

LONG ISLAND AMERICAN WATER INDEX TO TESTIMONY

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Watkins	Capital Structure, Comparative Financial Schedules, Depreciation, Rate Base, State & Federal Income Tax
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STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

CASE 11-W-_____

PROCEEDING ON THE 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

Testimony of William M. Varley

April 29, 2011

WILLIAM M. VARLEY – DIRECT TESTIMONY

1 **1. Q. Please state your name and business address.**

2 A. My name is William M. Varley. My current business address is 733 Sunrise
3 Highway, Lynbrook, New York 11563.

4 **2. Q. By whom are you employed and in what capacity?**

5 A. I am employed by Long Island Water Corporation, d/b/a Long Island American
6 Water Company (“LIAW” or the “Company”), as its President.

7 **3. Q. What are your responsibilities in this position?**

8 A. As President of LIAW, my continuing responsibility is to drive performance,
9 advance comprehensive and consistent best practices, and ensure that the Company
10 has open and effective relationships with key external stakeholders including
11 customers, regulators and other governmental stakeholders within New York. I
12 have executive-level authority for all LIAW business activities. As the Company’s
13 President, I am ultimately responsible for assuring that we meet our customers’
14 needs. That means I am responsible for the general operations of the regulated
15 water activities of LIAW. Additionally, I am responsible for maintaining the
16 Company’s financial health; enhancing the operating efficiency and reliability of
17 the Company; and for assuring that all functions of the Company are performed in
18 compliance with all applicable laws and regulations and standards of good business
19 practice.

20

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1 **4. Q. Does this position require any balancing of interests?**

2 A. Yes, I must balance the interests of our customers, employees, regulators and
3 shareholders. I try to take the interests of all these stakeholders into account in
4 significant Company decisions.

5 **5. Q. Please describe your educational background.**

6 A. I graduated from SUNY Canton Agricultural and Technical College with an
7 Associate Degree in Construction Technology in 1977. I received a Bachelor of
8 Science degree in Civil Engineering Technology from Rochester Institute of
9 Technology in 1981. I am a member of the American Water Works Association,
10 New York Section and I am currently the Chairman of the National Association of
11 Water Companies (“NAWC”) - New York Chapter.

12 **6. Q. What has been your business experience?**

13 A. I began my business career in 1981 at Camp Dresser & McKee as a civil
14 environmental engineer. In 1984, I was employed by Jamaica Water Supply
15 Company as Manager, Engineering, and was responsible for implementation and
16 oversight of that company's construction budget. A year later, I moved to Hazen &
17 Sawyer, P.C., as a Resident Engineer where my responsibilities included
18 supervision of a project to upgrade a portion of an existing wastewater treatment
19 facility. In 1987, I took a position as District Manager with Layne Christensen
20 Company where I was responsible for a well and pump contracting division for a
21 water supply contracting company. In 2000, I was hired by LIAW as Operations

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1 Superintendent and was responsible for production operations, which covers
2 LIAW's 24 facilities with production capabilities. In 2003, I was named Vice
3 President and Manager and held that position until I was named President in 2007.

4 **7. Q. Have you previously testified in regulatory proceedings?**

5 A. Yes, in New York State in the two previous LIAW regulatory proceedings before
6 the Public Service Commission (“Commission”), Case 04-W-0577, order issued
7 March 21, 2005, and Case 07-W-0508, order issued March 5, 2008.

8 **8. Q. What level of rate relief is the Company seeking in this proceeding?**

9 A. In the testimony and schedules submitted in this proceeding, the Company
10 demonstrates the need for a revenue increase of \$9,563,146. Mr. Watkins explains
11 the drivers behind this revenue increase request in greater detail within his direct
12 testimony. Given the level of capital expenditures, combined with the Company
13 not filing a general rate case for four years and increased operating expenses, we
14 have no choice but to file for rate relief at this time. Rate relief will enable the
15 Company to remain financially sound in order to make the investments needed to
16 render the level of safe, adequate and proper service that we do today.

17 **9. Q. What is the purpose of your direct testimony in this case?**

18 A. The purpose of my testimony is to provide an overview of the Company and also to
19 generally describe (1) the major reasons why LIAW is filing this case; (2) how
20 LIAW delivers value and performance to its customers in a cost-effective manner;

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1 (3) the cost-drivers behind our rate change request; and (4) the Company’s desire to
2 continue and expand its DSIC and SIC programs.

