

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 John M. Watkins

April 29, 2011

JOHN M. WATKINS - DIRECT TESTIMONY

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

2 A. My name is John M. Watkins, and my business address is 131 Woodcrest Road,
3 Cherry Hill, New Jersey 08034.

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

5 A. I am employed by American Water Works Service Company, Inc. (hereinafter
6 referred to as “AWWSC” or the “Service Company”) as Senior Manager – Rates &
7 Regulation.

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

9 A. My duties consist of reviewing, preparing and assisting in regulatory filings and
10 related activities for all of the regulated companies of American Water Works
11 (“AWW”). My responsibilities include the preparation of work papers, exhibits,
12 and prefiled testimony in support of rate applications and other regulatory filings
13 for Long Island Water Corporation, d/b/a Long Island American Water (“LIAW” or
14 the “Company”).

15 **4. Q. Please describe your educational background.**

16 A. I am a 1996 graduate of Trenton State College with a Bachelor of Science Degree
17 in Finance and Minors in Mathematics and Economics. I received a Masters in
18 Business Administration with a concentration in Accounting from Drexel
19 University in 2000.

20

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1 **5. Q. What has been your business experience?**

2 A. From May 1996 to October 1998, I was employed by U.S. Vision as a Staff
3 Accountant. I began my employment with the Service Company as a Rate Analyst
4 for the Regional Companies in November 1998. At that time, the Region included
5 AWW subsidiary companies located in the states of Connecticut, Iowa, Maryland,
6 Massachusetts, Michigan, Missouri, New Hampshire, New York, Ohio, Tennessee
7 and Virginia. On May 15, 2000, I transferred to Haddon Heights, New Jersey, in
8 conjunction with the transfer of the Service Company's responsibility for the
9 New England companies which, together with New Jersey American Water
10 Company ("NJAWC"), at that time formed AWW's Northeast Region. On
11 July 1, 2000, I was promoted to Financial Analyst-Intermediate. On April 1, 2003,
12 I was promoted to Senior Financial Analyst. In 2003, responsibility for
13 Elizabethtown Water Company ("EWC") and The Mount Holly Water Company
14 ("MHWC") were added to the Northeast Region in conjunction with the acquisition
15 of AWW by RWE. EWC and MHWC were merged with and into NJAWC as of
16 December 2006. In June of 2006, I had the additional responsibility of a direct
17 report added to my current duties. On September 3, 2007, I was promoted to
18 Principal Financial Analyst. On December 28, 2009, I was transferred from the
19 Service Company to NJAWC and at that time only had responsibilities for NJAWC.
20 On December 27, 2010, I was promoted to Senior Manager – Rates & Regulation
21 and transferred to the Shared Service Center ("SSC"), which is part of AWWSC. In

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1 my current position I lead the SSC Rates and Regulation group in supporting rate
2 case filings for all AWW regulated operating subsidiary companies. Currently, I
3 support filings for AWW subsidiary companies located in the states of Arizona,
4 California, Hawaii, Indiana, Illinois, Iowa, Kentucky, Maryland, Michigan,
5 Missouri, New Jersey, New Mexico, New York, Pennsylvania, Ohio, Tennessee,
6 Texas, Virginia and West Virginia.

7 **6. Q. Have you previously participated in regulatory matters?**

8 A. Yes. I have previously participated in the preparation and filing of rate cases in
9 Connecticut, Maryland, Massachusetts, Missouri, New Hampshire, New Jersey,
10 New York, Ohio, and Virginia. I have submitted testimony before State
11 Commissions in Missouri (WR-2000-281), Massachusetts (DTE 00-105), New
12 Jersey (WR03070511, WR06030257, WR08010020, WR10020149 and
13 WR10040260) and New York (Case 04-W-0577 and Case 07-W-0508) and
14 participated in the rate settlement processes in the states of Maryland, New Jersey,
15 New York and New Hampshire. I have filed testimony and exhibits in support of
16 NJAWC’s Purchased Water Adjustment Clause (“PWAC”) and the Purchased
17 Wastewater (Sewerage) Treatment Adjustment Clause (“PSTAC”). I have testified
18 orally before the State Commissions of Connecticut (Case 99-08-32) and New
19 Jersey (WR06030257). In my current role I have provided support in the
20 preparation of rate case filings, discovery requests and/or assisting in the
21 preparation of rebuttal testimony in the states of Arizona, California, Hawaii,

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1 Indiana, Iowa, Missouri, New Jersey, New Mexico, New York, Pennsylvania and
2 Ohio.

