

ORIGINAL

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

Commissioner	Yes	No	Not Participating
Huston	√		
Freeman	√		
Krevda	√		
Veleta	√		
Ziegner	√		

PETITION OF AQUA INDIANA, INC. FOR)
APPROVAL OF (1) CAPITAL EXPENDITURES FOR)
IMPROVEMENTS TO PETITIONER'S)
INFORMATION TECHNOLOGY SYSTEMS)
THROUGH THE DESIGN, DEVELOPMENT, AND)
IMPLEMENTATION OF THE SERVICE)
IMPROVEMENT PROJECT ("SIP"); (2) INCLUSION)
OF THE SIP ASSETS IN PETITIONER'S RATE BASE)
IN FUTURE RATE CASES; (3) AUTHORIZATION)
FOR CAPITALIZATION OF ALLOWANCE FOR)
FUNDS USED DURING CONSTRUCTION FOR SIP;)
AND (4) DEFERRAL OF DEPRECIATION AND)
DELAY OF AMORTIZATION ON SIP ASSETS)
FOLLOWING PLACEMENT IN SERVICE.)

CAUSE NO. 45675

APPROVED: JAN 18 2023

ORDER OF THE COMMISSION

Presiding Officers:

Stefanie N. Krevda, Commissioner

Jennifer L. Schuster, Senior Administrative Law Judge

On February 11, 2022, Aqua Indiana, Inc. ("Aqua Indiana," "Aqua," or "Petitioner") filed its Petition for approval of expenditures for improvements to its information technology ("IT") systems through the design, implementation, and development of a multi-year Service Improvement Project ("SIP") to replace and upgrade its IT systems; for confirmation that the SIP assets in Petitioner's rate base in rate cases after the SIP assets have been placed in service; and for authority to continue the accrual of Allowance for Funds Used During Construction ("AFUDC") and to defer depreciation and delay the commencement of amortization expense on the implementation of SIP following its placement in service.

In support of its Petition, Aqua Indiana contemporaneously filed the direct testimony and attachments of Gary M. VerDouw of VerDouw Regulatory Services LLC and Brian R. Latham, Controller for Petitioner. On June 17, 2022, the Indiana Office of Utility Consumer Counselor ("OUCC") filed the testimony of Margaret A. Stull, Chief Technical Advisor in the Water/Wastewater Division. On July 22, 2022, Petitioner filed the rebuttal testimony of Mr. VerDouw, a notice that Mr. Latham's direct testimony would be adopted by Paul J. Hanley, Regional Controller for Aqua Indiana, and certain corrections to the direct testimony of Messrs. VerDouw and Hanley.

The Commission held an evidentiary hearing at 9:30 a.m. on August 22, 2022 in Room 222 of the PNC Center, 101 West Washington Street, Indianapolis, Indiana. Petitioner and the OUCC

appeared at the hearing, the parties' pre-filed evidence was offered and admitted into the record without objection, and certain witnesses were cross-examined.

Based on the applicable law and the evidence of record, the Commission now finds:

1. Notice and Jurisdiction. Due, legal, and timely notice of the evidentiary hearing in this Cause was given by the Commission as required by law. Aqua Indiana is a public utility under Ind. Code § 8-1-2-1 and is subject to the jurisdiction of the Commission in the manner and to the extent provided by Indiana law. Petitioner seeks preapproval of certain additions and improvements to its utility system pursuant to Ind. Code § 8-1-2-23. Therefore, the Commission has jurisdiction over the Petitioner and the subject matter of this proceeding.

2. Petitioner's Characteristics. Aqua Indiana is an Indiana for-profit corporation and a subsidiary of Essential Utilities, Inc. Essential Utilities includes the Aqua America ("Aqua America") family of water and wastewater utilities, one of which is Aqua Indiana, and Peoples Natural Gas ("PNG"). Aqua Indiana currently provides water and wastewater utility service to over 30,000 customers in 14 counties in Indiana. Petitioner operates as 12 regulated divisions within Indiana, providing water utility service in three counties and wastewater utility service in nine counties. Aqua Indiana owns, operates, manages, and controls plant, property, equipment, and facilities which are used and useful for the collection, purification, distribution, and finishing of water to the public in such areas and for providing wastewater utility service. In addition, Aqua Indiana provides contract operations and management of water and wastewater systems for municipal clients at several locations in Indiana.

