 2013).

16 **Overtime (OT)**

17 Q. Please provide a breakdown of LIAW's union and
18 non-union OT forecast for the rate year.

19 A. LIAW forecasted \$946,857 for total OT, which
20 includes \$938,403 for union and \$8,454 for non-
21 union.

22 Q. How did the Company forecast OT for the rate
23 year?

24 A. The Company used a three year average of union

1 and non-union OT for the calendar years 2008
2 through 2010. Then the average was inflated by
3 3.50% for union and 3.00% for non-union to
4 project the rate year.

5 Q. Do you have any adjustments to OT?

6 A. Yes. I have decreased total OT by \$121,031.

7 Q. Please explain how you arrived to your OT
8 adjustment.

9 A. The Company's methodology is inappropriate
10 because it did not take into account the
11 diminishing number of hours and expenses charged
12 for OT in the last three years. I recommend
13 using the HTY 2010 overtime amount of \$771,003
14 and \$8,191 for union and non-union,
15 respectively, as the base for my forecast.
16 Consistent with my recommendation above, I
17 recommend rate year OT be forecast by increasing
18 this base by the rate of inflation (1.90% for
19 2012 and 1.99% for 2013).

20 Q. Why are you using the HTY 2010 amounts to
21 forecast rate year OT?

22 A. As explained in response to Staff Interrogatory
23 Staff-156, ACL-40, Exhibit___(ACL-15), the
24 number of OT hours performed by LIAW staff from

1 2008 through 2010 had decreased. The reduction
2 of OT was due to several factors. The factors
3 include (1) the allocation of work to outside
4 contractors; (2) LIAW's efforts to reduce OT by
5 curtailing working extended hours on routine
6 jobs and projects; and (3) the reduction of
7 service calls and man-hours needed for meter
8 reading due to the completion of the Automatic
9 Meter Reader (AMR) replacement program. The
10 consistent downward trend of OT over three years
11 and the company's efforts to reduce OT are the
12 basis for my proposed adjustments.

13 Q. Does LIAW have plans for new or recurring
14 projects that would affect OT?

15 A. Yes. As explained in response to Staff
16 Interrogatory Staff-156, ACL-40, Exhibit___ (ACL-
17 15), LIAW plans to start up the AMR program
18 again. The Company will start replacing meters
19 around 2012 according to age and registration
20 requirements required under the Commission's
21 guidelines. The Company expects OT hours to
22 increase back to levels in historical years 2004
23 and 2005 when the AMR program was implemented.

24 Q. Do you propose an increase in OT for this

1 program?

2 A. No. The Company did not provide normalization
3 adjustments or forecasts of expenses and
4 capitalized payroll associated with the AMR
5 project in their filing. Thus, it is
6 inappropriate to consider the AMR program in
7 forecasted OT and capitalized payroll.

8 **Incentive Compensation**

9 Q. Please provide an overview of the Company's AIP.

10 A. As described in the pre-filed testimony of
11 William M. Varley, pages 14-16, the AIP is a
12 management tool for the Company to attract and
13 retain talented employees. The program is
14 designed to award managers with compensation in
15 par with the efforts they provide in maintaining
16 accountability and personal responsibility for
17 the Company.

18 Q. Please continue.

19 A. The pre-filed testimony of Sean Burke, pages 2-
20 14 provides much greater detail in the workings
21 of the AIP. Mr. Burke states the importance of
22 the AIP is to help attract and retain high
23 quality employees. The testimony describes how
24 setting and aligning goals, setting targets,

1 measures and "key performance indicators" for
2 employee performance are important to setting
3 the compensation level for employees. Without
4 the AIP, Mr. Burke maintains, the Company would
5 be at a disadvantage in attracting and retaining
6 employees against other companies who would
7 offer similar incentive programs or pay more in
8 base salary. There are three components to the
9 AIP: (1) a financial (70%) component which
10 measures diluted earnings per share and
11 operating cash flow; (2) a non-financial (30%)
12 component which measures customer service
13 quality, customer satisfaction, environmental
14 compliance, and the health and safety
15 performance; (3) the individual component
16 includes measures and goals consistent with
17 individual performance, which is aligned with
18 the non-financial component. Details of LIAW's
19 calculation and distribution of rewards under
20 the AIP is described in an official copy of the
21 "2011 Annual Incentive Plan" provided in
22 response to Staff Interrogatory Staff-119, ACL-
23 33 Exhibit___ (ACL-13).