3 **7. Q. Have you prepared, or caused to be prepared, financial exhibits in support of**
4 **the Company’s application to increase rates?**

5 A. Yes, I have. LIAW has filed exhibits, which reflect its accounting and financial
6 condition. The exhibits and schedules that I am supporting with my direct
7 testimony were prepared by me or under my supervision and direction. I am
8 sponsoring certain pages of Exhibits 1 through 7, Exhibit 9, pages 1, 9 through 12,
9 39, 40, 45 and 46 as well as Exhibit 10. I am also proposing that the Commission
10 continue the Distribution System Improvement Charge (“DSIC”) for LIAW as first
11 established by the Commission in the Company’s Case 04-W-0577 and extended in
12 the Company’s prior rate proceeding, Case 07-W-0508. I am also proposing that
13 the Commission continue the System Improvement Charge (“SIC”) for LIAW as
14 first established by the Commission in Case 07-W-0508.

15 **8. Q. Are the exhibits as currently filed correct to the best of your knowledge and**
16 **belief?**

17 A. Yes, they are.

18 **9. Q. What is the source of these exhibits?**

19 A. The exhibits have been prepared utilizing the general books and records of the
20 Company and other supporting data utilizing the Company’s proposed forecast of
21 the twelve months ending December 2011, 2012 and March 2013 with a test year

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1 being the twelve months ended December 31, 2010. In most cases, the pro forma
2 adjustments extend until March 31, 2013. These adjustments will be explained in
3 the following text.

4 **INTRODUCTORY COMMENTS**

5 **10. Q. Do you have any general comments regarding this filing?**

6 A. LIAW has incurred substantial capital expenditures in almost all areas of its system
7 to improve supply and the quality of service to the customers we serve. The
8 Company has also incurred increases in its operating expenses, of which certain
9 components have increased at a rate higher than the overall consumer price index
10 would indicate.

11 These factors, together with their respective impacts on the Company's overall
12 revenue requirement, are addressed by the testimony of various witnesses and
13 supporting exhibits contained in this filing.

14 **11. Q. Should the actual test year data for the twelve months ended December 31,**
15 **2010 be the basis for setting rates in this case?**

16 A. No. That data does not reflect levels of expenses or revenues on a fully annualized
17 or normalized basis. Therefore, the test year results must be annualized; that is,
18 changes to revenues and expenses occurring during the test year must be reflected
19 on an annual basis.

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1 In addition, actual test year data must be normalized to eliminate non-recurring
2 items or to include costs that should have been reflected in the test year. Finally,
3 projections of conditions in the rate year are included.

4 **12. Q. What are the overall results shown on the Company’s Exhibits?**

5 A. The total effect of the pro forma adjustments on the Company’s operations results
6 in a required rate year revenue increase of \$9,563,146. This amount represents a
7 19.49% percent increase in revenue over present rate revenue. Please see the
8 testimony of Mr. Engle for a discussion of how the rates will be designed to
9 generate this revenue. It is important to note, however, that since the last rate case,
10 certain increases in costs have been recovered within the Revenue Adjustment
11 Clause (“RAC”). Specifically, increases associated with fuel, power and chemicals
12 have been flowed through the RAC. In this filing, LIAW proposes to move those
13 costs from the RAC to the base tariff rates and reset the RAC. Similarly,
14 adjustments have flowed through to the ratepayers for the Property Tax Adjustment
15 Clause (“PTC”). The Revenue and Property Tax Reconciliation Mechanisms
16 (“RPT”) reconciles the allowed revenues and expenses annually for the RAC and
17 PTC. It should also be noted that the Company has recovered revenues for plant
18 associated with the DSIC and the SIC since its last base rate case.

19

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1 **13. Q. Since the conclusion of Case 07-W-0508, how many DSIC filings has LIAW**
2 **made?**

3 A. LIAW has made four (4) DSIC filings, and the Company anticipates that two
4 additional DSIC filings will be made (as discussed below) before rates emanating
5 from this proceeding become effective.

6 **14. Q. Is the Company receiving any revenues for DSIC?**

7 A. Yes. The Company has a DSIC surcharge of 1.97% of all metered revenues
8 currently. There are another two filings scheduled for the six-month periods ended
9 3/11 and 9/11 that will also take effect prior to the rate order in this case. The DSIC
10 revenues are or will be recovered through customers bills prior to the effective date
11 of this rate order and effectively lower the requested increase as discussed below.

12 **15. Q. How much revenue is projected from the 6 DSIC filings?**

13 A. The DSIC revenues are shown on lines 17-22 of Exhibit 9, page 2. Line 17-20
14 includes revenues from the DSIC filing for the period ended 9/2010. Line 21
15 represents the DSIC filing for the period ended 3/11 with the expected revenue
16 starting as of 7/1/11. Line 22 represents the DSIC filing for the period ended 9/11
17 with the expected revenue starting as of 1/1/2012. The forecasted revenues that
18 would have been recovered through the DSIC at the end of 2012, if no rate
19 application had been filed, amount to approximately \$1.229 million. The shift in
20 the method of recovery of these costs from the DSIC to the base tariff rates
21 represents approximately 12.85% ($\$1,228,682/\$9,563,146$) of the Company's

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1 requested increase in base tariff rates in this proceeding, or 250 basis points out of
2 the 19.49% overall increase. Stated another way, excluding the projected effect of
3 revenues recovered through the DSIC effectively reduces the overall net requested
4 increase (and subsequent customer bill impact) from about 19.49% to about 16.99%
5 $((\$9,563,146 - \$1,228,682) / \$49,063,159)$.