3. Relief Requested. Petitioner seeks approval of expenditures for the design, development, and implementation of a multi-year SIP to replace and upgrade its IT systems. Petitioner seeks confirmation that the approximately \$2,517,000 of the total SIP capital investment allocated to Aqua Indiana from its parent company will be included in rate base and approval of the continued capitalization of AFUDC to continue after the SIP assets have been placed in service ("post-in-service AFUDC") and until the issuance of rate orders approving the recovery of SIP assets in rate base. Aqua Indiana is also seeking approval from the Commission for deferral of depreciation expense related to the development, implementation, and deployment of the SIP asset until issuance of rate orders approving recovery of SIP assets in rate base. Petitioner seeks approval of the post-in-service AFUDC and deferred depreciation be recorded as a regulatory asset, to be amortized over ten years. Petitioner also requests authorization from the Commission to use a ten-year depreciation accrual rate for all SIP assets once placed in service.

4. Evidence Presented.

A. Petitioner's Case-in-Chief. Mr. VerDouw testified in support of Aqua Indiana's SIP, which includes the development and system-wide deployment of new, integrated IT systems. Mr. VerDouw testified that the SIP is a significant company-wide project of Essential Utilities, and its subsidiary operating companies, such as Aqua Indiana, will receive many of the SIP benefits.

Mr. VerDouw and Mr. Hanley both testified that many of the current software systems Aqua Indiana uses in its daily operations are out of date and not adequate to support Aqua's growing customer and business requirements. Mr. Hanley testified that many of Aqua's current IT business systems, including its financial and customer billing systems, are not fully integrated, and the systems that are currently in use are reaching the end of their useful life and are not or will not continue to be supported by the companies who own and service the software. He testified that Aqua Indiana's aging software, much of which dates back 25 or more years, creates many issues for the utility. He testified that Aqua Indiana's accounting software has no known operating manuals, and the software is no longer supported by its company, which means there is no customer support available to assist when issues arise. Mr. Hanley testified that this creates a heavy burden on Aqua to troubleshoot alone and to hire personnel who can use the accounting software. He testified that supplementary software is needed to fill in the gaps in operations that the primary software is unable to complete. Mr. Hanley testified that all these issues with Aqua's current software continue to escalate with time. Mr. VerDouw and Mr. Hanley both testified that the SIP would create a new business software platform for Aqua America and Aqua Indiana, allowing Aqua Indiana to eventually retire or eliminate dependences on old, unsupported software.

Mr. Hanley testified that several business projects and software will be implemented as Phase One of the SIP in the first quarter of 2022. He stated that the software included in Phase One of the SIP includes: SAP S/4HANA Enterprise Resource Planning, WorkForce (Time Track), ADP (Payroll), Enterprise Asset Management Restructuring, PowerPlan (Asset Accounting), SAP Plant Maintenance, Budget Planning and Considerations, Compliance Wire (Training), Construction (P6), and Contract Management. Mr. Hanley testified that the SIP will not only benefit Aqua Indiana and its customers through enhanced software, but will also include enhanced hardware that, in conjunction with the SAP Platform that it is using, will provide greater network reliability, backup, disaster recovery, and security. He stated that some of the hardware and infrastructure projects included in the SIP include network integration and optimization, data center consolidation, server management, office systems integration, service desk integration, SharePoint alignment, disaster recovery integration, and cybersecurity. Mr. VerDouw provided a comprehensive SIP overview, including its estimated cost, as Attachment GMV-2 to his direct testimony.

Mr. VerDouw testified that Essential Utilities chose SAP as the operating system to use in development of future software because over 800 utilities worldwide use SAP's customer management and billing modules, including over 80% of the largest utilities in the world. Mr. VerDouw testified that PNG has been using SAP since 2010, and PNG's experience with SAP has shown to significantly improve PNG's customer service numbers. He opined that using SAP for SIP will improve network reliability, backup, disaster recovery, security, and other benefits.

Mr. VerDouw testified that the total planned cost for the SIP capital additions is \$143.1 million to be incurred during 2020 through 2023. He testified that, of the \$143.1 million total, \$32.4 million of capital costs are attributed to PNG and \$110.7 million are attributed to Aqua America. Of the \$110.7 million, Aqua Indiana's allocation is 3.02%, or \$3.4 million. Attachment GMV-4 shows the allocation of Aqua Indiana SIP capital investment by customer counts for all Aqua Indiana districts and unregulated operations as of October 31, 2021. Mr. VerDouw testified that the total SIP capital investment for Aqua Indiana's regulated customers is \$2,517,593.