24 Q. Is there another component of the Company's

1 incentive compensation other than the AIP?

2 A. Yes, it is the Long Term Incentive Plan (LTIP).

3 As indicated in the pre-filed testimony of

4 Robert A. Engle, page 19, lines 5-6, the LTIP

5 provides designated employees with the

6 opportunity to receive grants of stock options

7 and stock units. As noted in the pre-filed

8 testimony of Sean Burke, page 14, lines 12-14,

9 the LTIP "encourages long-term thinking and

10 focuses leadership's attention on key aspects of

11 the company's performance that deliver value to

12 the stakeholder." Like the AIP, the LTIP is "at

13 risk," meaning that the amount of compensation

14 is based on performance of the employee.

15 Q. How much incentive pay is included LIAW's

16 payroll forecast?

17 A. The Company included \$260,010 of incentive pay

18 in its rate year labor forecast, \$242,576 for

19 the AIP and \$17,434 for the LTIP. Actual

20 amounts could be higher or lower depending on

21 Company and individual employee performance.

22 Q. Do you agree with the inclusion of AIP and LTIP

23 in the company's rate year forecast?

24 A. No. The Company quantified its costs related to

1 incentive pay in its rate year expense forecast,
2 but provided no proof to support these costs.

3 Q. Has the Commission provided criteria that a
4 utility must meet if it wants to collect
5 incentive compensation costs in customer rates?

6 A. Yes. In a recent Orange and Rockland Utilities,
7 Inc. (O&R) rate case the Commission stated:
8 First and foremost, the Company must
9 demonstrate that its overall management
10 compensation levels, including its
11 incentive compensation, are reasonable
12 relative to similarly situated companies.
13 This is best demonstrated through a
14 compensation study that compares each of
15 the elements of O&R's total management
16 compensation, including base pay, incentive
17 compensation and employee benefits, to the
18 relevant market. An unsupported claim that
19 incentive compensation is necessary to
20 attract and retain competent, qualified
21 management personnel will be insufficient
22 to meet the Company's burden of proof.¹

23 Q. Did LIAW support the inclusion of incentive
24 compensation in rates with a compensation study
25 that compares incentive compensation to the
26 relevant market?

27 A. No.

28 Q. Did the Company provide identifiable and

¹ Case 10-E-0362, Orange and Rockland Utilities, Inc. for Electric Service, Order Establishing Rates for Electric Service (Issued and Effective June 17, 2011), pp. 40.

1 quantifiable ratepayer savings and/or benefits
2 and did the Company reflect these savings and/or
3 benefits within its forecasted rate year revenue
4 requirement?

5 A. No. The Company did not identify or quantify
6 any ratepayer savings and/or benefits associated
7 with incentive compensation. This was conceded
8 by LIAW in its response to Staff Interrogatory
9 Staff-120, ACL-34 Exhibit___ (ACL-14). The
10 Company believed that to perform such a study
11 would be too costly and complex. Furthermore,
12 the Company could not reflect any
13 savings/benefits to ratepayers in the company's
14 revenue requirement. As a result, I have
15 removed LIAW's AIP and LTIP from rates, reducing
16 the company's payroll forecast by \$260,010.

17 **Payroll Capitalized**

18 Q. Please explain how LIAW calculated the
19 percentage of payroll to be charged to capital
20 accounts during the rate year.