3 **OVERVIEW OF RATE CASE DRIVERS**

4 **10. Q. Mr. Varley, why is the Company filing this rate case within this challenging**
5 **economic environment?**

6 A. Since LIAW’s current rates were set in March of 2008, we have continued to
7 provide safe, adequate and proper service to our customers. The Company
8 managed to avoid filing a rate case in 2010 due in large part to its aggressive
9 containment and careful management of costs. Careful management, however,
10 cannot contain costs indefinitely. Additionally, over the past several years the
11 Company has made substantial investments in its infrastructure needed to provide
12 the level of safe, adequate and proper service that our customers have come to
13 expect of us. Our primary focus has been in two areas: water quality and aging
14 water mains. To address the water quality issue, in particular the high iron levels
15 that are naturally occurring in our source of supply, we have constructed new iron
16 removal facilities as well as upgraded existing ones. We have also implemented an
17 aggressive water main replacement program to address the aging piping network,
18 which in turn will also help enhance water quality.

19 **11. Q. How does the Company manage costs?**

20 A. Expenses are carefully managed by the Company through a combination of a
21 “bottom up” and a “top down” set of activities. Each functional division is

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1 responsible for participating in a monthly financial performance review and a
2 monthly business performance review. These reviews include a close analysis of
3 our expenses. Actual expenses are compared to expected expenses, either budgeted
4 or historical, and where variances exist the reasons for those variances are
5 investigated. Opportunities to improve and vulnerabilities to success are identified,
6 and the business leaders take steps to achieve opportunities and mitigate
7 vulnerabilities. These steps apply to all expenses.

8 **12. Q. Please provide an overview of the cost drivers underlying this rate change**
9 **request.**

10 A. Generally speaking, these drivers fall under four categories: operating expenses,
11 property taxes, capital investment, and information technology systems upgrade.

12 **OPERATING EXPENSES**

13 **13. Q. Please describe the drivers that fall under the category of “operating**
14 **expenses.”**

15 A. One driver in this rate case is the increase in various operating expenses that we
16 have experienced that we have not been able to recover via one of the various
17 surcharge mechanisms that we currently have in place. Continuing to carry these
18 costs without rate relief is not a sustainable option. While the Company has
19 worked hard to control, and in some cases reduce certain operating expenses,
20 overall, expenses have increased by 7.65% over the amount allowed in Case 07-W-
21 0508, which amounts to an annual expense increase of less than 2 percent per year.

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1 **14. Q. Please describe the major operating expenses for which the Company is**
2 **requesting recovery.**

3 A. One area in which the Company has experienced an increase in costs is in labor.

4 As demands for infrastructure improvements increase and increasing demands are
5 placed on our system (as especially witnessed during this past hot, dry summer) a
6 restructuring of the Company's management team was necessary to continue to
7 effectively serve our customers. This change included the addition of a Director of
8 Operations position. Prior to this addition, one manager was performing the duties
9 of Engineering Manager and the above referenced position. Because the Company
10 has made significant capital improvements and physical plant additions, a Director
11 of Operations is required to manage the provision of service to our customers in
12 order to allow the Engineering Manager to focus on management of our capital
13 assets.

14 Secondly, as a result of increasing iron levels in our source of supply, since 2005
15 LIAW has constructed and placed in service three new iron removal facilities, and
16 there is an additional plant under design and anticipated to be placed in service in
17 late 2013. Additional facilities are planned for construction as well. As a result of
18 these much needed and required facilities, an increase in labor for mechanical
19 upkeep as well as plant monitoring is required. As a result of these new facilities,
20 we have included an additional Maintenance Mechanic B and Station Attendant B
21 within the Production Department.