6 **16. Q. How many SIC filings has LIAW made since the conclusion of Case**
7 **07-W-0508?**

8 A. One; on March 24, 2011, the Company made a SIC filing regarding the
9 construction of Plant #8.

10 **17. Q. How much revenue is projected from the SIC filing?**

11 A. The SIC revenues are shown on lines 24 of Exhibit 9, page 2. Line 24 represents
12 the SIC filing from March 24, 2011 with the expected revenue starting as of 6/1/11.
13 The forecasted revenues that would have been recovered through the SIC at the
14 end of 2012, if no rate application had been filed, amount to approximately \$0.542
15 million. The shift in the method of recovery of these costs from the SIC to the base
16 tariff rates represents approximately 5.67% $(\$542,593 / \$9,563,146)$ of the
17 Company's requested increase in base tariff rates in this proceeding, or 110 basis
18 points out of the 19.49% overall increase. Stated another way, excluding the
19 projected effect of revenues recovered through the SIC effectively reduces the
20 overall net requested increase (and subsequent customer bill impact) from about
21 19.49% to about 18.39% $((\$9,563,146 - \$542,593) / \$49,063,159)$. If you also remove

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1 the effect of the DSIC the increase would fall to 15.88% $((\$9,563,146 - \$542,593 -$
2 $\$1,228,682) / \$49,063,159$).

3 **18. Q. How much of the increase is associated with the RAC?**

4 A. The forecasted costs that would have been recovered through the RAC at the end of
5 2012, if no rate application had been filed, amount to approximately \$0.046 million.

6 The shift in the method of recovery of these costs from the RAC to the base tariff
7 rates represents approximately 0.48% $(\$46,049 / \$9,563,146)$ of the Company's
8 requested increase in base tariff rates in this proceeding, or approximately 9 basis
9 points out of the overall 19.49% increase. Stated another way, excluding the
10 projected effect of expenses deferred or recovered through the RAC effectively
11 reduces the overall net requested increase (and subsequent customer bill impact)
12 from about 19.49% to about 19.40% $((\$9,563,146 - \$46,049) / \$49,063,159)$. If you
13 also remove the effect of the DSIC and SIC the increase would fall to 15.79%
14 $((\$9,563,146 - \$46,049 - \$542,593 - \$1,228,682) / \$49,063,159)$.

15 **19. Q. How much of the increase is associated with the PTC?**

16 A. The forecasted costs that would have been recovered through the PTC at the end of
17 2012, if no rate application had been filed, amount to approximately \$1.3 million.

18 Please note that the \$1.3 million is 85% of the forecasted increase of approximately
19 \$1.5 million at the end of 2012. The shift in the method of recovery of these costs
20 from the PTC to the base tariff rates represents approximately 13.13%
21 $(\$1,255,253 / \$9,563,146)$ of the Company's requested increase in base tariff rates in

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1 this proceeding, or approximately 256 basis points out of the overall 19.49%
2 increase. Stated another way, excluding the projected effect of expenses deferred
3 or recovered through the PTC effectively reduces the overall net requested increase
4 (and subsequent customer bill impact) from about 19.49% to about 16.93%
5 (((\$9,563,146-\$1,255,253)/\$49,063,159). If you also remove the effect of the DSIC,
6 SIC and the RPT the increase would fall to 13.23% (((\$9,563,146-\$1,255,253-
7 \$46,049-\$542,593-\$1,228,682)/\$49,063,159).

8 **20. Q. Is the Company proposing to continue the DSIC, RAC and Property Tax**
9 **Reconciliation Clause (“PTC”)?**

10 A. Yes. Please refer to my testimony below for the discussion on DSIC and SIC.
11 Please refer to Mr. Engle’s testimony for the discussion on RAC. Please refer to
12 Mr. Casillo’s testimony for the discussion on PTC.

13 **21. Q. If the impact of the charges discussed above was netted from the proposed**
14 **overall rate increase, what would the bill impact amount to?**

15 A. The overall increase would be 13.23%, as compared to the as filed amount of
16 19.49%. This would cause the increase per each tariff class to be 13.24%, as
17 compared to the as filed amount of 19.51%.

18

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1 **HISTORIC FINANCIAL DATA**

2 **22. Q. Please summarize Exhibits 1 through 6.**

3 A. Exhibit 1 shows the comparative balance sheets for the calendar years 2007 through
4 2010 based on information taken from the Company's books and records. Exhibits
5 2 through 6 contain the 2007 - 2010 financial statements in the form of comparative
6 statements of income, retained earnings, operating revenues, operation and
7 maintenance expenses and taxes charged to operations.