21 A. The Company used a three-year average of
22 capitalized payroll to total payroll for the
23 calendar years 2008, 2009 and 2010. This
24 resulted in a capitalized payroll percentage of

1 16.98%.

2 Q. What capital payroll percentage do you
3 recommend?

4 A. I recommend using the HTY 2010 capitalized
5 payroll percentage of 16.59% in order to be
6 consistent with the adjustments I propose be
7 made to OT as described above.

8 Q. What is your overall adjustment to rate year
9 payroll charged to O&M expenses?

10 A. The rate year payroll charged to O&M expenses is
11 decreased by \$617,231, reducing the rate year
12 payroll forecast from \$7,033,860 to \$6,416,629.

13 **Productivity Adjustment**

14 Q. Do you recommend any adjustment to LIAW's
15 productivity adjustment?

16 A. Yes, as elaborated above LIAW's calculation of
17 the productivity adjustment is directly tied to
18 payroll and payroll related costs. Thus, the
19 amount forecasted by the Company needs to be
20 modified to reflect Staff's proposed adjustments
21 to payroll and payroll related costs.

22 **401(k) SAVINGS PLAN EXPENSE**

23 Q. How much did LIAW include in rate year O&M
24 expenses for 401(k) Savings Plan costs?

1 A. \$132,786, which is net of the amount forecasted
2 to be capitalized (16.98%). This amount is
3 \$19,296 greater than the actual HTY expense of
4 \$113,490.

5 Q. Provide a brief overview of the 401(k) plan.

6 A. Under the 401(k) plan, employees are allowed to
7 contribute up to 20% of their base salary
8 (within Internal Revenue Service limitations) on
9 a tax deferred basis. For all LIAW non-union
10 employees hired prior to January 1, 2001, the
11 company matches fifty cents on the dollar on the
12 first 5% the employee contributes to the plan.
13 For all LIAW non-union employees hired on or
14 after January 1, 2006, and all LIAWC union
15 employees hired on or after January 1, 2001, the
16 company matches dollar for dollar on the first
17 3% and fifty cents on the dollar for the next 2%
18 (maximum match is 4%) the employee contributes
19 to this plan.

20 Q. What is your monetary adjustment to the 401(k)
21 expense forecast?

22 A. I propose the Company's 401(k) expense forecast
23 be reduced by \$9,853 tracking my proposed
24 adjustments to rate year payroll and the rate

1 year capitalized percentage as described above.

2 **DEFINED CONTRIBUTION PLAN EXPENSE**

3 Q. How much did LIAW include in rate year O&M
4 expenses for Defined Contribution Plan (DCP)
5 costs?

6 A. \$96,315, which is net of the projected amount to
7 be capitalized (16.98%). This amount is \$23,435
8 greater than the actual HTY expense of \$72,880.

9 Q. Provide a brief overview of the DCP.

10 A. The DCP is a new plan for all non-union
11 employees hired on or after January 1, 2006 and
12 all union employees hired on or after January 1,
13 2001, in lieu of the Company's defined benefit
14 pension plan. The company will contribute 5.25%
15 of base pay for each employee who is eligible to
16 participate in the DCP.

17 Q. What is your monetary adjustment to the DCP
18 expense forecast?

19 A. I propose LIAW's rate year DCP expense forecast
20 be reduced by \$11,042 tracking my proposed
21 adjustments to rate year payroll and the rate
22 year capitalized percentage as described above.

23 **EMPLOYEE STOCK PURCHASE PLAN (ESPP)**

24 Q. Provide a brief overview of LIAW's ESPP.

1 A. The ESPP is a plan that allows non-union
2 employees to purchase stock from American Water
3 Works, Inc. (American Water) with 1% to 10% of
4 their base wages on an after-tax basis.

5 Q. Do you have any adjustments to the ESPP?

6 A. Yes. I am proposing to remove the ESPP from the
7 company's rate year forecast.

8 Q. Please explain why you are removing the ESPP.

9 A. The ESPP is similar to the company's proposed
10 incentive compensation, in which non-union
11 employees are provided additional compensation.
12 Therefore, the proposed \$3,163 in ESPP should be
13 removed from rates consistent with the
14 recommendations for the other incentive
15 compensation items addressed above.