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1 Thirdly, the Company has contracted with an outside firm to provide assistance in
2 managing its external affairs including providing support for the execution of the
3 Company’s policies and strategies pertaining to media and governmental relations.
4 The outside firm also performs such tasks as media coordination, support of
5 external activities such as the arrangement of meetings with public officials, as well
6 as generally provides support for the external relations efforts of LIAW. To further
7 enhance this function a shared resource dedicating fifty percent of his or her time to
8 LIAW will be filled to round out the external affairs role. Coordination with the
9 outside firm and the in-house expertise will enable the management of
10 governmental and media affairs to be consistent within LIAW and also across
11 American Water Works (“AWW” or “American Water”). The combined cost of the
12 shared resource and the outside firm will be the equivalent of one full time person
13 (“FTE”) allowed in the prior rate filing. This position is also critical. As the
14 Company continues to address the levels of iron in its groundwater supply, it will
15 continue its outreach and communications efforts about this issue with our
16 customers and external governmental stakeholders, and this FTE will work to
17 develop and coordinate the communications plan that will be utilized.

18 Lastly, in the interests of efficiency and additional cost reduction, LIAW will be
19 filling the role of the Human Resources Manager; based on past experience we have
20 allocated thirty percent of one FTE to execute this role. Adding this FTE to focus

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1 on human resources issues will allow other LIAW personnel to focus on their day-
2 to-day work in operating the Company.

3 **15. Q. Please describe another operating expense for which the Company is**
4 **requesting recovery.**

5 A. Another area in which the Company has experienced an increase in costs is
6 chemical expenses. Please refer to the testimony of Mr. Casillo for a discussion on
7 the increase in expense related to sodium silicates.

8 **PROPERTY TAXES**

9 **16. Q. Are property taxes a significant cost to the Company?**

10 A. Yes. Currently property taxes total approximately 24.39%, based on the actual
11 property tax expense of \$10,874,221 and the allowed amount of revenues per the
12 Revenue Adjustment Clause of \$44,591,311 for the RYE 3/31/2011. Based on
13 present rate revenues of \$49,063,159, property tax expense totals 22.16% of
14 revenues. While the Company has aggressively pursued its tax challenges against
15 Nassau County and the various villages that assess property taxes, this is a cost that
16 is essentially beyond LIAW's cost control efforts. PSC-approved property tax
17 refund petitions have resulted in customer refunds totaling \$11.464 million, which
18 have been returned to our customers via bill credits or offsets.¹ The \$11.464
19 million does not include a refund for Case 10-W-0449 which is currently pending.
20 The Company will continue to aggressively pursue these challenges as necessary

¹ Cases 06-W-0069, 08-W-1251, and 09-W-0581.

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1 and appropriate. Please see the testimony of Mr. Casillo for more information
2 about this issue.

3 **17. Q. Does LIAW have any other property tax cases that are currently pending?**

4 A. Yes. The Company currently has a case against the Town of Hempstead and the
5 various garbage and refuse districts therein. The Company is challenging the taxes
6 levied for garbage and refuse services on the theory that such taxes may only be
7 levied on real property that is benefitted by such services. This case is currently
8 pending before the New York Court of Appeals.

9 Also, LIAW has initiated matters challenging special levies imposed for all non-
10 countywide special districts in Nassau County, claiming that the real property tax
11 law does not support Nassau County’s method of taxation in these districts and that
12 such remittances paid by the Company must be refunded with interest. These
13 matters are also pending. Mr. Casillo discusses both of the above matters in his
14 testimony.

15 The Company has also instituted property tax certiorari challenges against the
16 villages in its service territory. Currently, the Company has settled these challenges
17 with all but one of the villages. With regard to the property tax refunds received,
18 LIAW has filed a property tax refund petition that is pending under Case 10-W-
19 0449. As it receives further refunds, LIAW will make additional filings as

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1 appropriate. Mr. Casillo also discusses the status of these property tax proceedings
2 in his direct testimony.

3 Finally, LIAW has also investigated the issue of its property taxes being allocated
4 to special districts outside of its service territory. The results of this investigation
5 are also discussed within Mr. Casillo’s direct testimony.

6 **18. Q. What part of the overall increase requested by LIAW can be accounted for by**
7 **the forecasted increase in Property Taxes?**

8 A. Property taxes are forecasted to go up to \$14,365,278 which is an increase of
9 \$1,833,562 over the allowed amount for the Property Tax Reconciliation
10 Mechanism of \$12,531,716 for the 12 months ended 3/31/2011. The \$1,833,562 is
11 19.17% ($\$1,833,562 / \$9,563,146$) of the total increase requested.