8 **HISTORIC AND PROJECTED CAPITAL STRUCTURE AND COST DATA**

9 **23. Q. Please describe the historic and projected capital structure and cost data.**

10 A. Exhibit 7, page 1, sets forth the Company's historical capital structure and
11 capitalization ratios for the years 2007 – 2010. Page 2 identifies the funds
12 requirement statement for the years 2011 and 2012.

13 Exhibit 7, page 3 presents the actual calendar year capitalization of the Company
14 for 2010 and the estimated capitalization for the calendar years 2011 and 2012. The
15 figures for 2011 include two long-term debt financings of \$9.0 million (see
16 response to Question 24) and \$6 million as well as \$3.0 million of common equity
17 infusion by AWW. The figures for 2012 include a \$6.0 million of long-term debt
18 financings as well as \$3.25 million of common equity infusion by AWW.

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1 Exhibit 7, page 5 reflects the overall rate of return of 8.40%, which includes Ms.
2 Ahern's 11.50% return on equity that she explains and supports in her pre-filed
3 testimony.

4 **24. Q. Please describe further the debt financing.**

5 A. In 2011, the Company proposes to reissue \$9.0 million of long-term debt and issue
6 \$6 million of new long-term debt at an all-in rate of 6.45% and 6.60%, respectively.

7 The coupon rate, maturity and cost of issuance are estimates at this time and will
8 be adjusted to reflect the actual conditions of the issue. This information will be
9 available in sufficient time to be reflected in the Commission's decision in this
10 proceeding. In 2012, the Company proposes to issue \$6.0 million of long-term debt
11 at an all-in rate of 7.00%. LIAW will make the appropriate filing for this new debt
12 issuance according to PSC rules and regulations.

13 **25. Q. How will the proceeds of this financing program be used?**

14 A. As noted above, the proceeds will be used primarily to fund the capital projects
15 discussed in the testimony of Mr. Richard P. Kern.

16 **26. Q. Please describe the equity infusions projected for this proceeding.**

17 A. The Company intends to maintain its capital structure and is prepared to receive an
18 infusion of \$3.0 million from its parent, AWW, in 2011. The Company is prepared
19 to receive an infusion of \$3.25 million in 2012.

20

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1 **27. Q. Please explain the calculation of the Company’s overall rate of return.**

2 A. The overall rate of return for LIAW is the sum of the weighted cost rates for long-
3 term debt, preferred stock and common equity. LIAW’s overall rate of return,
4 which is reflected on Exhibit 7, page 5 has been calculated based on the Company’s
5 pro forma capitalization and related cost rates. The data required to calculate the
6 cost rate for each of the long-term debt issues are shown on Exhibit 7, page 4.

7 **PROJECTED INCOME STATEMENT/REVENUE REQUIREMENT DATA**

8 **28. Q. Please explain the forecasted income statements shown on Exhibit 9, page 1.**

9 A. Exhibit 9, page 1, entitled “Pro Forma Statement of Income,” presents the summary
10 forecasted income statements commencing with the year ended December 31, 2010,
11 and continuing through the rate year ending March 31, 2013. The calendar years
12 ended December 31, 2011 and December 31, 2012 are shown between the test year
13 and the rate year.

14 The supporting schedules that follow the income statements (pages 2 – 46) detail
15 the revenues by class of customer, including bill analysis applications, operation
16 and maintenance (“O&M”) expense summaries and adjustments, depreciation, taxes
17 other than income taxes and, finally, state and federal income taxes. All of these
18 schedules reflect data for the years ending December 31, 2011, and December 31,
19 2012, and for the twelve months ending March 31, 2013.

20

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1 **29. Q. Please explain pages 9 through 12 of Exhibit 9.**

2 A. Pages 9 through 12 are summary schedules for the actual twelve months ended
3 December 31, 2010, and forecasts for the twelve months ending December 31,
4 2011, December 31, 2012 and March 31, 2013. These summaries break down the
5 O&M expenses by functional group and then subdivide those among payroll,
6 power, fuel, chemicals, invoices and Other O&M expenses.

7 **30. Q. Is there an inflation percentage used in calculating the pro forma amounts?**

8 A. Yes, the annual inflation percentage of 1.59% was based on the Consumer Price
9 Index (“CPI”). Unless a separate, discrete escalation factor is employed, this rate
10 filing employs that annual inflation rate of 1.59% to derive rate year results. The
11 inflation calculation is shown on the work papers as Exhibit 12, Tab 8.