16 Q. Will the removal of ESPP affect the productivity
17 adjustment?

18 A. Yes. The ESPP will not be used as part of the
19 1% productivity adjustment calculation.

20 **PAYROLL TAXES**

21 Q. Are you proposing an adjustment to Payroll
22 Taxes?

23 A. Yes. I propose rate year payroll taxes be
24 reduced by \$38,638 net of the adjusted

1 capitalized payroll (16.59%) tracking my
2 proposed adjustments to rate year payroll and
3 the capitalized payroll percentage described
4 above.

5 **Earnings Base vs. Capitalization Adjustment**

6 Q. In general, what does the Earnings Base vs.
7 Capitalization (EB/Cap) adjustment represent?

8 A. The EB/Cap adjustment represents the difference
9 between the average historic test year earnings
10 base and the capitalization that supports
11 earnings base.

12 Q. What is the theory behind this adjustment?

13 A. In order for rates to be set in a rate case are
14 reasonable, a utility must be allowed to earn a
15 fair return on the investment dedicated to
16 public service. The investment entitled to a
17 fair return is not the assets dedicated to
18 public service, but rather to the holders or
19 investors of the capital that support the
20 assets. The capital includes common equity and
21 debt of the Company. The Commission provides
22 recovery in rates of costs of capital dedicated
23 to utility service. The rate base is a
24 surrogate to measure utility dedicated capital;

1 it is usually measured by the investment of
2 assets allocated between various operations of
3 the utility. The amount of rate base should not
4 exceed the Company's capitalization; investors
5 only needed the opportunity to earn a fair
6 return on the capital they have invested in the
7 utility. If a utility was allowed to earn a
8 return on a rate base greater than
9 capitalization, then the equity return would be
10 greater than what was allowed on the basis of
11 capitalization.

12 Q. What are the reasons for this difference between
13 rate base and the capitalization that supports
14 it?

15 A. Rate base includes a component for an estimate
16 of cash working capital; the lag in cash flow
17 where costs are incurred to provide service but
18 not yet collected through the billing process.
19 There are a number of reasons why an individual
20 utility's cash working capital requirements can
21 be more or less than the estimate. These
22 differences include but not limited to: (1) the
23 arbitrariness of the cash working capital
24 allowance in rate base; (2) paying state and

1 federal income taxes on a quarterly basis while
2 collecting monies for such taxes from ratepayers
3 on a monthly or bi-monthly basis; (3) paying
4 interest on long term debt on a quarterly basis
5 while collecting monies for such interest
6 payments from ratepayers on a monthly or bi-
7 monthly basis; (4) the timing of when expenses
8 are actually incurred / paid compared to when
9 such monies are collected from ratepayers; (5)
10 the lag in receiving and then paying invoices
11 versus when the cost was actually incurred; and
12 (6) the company's cash management efficiencies /
13 inefficiencies. It should be noted that the
14 above reasons may not all be applicable to every
15 utility.

16 Q. What has been the Commission's ratemaking policy
17 with regards to this EB/Cap adjustment?

18 A. The Commission's policy has been to reduce the
19 projected rate year rate base by the excess HTY
20 EB/Cap adjustment. Inherent in this policy is
21 the assumption that beyond the HTY, every dollar
22 of earnings base addition or reduction is
23 matched by a dollar change in capitalization.
24 The EB/Cap adjustment helps set rates on the

1 capitalization that supports rate base rather
2 than on rate base itself. To do otherwise would
3 result in providing the company with an excess
4 return on the portion of rate base that has no
5 capitalization (and thus no cost of capital)
6 supporting it.