12 **CAPITAL INVESTMENTS**

13 **19. Q. Please describe the drivers that fall under the category of “capital investment.”**

14 A. The Company continues to make the necessary capital investments to our system in
15 order to provide safe, adequate and proper service to our customers. LIAW has
16 invested over \$40 million in capital improvements in 2008, 2009, and 2010. LIAW
17 plans to invest approximately \$16 million in capital improvements in calendar year
18 2011 and approximately \$18 million in capital improvements in calendar year 2012.
19 The Company has made the additional investment based on the system’s needs and
20 in order to continue to provide the high-quality and reliable service our customers

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1 have come to expect. Please see the testimony of Mr. Richard Kern for further
2 information regarding this matter.

3 Furthermore, and as discussed in more detail by Mr. Kern in his testimony, the
4 Company has made effective use of its Commission-approved Distribution System
5 Improvement Charge (“DSIC”) and System Improvement Charge (“SIC”)
6 mechanisms. Over the past three (3) years, LIAW has replaced or rehabilitated
7 approximately 16 miles of distribution pipelines within its service territory, with an
8 average DSIC surcharge to its customers of approximately \$1.00 per month. In
9 fact, due to the capital-intensive nature of the water service business and the need to
10 replace and rehabilitate its infrastructure to provide safe, adequate and proper
11 service, LIAW has made additional investments over and above the current DSIC
12 cap of \$3 million.

13 The Company has also utilized its Commission-authorized SIC charge to build a
14 new iron removal plant in the Town of Hempstead. This new plant went into
15 service on March 8, 2011. The Company has made its required SIC filing for \$4
16 million of the costs to construct this plant (net of associated retirement,
17 accumulated deferred income taxes, and accumulated depreciation reserve) on
18 March 24, 2011 as allowed under the Commission’s Order in Case 07-W-0508. To
19 date this SIC filing is pending before the PSC. LIAW will seek the balance of the

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1 costs to build this plant (\$3.6 million) within this instant proceeding. Please see
2 Mr. Kern’s testimony for further discussion about this issue.

3 As a result of the Company’s successful implementation of its DSIC and SIC
4 charges, the Company proposes to continue to use these mechanisms to timely
5 recoup its costs for qualified projects. Additionally, the Company proposes that the
6 cap be increased to \$7.75 million. Please refer to Mr. Watkins’ testimony for
7 DSIC-eligible projects in light of the level of the Company’s increased and
8 necessary replacement and rehabilitation (over and above the authorized DSIC cap)
9 of mains and related services (valves, hydrants, e.g.) that have reached the end of
10 their useful life. Similarly, as to the SIC, the Company proposes continued use of
11 this charge for construction of an additional iron removal plant, rehabilitation of a
12 ground storage tank and a suction wells project at Plant No. 15. Mr. Kern also
13 discusses these proposals in greater detail in his testimony.

14 **INFORMATION TECHNOLOGY SYSTEM UPGRADES**

15 **20. Q. Please describe the driver that falls under the category “information
16 technology system upgrades.”**

17 A. This cost driver deals with the information technology systems upgrade that is
18 currently underway at LIAW and across American Water. It is referred to by the
19 Company as Business Transformation.
20

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1 **21. Q. Please briefly describe the Business Transformation Program.**

2 A. LIAW is undertaking an upgrade of its information technology systems to
3 modernize its business processes, resulting in improved service to our customers.
4 Business Transformation is the name for the American Water initiative that is
5 designed to update and modernize these outdated business processes in order for
6 LIAW to continue to provide high quality, reliable water service to its customers.
7 Business Transformation aims to optimize workflow throughout our field
8 operations, improve our back office operation and enhance our customer service
9 capabilities. Please see the testimony of Mr. Watkins for additional information
10 regarding this initiative.

11 **22. Q. Please provide a brief overview of the scope of the Business Transformation**
12 **program.**

13 A. In 2008-09, American Water's Business Transformation Team embarked on a
14 comprehensive review and analysis of the state of its information technology
15 systems, including the information technology systems utilized by LIAW, and as a
16 result, the investments necessary to replace and upgrade applicable system
17 components were identified. The scope of the Business Transformation program
18 includes a range of core functional areas, including human resources, finance and
19 accounting, purchasing and inventory management, capital planning, cash
20 management, and customer and field services.