12 **DEPRECIATION EXPENSE**

13 **31. Q. Please explain the development of pro forma depreciation expense.**

14 A. Depreciation expense appears on pages 39 and 40 of Exhibit 9 and was developed
15 using the 13 month average Utility Plant in Service balances for the test year and
16 thereafter adding 13 month average plant additions, less retirements, for 2011, 2012
17 and the first 3 months of 2013. To develop the adjustment for depreciation
18 expense, I applied the relevant depreciation rate to each respective plant account
19 balance. As discussed below, in the Rate Base section of my testimony,
20 depreciation expense includes the cost of the requested study that is associated with

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1 the information technology systems upgrade this is discussed below, with expense
2 beginning on April 1, 2012. (See questions 38-39 below.)

3 **32. Q. Is the Company proposing to make a change to the depreciation expense**
4 **requested in this proceeding?**

5 A. The Company is requesting a change to the depreciation rate for vehicles.

6 Currently, the Company depreciates all vehicles at a rate of 23.28%. This equates
7 to a useful life of approximately 4.3 years, since the Company believes the useful
8 life of vehicles is longer and varies between vehicle classification it is proposing
9 new rates. The Company is requesting the following rates be applied in this
10 proceeding:

- 11 • Cars- 5 Years or 20%
- 12 • SUV/Vans- 6 Years or 16.67%
- 13 • Light Duty Trucks- 6 Years or 16.67%
- 14 • Heavy Duty Trucks- 8 Years or 12.5%
- 15 • Backhoes- 7 years or 20%

16 **RATE BASE**

17 **33. Q. Please describe how you calculated the Company's rate base.**

18 A. The Company's rate base is detailed on page 1 of Exhibit 10. With the exception of
19 cash working capital, all of the components of rate base were averaged over a 13-
20 month period utilizing the last month of the prior fiscal period and all of the
21 applicable current fiscal year, the twelve months ended December 31, 2010, or test
22 year. The details of the calculation of the individual rate base components are
23 reflected in the Company's workpapers, filed herein as Exhibit 12, Tab 31.

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1 **34. Q. How did you develop the 13-month averages for Water Utility Plant in Service**
2 **and Reserve for Depreciation?**

3 A. These rate base components beginning with actual calendar year 2010 or test year
4 data and thereafter for calendar years 2011 and 2012 and for the rate year ending
5 March 31, 2013, are based on the Company's construction forecast (Exhibit 8)
6 sponsored by Mr. Richard P. Kern, and includes his estimates of plant construction
7 and in-service dates. I have also projected retirements, salvage and cost of removal,
8 which are included in Exhibit 12, Tab 31. Using these estimates, I developed a
9 monthly balance for each utility plant in service account, the depreciation reserve,
10 customer advances and Non-Interest Bearing Construction Work in Progress from
11 the end of the test year through the end of the rate year.

12 **35. Q. How did you develop Materials and Supplies and Prepayments, as shown on**
13 **Exhibit 10, page 1?**

14 A. For Materials and Supplies, I escalated the 2010 test year 13-month average
15 balance at the rate of 1.59% through the rate year. The 1.59% represents the
16 percentage change in the CPI as previously mentioned above.

17 Prepayments were developed in conjunction with the operating forecast as detailed
18 in Exhibit 9. That is, the 2010 test year 13-month average balances for prepaid
19 property/school taxes and insurance were escalated by the percentage rates utilized
20 in the Company's operating forecast for 2012 over 2011.

21

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1 **36. Q. Please explain the unamortized balances shown on page 1 of Exhibit 10.**

2 A. The unamortized balances included in rate base represent two new deferral and
3 amortization requests made in this rate filing as well as unamortized balances of
4 deferrals previously authorized by the Commission. The unamortized balances are
5 as follows: (i) Tank Painting cost was previously authorized by the Commission in
6 Case 04-W-0577 based on a 15 year amortization, and is reflected herein on Exhibit
7 9, pg. 32; (ii) Rate Case expense reflects a combination of the unamortized balance
8 of the Company's 2007 Rate Case costs authorized by the Commission in Case 07-
9 W-0508 based on a 3 year amortization, and a new proposed 3 year amortization of
10 the Company's estimated 2011 Rate Case costs, and reflected herein on Exhibit 9,
11 pg. 29; (iii) Customer Service Center ("CSC") and Shared Services Center ("SSC")
12 costs were previously authorized by the Commission in Case 02-W-0054 and again
13 in Case 04-W-0577. These amortizations are not included in the Company's cost of
14 service; rather, we propose their continued recovery be included through the RAC;
15 (iv) Asbestos cost previously authorized by the Commission in Case 07-W-0508
16 based on a 3 year amortization, Exhibit 9, pg. 36; (v) Demutualization reflects the
17 continuation of a 10 year amortization authorized by the Commission in its Order in
18 Cases 01-W-1949, 02-W-0054 and 02-W-0056 of funds received by the Company
19 from a mutual insurance company that converted to a corporation. This
20 amortization represents monies being passed back to customers. Similar to the CSC
21 and SSC proposal above, this amortization is not included in cost of service, but

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1 rather is accounted for in the RAC; (vi) Pension Actuarial Studies is a new deferred
2 liability for monies spent for the calculation of stand-alone Pension costs for LIAW
3 (Exhibit 9, pg. 38).