7 Q. How much did LIAW include in its rate case
8 presentation for the EB/Cap adjustment?

9 A. The company reflected an EB/Cap adjustment of
10 \$1,200,826, as shown on line 18 of Exhibit 10,
11 page 3.

12 Q. How did LIAW determine the EB/Cap adjustment of
13 \$1,200,826?

14 A. As shown on the last page of Exhibit 12, Tab 31
15 of the Company's filing, the Company compared
16 its total average HTY capitalization of
17 \$107,000,105 to its calculation of HTY earning
18 base (historic rate base + interesting bearing
19 construction work in progress) of \$108,200,932.
20 The difference of \$1,200,826 represents the
21 company's EB/Cap adjustment.

22 Q. Are you proposing to adjust the Company's EB/Cap
23 adjustment?

24 A. Yes. I am proposing adjustments to five of the

1 components of LIAW's EB/Cap adjustment
2 calculation that in total increase the
3 adjustment (decrease the rate year rate base)
4 from \$1,200,826 to \$4,567,379, or by \$3,366,552.
5 Exhibit___(ACL-6) summarizes LIAW's EB/Cap
6 adjustment calculation and reflects the
7 adjustments I propose as well as the Company's
8 EB/Cap adjustment as adjusted by Staff.

9 Q. Please explain your adjustment to the Paid-in-
10 Capital component of the LIAW's HTY
11 Capitalization.

12 A. The \$15,715,457 for Paid-in-Capital determined
13 by the Company is the 13 month average for the
14 test year. However, the Commission has a long
15 standing policy of using the average daily
16 balance whenever possible to determine a
17 utility's capitalization. For example, see
18 Cases 28848 and 26849, Rochester Gas and
19 Electric - Rates, Opinion No. 76-8 (issued April
20 8, 2976) p. 8. Using the historic daily average
21 for Paid-in-Capital reduces LIAW's amount by
22 \$149,596.

23 Q. Are any of the other proposed adjustments on
24 Exhibit___(ACL-6) related to the use of a daily

1 versus monthly average?

2 A. Yes. The proposed \$720,943 decrease to Long
3 Term Debt and \$597,893 increase Short Term Debt
4 are the impacts of using a daily versus monthly
5 average for those items.

6 Q. Please describe the \$185,360 proposed increase
7 to Unamortized Debt Expense.

8 A. The \$185,360 increase corrects the error made by
9 the Company in its calculation of Unamortized
10 Debt Expense. The Company used the wrong
11 amounts for the months of December 2009, January
12 2010 and February 2010. The Company
13 acknowledged the mistakes in its response to
14 Staff Interrogatory Staff-171, MVH-15, and an
15 adjustment is proposed to correct the error.

16 Q. Please describe the \$2,908,546 proposed increase
17 to LIAW's EB/Cap adjustment.

18 A. The \$2,908,546 increase corrects the errors made
19 by the Company in its calculation of HTY
20 Accumulated Deferred Income Taxes (ADIT). The
21 Company used the wrong amounts for the months of
22 December 2009, January 2010, February 2010 and
23 December 2010. The corrections are placed as a
24 proposed increase to Earnings Base, which in

1 turn increases the EB/Cap adjustment. Details
2 on the adjustment are provided in
3 Exhibit___(ACL-7), Exhibit___(ACL-8) and
4 Exhibit___(ACL-9).

5 **Accumulated Deferred Income Taxes**

6 Q. Please explain your adjustments to the average
7 rate year rate base forecast of Accumulated
8 Deferred Income Taxes (ADIT).

9 A. My proposed adjustments to ADIT track the
10 proposed Staff adjustments to Deferred Income
11 Taxes described below in the State and Federal
12 Income Tax section.

13 **STATE AND FEDERAL INCOME TAXES**

14 **Interest Expense**

15 Q. How did LIAW project the rate year income tax
16 deductions for interest expense?

17 A. The Company's projected interest expense
18 deduction is calculated on Exhibit 9, page 45,
19 lines 32-35 for state income taxes and page 46,
20 lines 31-34 for federal income taxes. The
21 calculations are identical. Specifically, the
22 Company multiplied the projected rate year rate
23 base times the debt component of its proposed
24 capital structure.