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1 **23. Q. Why was it necessary for American Water to undertake its Business**
2 **Transformation program?**

3 A. In the first instance, our technology had become antiquated, and our information
4 technology systems need to be replaced. The comprehensive review and analysis
5 of American Water’s information systems, including those pertaining to LIAW,
6 demonstrated that the information technology systems that support many core
7 processes are at the end of their useful life cycles, were designed to accommodate a
8 smaller customer base, are outdated, and lack the functionality to meet today’s
9 customer expectations.

10 **24. Q. What are some of the anticipated benefits of Business Transformation?**

11 A. This information technology systems upgrade will provide a platform for
12 connecting people, processes, assets, industry-based knowledge, and decision
13 support capabilities based on quality information. Mr. Watkins explains the benefits
14 in greater detail in his testimony.

15 **INCENTIVE COMPENSATION**

16 **25. Q. How does the Company attract and retain the highly qualified and motivated**
17 **employees needed to run a utility company in the 21st Century?**

18 A. One of the critical tools in attracting and retaining talented employees is the ability
19 to use incentive compensation. Our incentive compensation plan is called the
20 Annual Incentive Plan (“AIP”) and it is designed to give us basic compensation
21 levels that are on par with those offered by our peers in the water industry, as well

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1 as other utilities in the state and the region. As discussed in the direct testimony of
2 Mr. Burke, the incentive compensation plan we use places a great emphasis on
3 customer service, operational targets, personal development, and appropriate
4 financial measures that demonstrate discipline and efficiency.

5 This plan is what makes our overall compensation package competitive with what
6 is offered in our industry and beyond. Our AIP makes our compensation levels
7 market competitive; otherwise our employees would leave and go into other fields
8 or industries. If we are not able to offer incentive compensation, we will be at a
9 disadvantage in the employment marketplace, and we will lose the ability to attract
10 and retain talented people. Our incentive compensation plan is not an addition to
11 reasonable compensation; it makes our compensation reasonable and competitive.

12 **26. Q. Why is the incentive compensation plan an important management tool?**

13 A. While policies, directives, and instruction from managers can all be effective in
14 motivating and guiding employees, I believe that accountability and personal
15 responsibility should be aligned with business objectives. This includes aligning
16 compensation with the goals of the business. Our incentive compensation plan is a
17 targeted, performance-based component of overall compensation. It is not a
18 “bonus.” The AIP is designed for employees who are not eligible for overtime, and
19 it places a portion of their overall base compensation at risk unless key performance
20 indicators, or goals, are achieved. These goals are developed through a process in
21 which the overall goals of the business are cascaded down through the organization

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1 so that the goals of the president, director, managers and supervisors are all aligned.

2 Please see Mr. Burke’s testimony for a description of the details of the plan. As I
3 stated at the beginning of my testimony, I believe that accountability and personal
4 responsibility are crucial to success. Our incentive compensation plan is an
5 important tool for me to drive accountability through all levels and aspects of our
6 business.

7 **ENHANCEMENTS TO ORGANIZATIONAL STRUCTURE AND**
8 **CUSTOMER SERVICE**

9 **27. Q. Have there been any updates to the organizational structure of American**
10 **Water since the Company’s last rate case?**

11 A. Yes, there have been. Since the conclusion of LIAW’s last rate case, AWW has
12 implemented changes to its organizational structure designed to enhance
13 performance and overall effectiveness as a state-focused company that provides
14 maximum value to its customers. These changes have resulted in the creation of
15 AWW’s Eastern and Western Divisions, with New Jersey American Water and
16 Pennsylvania American Water becoming separate divisions within AWW in
17 addition to the Eastern and Western Divisions. LIAW is part of the Eastern
18 Division.

19

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1 **28. Q. Have there been any other enhancements to the way LIAW provides service to**
2 **its customers?**

3 A. Yes, the Company has been actively involved in outreach to and education of its
4 customers and key stakeholders to communicate with and educate these groups
5 about water issues specifically related to LIAW as well as issues pertinent to the
6 water industry as a whole. Key communications include creating awareness about
7 the value of water, the Company's commitment to capital investment in its systems,
8 conservation measures and practices, source of supply issues, and the protection of
9 the source of the water supply. The Company also continues to work with local
10 mayors, assemblymen and village officials to keep them informed on current issues
11 with respect to LIAW.

12 **29. Q. Does this conclude your direct testimony at this time?**

13 A. Yes, it does.