4 **37. Q. Have you reflected other deductions to rate base?**

5 A. Yes. Deferred State and Federal Income Taxes associated with excess tax over
6 book depreciation amounts have been deducted from rate base.

7 **38. Q. Please identify any transfers or adjustments made to Utility Plant in Service**
8 **since Case 07-W-0508.**

9 A. Rate base for a prior Comprehensive Planning Study related to transmission and
10 distribution main as identified in Case 07-W-0508 in the amount of \$256,563.03
11 transferred from a/c 303 (Other P/E CPS) to a/c 343 (Mains 6" & Greater).
12 Depreciation on the balance in a/c 343 (Mains 6" & Greater) is 1%.

13 **39. Q. Are you proposing a new study?**

14 A. Yes, approval is requested for return on and recovery of expenditures for a study of
15 business processes and identification of new software for the "Business
16 Transformation" Project. The first phase of the project is a study and LIAW plans
17 to record the expenditures to Plant Account 303-Misc. Intangible Plant and
18 requests to depreciate the cost of \$150K over a 5 year period beginning April 2012.
19 Approval of this rate treatment will authorize recording of the plant balance with an
20 associated annual depreciation rate of 20%.

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1 **CASH WORKING CAPITAL**

2 **40. Q. Please describe your calculation of cash working capital.**

3 A. Cash Working Capital (“CWC”) was developed on Exhibit 10, page 2, on the basis
4 of the Federal Energy Regulatory Commission formula, using the operating
5 expenses as forecasted in this filing. In calculating CWC, the total operation and
6 maintenance expense is reduced by uncollectible expense and is also adjusted by
7 amortization expenses as applicable. Currently the Company bills its customers
8 predominately on a monthly basis. I have employed a weighted billing factor of
9 .125 reflecting 100% monthly billing in the CWC formula.

10 **EB/CAP ADJUSTMENT**

11 **41. Q. Please explain how you calculated the EB/Cap adjustment.**

12 A. The EB/Cap adjustment is shown on Exhibit 10, page 3, on a page entitled the
13 “Earnings Base/Capitalization Differential.” This differential serves to reduce the
14 overall rate base by balancing the rate year average rate base with the rate year
15 average capitalization. The intent of the EB Cap adjustment is to set rates based on
16 a calculated capitalization supporting rate base as opposed to the calculated rate
17 base itself. Each component of the EB/Cap reflects the 13-month average balance
18 from the test year, the 12 months ended December 31, 2010. Included as reductions
19 to test year capitalization is unamortized debt expense, unamortized RAC/PTC,
20 unamortized demutualization, accrued utility revenues, and non-utility property,
21 while the capitalization has been increased by unamortized ITC, dividends declared

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1 but unpaid, property tax refund and Pension/OPEB internal reserve. Finally, the
2 13-month average balance of interest-bearing construction work in progress is a
3 reduction to test year capitalization.

4 **FEDERAL AND STATE INCOME TAXES**

5 **42. Q. Please explain the calculation of the Company's pro forma current state**
6 **income tax as shown on Exhibit 9, page 45.**

7 A. In arriving at the Company's current state income tax expense, I calculated taxable
8 income by deducting the following items from operating revenues: (i) operation
9 and maintenance expenses; (ii) book depreciation expense; (iii) amortization
10 expenses (iv) taxes other than income taxes; (iv) interest charges, calculated by
11 utilizing the interest synchronization method shown in Note (1) at the bottom of
12 page 45; and (v) excess tax depreciation over book depreciation. For state income
13 tax purposes, only post-1999 plant in service is subject to the application of
14 accelerated tax depreciation rates.

15 I then applied the current effective tax rate of 8.63% to taxable income to derive the
16 State Income Tax liability. The effective rate is comprised of the current state
17 statutory corporate rate of 7.10%, and an MTA tax rate of 1.53% (17% of 9%).

18

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1 **43. Q. Please describe how the amount of deferred state income tax was calculated.**

2 A. The Company applied the effective state income tax rate of 8.63% to the amount of
3 tax depreciation in excess of book depreciation and amortization expense. As
4 stated previously, the accelerated tax depreciation rates apply only to post-1999
5 plant in service. The accumulated deferred state tax liability is deducted from rate
6 base.

7 **44. Q. Please explain the calculation of the Company's pro forma current federal**
8 **income tax as shown on Exhibit 9, page 46.**

9 A. The calculation was performed in the same manner as previously described for pro
10 forma current state income taxes, except the calculation of the excess tax over book
11 depreciation amount is based on all plant in service (not just the post-1999 plant in
12 service) and a 34% tax rate has been utilized.