1 Q. Do LIAW's calculations comply with the
2 Commission Policy's for computing the tax
3 deductions associated with interest expense?

4 A. Not completely. While the basic calculation
5 complies with the Commission's Policy, the
6 Company should have added interest bearing CWIP
7 to rate base and then multiplied the total times
8 the debt component of the proposed capital
9 structure to get the projected rate year tax
10 deduction for interest expense.

11 Q. Have you made this correction in the federal
12 income tax calculations included in
13 Exhibit___(ACL-1)?

14 A. Yes. I have added the interest bearing CWIP
15 balance projected for the rate year by LIAW as
16 shown in Exhibit 12, Tab 31 to the Staff
17 adjusted rate base derived on Schedule 5 of
18 Exhibit___(ACL-1) and multiplied the total by
19 the debt component of the capital structure
20 proposed by Staff Witness Duah.

21 **Depreciation Differences**

22 Q. What does the caption Depreciation Differences
23 mean on Exhibit___(ACL-1), Schedule 3?

24 A. Depreciation Differences represent the

1 forecasted difference between the amount of
2 depreciation LIAW will deduct on its tax returns
3 versus the amount it will record on its books as
4 a current expense.

5 Q. Please describe your proposed adjustment to the
6 Company's forecast for Depreciation Differences?

7 A. This adjustment reflects the impacts of the
8 adjustments to Plant in Service proposed by
9 Staff Witness Michael Horan.

10 **Deferred Taxes**

11 a) Introduction

12 Q. What are deferred taxes?

13 A. The Uniform System of Accounts for Class A Water
14 Companies defines deferred taxes as "an amount
15 equal to that by which income taxes payable for
16 the year are higher because of the inclusion of
17 certain items in income for tax purposes, which
18 items for general accounting purposes will not
19 be fully reflected in the utility's
20 determination of annual net income until
21 subsequent years." Deferred taxes are timing
22 differences or temporary differences between the
23 accounting value of assets and liabilities and
24 their value for tax purposes. For the utilities

1 regulated by the Commission, the largest
2 temporary difference generally results from the
3 liberalized depreciation rates allowed for tax
4 purposes than is used for determining
5 depreciation expense for rate purposes.

6 Q. How are deferred taxes considered in rate cases?

7 A. The utility first forecasts the amount of income
8 taxes it will owe the taxing authority in the
9 rate year based on the forecasted operating
10 income and adjustments it will make on in its
11 tax return based on the expected income tax
12 regulations in the rate year. The impacts of
13 temporary differences are then eliminated
14 through establishment of deferred taxes. As the
15 establishment of deferred taxes results in an
16 item be considered in customer rates that has no
17 cash flow involved, the cash flow impacts of
18 deferred taxes by adding (deducting) the
19 deferred tax asset (liability) to rate base.

20 b) Depreciation Differences

21 Q. Please describe your proposed adjustment to
22 LIAW's forecast of rate year deferred taxes for
23 Depreciation/Differences.

24 A. Under current federal and state regulations the

1 income tax impacts of Depreciation Differences
2 must be deferred. These adjustments simply track
3 my proposed adjust to the tax adjustment for
4 Depreciation Differences described above.

5 c) Regulatory Asset Amortizations

6 Q. Did LIAW err in its computation of rate year
7 deferred income taxes related to regulatory
8 asset amortizations in this proceeding?

9 A. Yes, in computing rate year state deferred
10 income taxes on Lines 24-29 of Exhibit 9, page
11 45 and rate year federal deferred income taxes
12 on Lines 20-27 of Exhibit 9, page 46 the company
13 included the amortizations on Lines 7-10 on page
14 45 and 8-11 of page 46. However, because the
15 Company deducted the amortizations from the
16 Operation & Maintenance Expense amounts on Line
17 4 of pages 45 and 46 it in effect did not
18 reflect the federal income tax adjustment or
19 temporary difference it created a deferred tax
20 for.