13 **45. Q. Please describe how the amount of deferred federal income tax was calculated.**

14 A. I calculated deferred federal income tax by applying the tax rate of 34% to the
15 excess tax over book depreciation and amortization expense as previously
16 described, after first reducing that amount by the balance of deferred State Income
17 Taxes. Total deferred Federal Income Tax amount is further reduced by the
18 amortization of excess deferred taxes. In addition, the Company has included the
19 amortization of previously flowed-through tax benefits effective with rates
20 established in this rate filing. The annual amortization of these previously flowed-
21 through tax benefits is \$160,659 for the rate year and is based on the reversal of

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1 temporary differences brought about by the excess of book depreciation over tax
2 depreciation of flow through property. Finally, the accumulated deferred federal
3 tax liability is deducted from the Company's rate base on page 1 of Exhibit 10.

4 **DISTRIBUTION SYSTEM IMPROVEMENT CHARGE ("DSIC")**

5 **46. Q. What has been the Company's experience with the DSIC authorized by the**
6 **Commission in the prior two rate case proceedings, Case 04-W-0577 and Case**
7 **07-W-0508?**

8 A. In November 2006, the Company filed with the Commission its initial DSIC filing
9 and has continued to utilize this effective means of replacing infrastructure in a
10 regularized, timely manner to the present. The Company strongly believes that all
11 parties benefit from the DSIC program and that this program is an important
12 component of sound public utility policy. Customers benefit from the Company's
13 installation of infrastructure improvements consisting of the replacement of
14 numerous aged mains, hydrants and services. The Company benefits from being
15 able to invest additional funds in needed infrastructure replacement while also
16 being provided the funds it needs to pay for the costs of this investment on a
17 regular, timely basis. The DSIC program allows for necessary infrastructure
18 investments to occur on a reasonable schedule, and the small surcharge associated
19 with the program helps to mitigate the potential for "rate shock" that can result if all
20 of these costs were deferred for recovery in a rate proceeding.

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1 **47. Q. What is the Company's recommendation with regard to the current DSIC**
2 **program?**

3 A. In the Company's prior base rate proceeding, Case 07-W-0508, the DSIC program
4 was authorized. Given the Company's belief that this program benefits all parties,
5 we propose that the Commission establish the DSIC on a permanent basis. The
6 current provision of allowing semi-annual filings is a positive feature and should
7 remain unchanged.

8 **48. Q. Should the level of DSIC be increased over the previously allowed amount?**

9 A. Yes, the Company has spent over the overall cap of approximately \$6 million
10 established in Case 07-W-0508. The Company has spent \$7,694,763 and
11 \$7,545,382 for the rate years ended 3/31/2009 and 3/31/2010, respectively. Based
12 on this information the Company would propose to increase the overall cap to \$7.75
13 million.

14 **SYSTEM IMPROVEMENT CHARGE**

15 **49. Q. What has been the Company's experience with the SIC authorized by the**
16 **Commission in the prior rate case proceeding, Case 07-W-0508?**

17 A. The Company filed its first SIC filing on March 24, 2011. The Company filed for
18 recovery of surcharge of 1.21% based on a net rate base change of \$3,741,463.¹

19 The Company strongly believes that all parties benefit from the SIC program and

¹ Please note that the Company is seeking to recover the balance of the costs to construct Plant No. 8, the iron removal plant that was the subject of this first SIC filing, within base rates in this proceeding. See Mr. Kern's testimony for more information.

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1 that this program is sound public policy. Customers benefit from the Company’s
2 installation of improvements consisting of the iron removal plant. The Company
3 benefits from being able to invest additional funds in needed infrastructure while
4 also being provided the funds it needs to pay for the costs of this investment on a
5 timely basis. The SIC program allows necessary infrastructure investments to occur
6 on a reasonable schedule, and the small surcharge associated with the program
7 helps to mitigate the potential for “rate shock” that can come if all these costs were
8 deferred for recovery in a rate proceeding.

9 **50. Q. What is the Company’s recommendation with regard to the current SIC**
10 **program?**

11 A. In the Company’s prior proceeding, the SIC program was authorized for 2 specific
12 iron removal filtration units to be placed in service at the Company’s Plant No. 8
13 and Plant No. 15. Given the Company’s belief that this program benefits all parties,
14 we propose that the Commission establish to continue SIC program in the future.

15 **INFORMATION TECHNOLOGY SYSTEMS UPGRADE**

16 **51. Q. Is LIAW participating in an upgrade of its information technology systems?**

17 A. Yes. As generally described by Mr. Varley, AWW is in the process of upgrading
18 its information technology systems, known internally as Business Transformation,
19 or BT.

20

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1 **52. Q. Do the current information systems adequately support LIAW's customer and**
2 **business requirements?**

3 A. No. While the current systems are functional, they are no longer adequate to meet
4 the changing needs of the business. When American Water's IT systems were
5 implemented in the mid-1990s, they met the customer expectations of the time.
6 LIAW's customer requirements still are being met through our existing systems, but
7 American Water's non-integrated systems that are utilized by the Company have
8 limited automation and functionality, and over the last 10 to 15 years, more has
9 changed than just technology. This information technology upgrade is needed to
10 address the modern needs of LIAW and its customers. Customer expectations have
11 also shifted. As always, LIAW customers expect to receive high quality, reliable
12 supplies of water service. Today's customers expect more (including internet
13 billing, self-service inquiry, and the ability to make online appointments for repair
14 calls) than our existing information technology systems can support.

15 The use of the current software and systems have been fully maximized by
16 implementing significant customizations or workarounds, in part, to meet
17 requirements and expectations that the original software was not equipped to
18 support. These customizations have addressed the needs of the business, but the
19 Company has reached a point where additional customizations would be inefficient
20 and increasingly costly to maintain. In addition, when customizations were too
21 costly or impractical, manual processes were put in place. These manual solutions

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1 are not optimal because they introduce redundancy and inconsistency of data,
2 require additional manual steps, and limit information availability. Because the
3 software has such a large number of customizations, system upgrades would be cost
4 prohibitive and still would result in limited functionality. Therefore, keeping the
5 current systems and processes in place is not in the best long-term interests of either
6 the customers or the business.

7 **53. Q. What are the projects that make up this initiative?**

8 A. There are three projects that comprise the core of our Business Transformation
9 program: Enterprise Resource Planning (“ERP”); Enterprise Asset Management
10 (“EAM”), and Customer Information System (“CIS”). ERP includes human
11 resource, finance and accounting, supply chain, and procurement management.
12 EAM includes the management of asset lifecycles including the design,
13 construction, commissioning, operations, maintenance and
14 decommissioning/replacement of plant, equipment and facilities as well as work
15 management for both customer service field work (service turn-ons, leak
16 inspections, etc.) and Transmission & Distribution system work. CIS includes all
17 billing and personal data pertaining to our customers, including billing rates, water
18 consumption, associated charges, meter information, and the strategy for managing
19 and nurturing our interactions with our customers. Through these projects, data
20 will be rationalized and technology upgraded so as to enhance our ability to
21 continue delivering high-quality water service to our customers.

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1 **54. Q. Please explain how the BT costs fit into the context of LIAW's rate case.**

2 A. The three projects that comprise the core of the Business Transformation programs
3 – ERP; EAM, and CIS – are all capital improvement projects, and as a result the
4 Company is requesting rate base recognition for this entire initiative.

5 **55. Q. When will this project be implemented?**

6 A. These projects will be implemented in two phases. The ERP project is scheduled
7 for mid-2012 deployment. The EAM and CIS projects are scheduled for multiple
8 deployment waves in 2013.

9 **56. Q. What is the total estimated share of the investment of BT that LIAW seeks to**
10 **capitalize?**

11 A. This investment for LIAW is estimated to be \$7,555,022.

12 **57. Q. Please summarize how the BT program has progressed from 2010 through the**
13 **recently completed Blueprint phase.**

14 A. In early 2010, SAP was selected as the software solution. Employees from across
15 the organization helped in the review process. Based on the information gathered,
16 it was determined that SAP was the best platform for our enterprise-wide systems.
17 The SAP software solution is a fully integrated software application that offers
18 better real-time functionality, requires less hardware, and will meet our current and
19 future business requirements. SAP is an integrated solution that includes the ERP,
20 EAM and CIS modules that the Company requires.

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1 In 2010, Accenture was selected to help implement the new software solutions. As
2 the solution implementer, Accenture is responsible for working closely with the
3 Business Transformation team to realize the full potential of the new technology
4 implementation by helping to confirm that business processes are aligned with the
5 new software. Accenture also will share their skills and knowledge about SAP with
6 American Water employees throughout the implementation.

7 The Business Transformation team began its Blueprint Phase of the program in the
8 last quarter of 2010 and completed the Blueprint Phase on April 15, 2011. The
9 Blueprint Phase includes analyzing, planning and designing. Within this phase,
10 employees from the regulated companies and AWWSC participated in workshops
11 to provide input and feedback that resulted in the design of business process maps,
12 confirmed the project's scope, established a project schedule and established a
13 governance process.

14 Next is the Implementation Phase. The first component of this phase is Detailed
15 Design, the primary focus of which is to finalize the business processes and
16 requirements to ensure they are aligned with the new software and technology
17 solutions. In the second and third stages, Build and Test, we begin to input the data
18 and requirements into the systems so they meet our business needs and we can start
19 testing in controlled environments to make sure the solutions are delivering on our
20 objectives. This is the phase where we identify key areas to fix and then address

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1 these issues to ensure the final stage, Deploy, is seamless. Deploy is when final

2 preparations are made to make the systems available for use.

3 **58. Q. Does this conclude your direct testimony at this time?**

4 A. Yes, it does.