21 Q. Has Staff corrected this error in its revenue
22 requirement calculations?

23 A. Yes, pages 3 and 4 of Exhibit___(ACL-1) reflect
24 the amortizations the company established a

1 deferred tax for as an adjustment for computing
2 taxable income from net operating income.

3 d) Repairs Expense Deduction

4 Q. Please provide a brief overview of the Repairs
5 Expense Deduction.

6 A. The Repairs Expense Deduction is the result of
7 applying a tax accounting method in which
8 routine repairs and maintenance expenses of
9 network assets are made immediately tax
10 deductible (pursuant to Internal Revenue Code
11 Section 162) against income rather than
12 capitalizing and depreciating them over the tax
13 life of the asset, as was done for book
14 accounting and rate purposes.

15 Q. Please explain your adjustments to the Repairs
16 Expense Deduction.

17 A. LIAW's made two errors in its rate filing
18 related to the Repairs Expense Deduction. In
19 its response to Staff Interrogatory Staff-66
20 ACL-12, Exhibit___ (ACL-10) the Company admitted
21 that it erroneously applied \$422,944 in repairs
22 expense as the deduction for the rate year. The
23 correct amount should be \$1,094,626 as reflected
24 in LIAW's response to Staff Interrogatory Staff-

1 171, MVH-15.

2 Q. Please continue.

3 A. In its response to Staff Interrogatory Staff-108
4 ACL-23, Exhibit___(ACL-12), LIAW admitted that
5 it inadvertently did not establish a deferred
6 tax for the Repairs Expense Deduction in its
7 rate year forecast.

8 Q. Do Staff's income tax calculations correct these
9 errors?

10 A. Yes.

11 e) Amortization of Flow-Through Regulatory Asset

12 Q. Please explain your adjustment to the rate
13 amount for "Amortization of Flow-Through
14 Regulatory Asset."

15 A. In its response to Staff Interrogatory Staff-67,
16 ACL-13, Exhibit___(ACL-11), LIAW admitted the
17 \$324,519 rate year amount shown for this item on
18 Exhibit 9, page 46, line 28 was wrong. The
19 Company stated the number was erroneously
20 grossed up for taxes and should actually be
21 \$210,938. I agree with the Company's
22 correction, which results in an \$113,581
23 reduction to Federal Income Taxes.

24 **RATE BASE**

1 **Monthly Averages**

2 **Q.** How did the LIAW calculate the monthly average
3 of items included in rate base in the historic
4 test year and rate year?

5 **A.** The company added the balance at the end of the
6 prior period to the 12 end of month balances
7 during the year and divided the total by 13. For
8 example, see the calculations Exhibit 12, Tab 31
9 for interest and non-interest bearing
10 Construction Work in Progress (CWIP).

11 **Q.** Does LIAW's methodology comport with Commission
12 policy?

13 **A.** No. The Commission's longstanding policy is to
14 use an average of the monthly averages. This
15 accomplished by subtracting from the 13 month
16 total computed by LIAW, one-half of the balances
17 at the end of the prior and current years and
18 dividing the remainder by 12.

19 **Q.** Do you recommend an adjustment to correct for
20 this?

21 **A.** There are numerous 13-month average calculations
22 included in LIAW's filing and making the
23 correction will only result in a material
24 adjustment if there is a significant change in

1 the year end balances. My review of the affected
2 items indicate this would only be the case for
3 the items in the Earnings Base vs.
4 Capitalization Adjustment that I recommend be
5 computed on a daily basis below. Thus, I am not
6 proposing an adjustment to correct LIAW's 13-
7 month average calculation errors. However, in
8 future filings, the Company's should reflect the
9 proper calculation.

10 Q. Does this conclude your testimony at this time?

11 A. Yes.