Mr. VerDouw testified that this amount is reasonably needed to be invested because Essential Utilities and Aqua America need to replace their aging software products, and SIP implementation will provide a fully integrated system and allow growth for many years. He stated that the software platform, built on SAP, will provide expandability for growth of the enterprise, including Aqua America and Aqua Indiana; comfortably support a multi-company and multi-corporate framework; allow easy integration with other commercially sold software, as well as custom-developed applications; provide use of a software platform that has a significant number of proven implementations at other utilities; provide use of a software that shows a commitment to supporting utility-type businesses; and upgrade to SAP software that has already exhibited a proven track record of improving customer service at PNG; and all of these benefits of the SIP will benefit Aqua Indiana customers.

Mr. VerDouw stated that the SIP has progressed within budget and on time. He stated that the major pieces of the SIP implementation went live on January 1, 2022, and provided a timeline of software implementation dates for the SIP in his Attachment GMV-2.

Mr. VerDouw testified that AFUDC is being accrued as part of the SIP. He stated that SIP assets are being placed in service upon their completion, with some being placed in service in January 2022 and others later in 2022 and in 2023. He explained that SIP assets will not be placed in rates and earn a return until Aqua Indiana files and receives approval from the Commission for the SIP assets as part of its respective rate case filings for each of its 12 regulated utility districts. Mr. VerDouw testified that the recording of depreciation begins on the in-service date and continues over the anticipated life of the plant, and the depreciation rate that will be used for SIP assets is 10%, or 1/10 of the asset life per year for ten years.

Mr. VerDouw testified that Aqua Indiana will continue to incur capital costs on the SIP after its in-service date, and that the cost of capital continues throughout the life of the utility plant. He testified that the cost is recognized during the construction period with the inclusion of AFUDC as a component of construction costs.

Mr. VerDouw explained that Aqua Indiana's request that the Commission authorize the proposed accounting treatment with respect to post-in-service AFUDC and the deferral of depreciation for this project is necessary due to the magnitude of the project. He stated that, unless the requested authorization is obtained, Aqua Indiana will suffer a negative impact on its earnings during the period between the in-service date of the SIP assets and the issuance of rate orders including the assets in Aqua Indiana's rate base and including depreciation on its recoverable operating expenses. Mr. VerDouw testified that Aqua Indiana would also lose any opportunity to recover the carrying costs of this project during the interim period and would inhibit Aqua Indiana in attracting permanent capital on reasonable terms.

Pet. Ex. 1, Attachment GMV-4, shows the total SIP capital investment relative to Aqua Indiana is \$3.4 million, and Mr. VerDouw testified this is spread to all Aqua Indiana customers, including its Unregulated Operations customers. Mr. VerDouw testified that \$882,407 of the \$3.4 million is allocated to Unregulated Customers and \$2,517,593 is allocated to Regulated Customers.

Pet. Ex. 1, Attachment GMV-5, demonstrates that the SIP represents a 3.82% increase over Aqua Indiana's current total net original cost rate base for its 12 regulated districts, and Mr. VerDouw testified that magnitude of the SIP is such that it would satisfy the standard to qualify as a "Major Project" under the Commission's Minimum Standard Filing Requirements.

Pet. Ex. 1, Attachment GMV-6, provides the calculation Aqua Indiana has proposed to use for its weighted cost of capital using the capital structure in place as of the date AFUDC is recorded, and the cost of equity used in the most recent rate order for each of Aqua Indiana's regulated operating districts. Mr. VerDouw testified that, as of December 31, 2021, the post-in-service AFUDC rate consists of an after-tax weighted cost of debt of 1.91% and an after-tax weighted cost of equity of 4.88%, for a total weighted cost of 6.79%.

Pet. Ex. 1, Attachment GMV-7 is a schedule showing earnings erosion with and without the requested accounting treatment, illustrating that, once the project is placed in service, Aqua Indiana's pre-tax earnings will erode by \$38,875 per month because of the discontinuance of the accrual of AFUDC and the commencement of the accrual of depreciation expense. Mr. VerDouw testified that if Aqua Indiana filed rate cases for all 12 districts so that rate orders were received from the Commission by June 2024, then Aqua Indiana would be able to earn a return and recover depreciation on just 75% of the SIP assets if the request for post-in-service AFUDC and deferred depreciation were not granted.

Mr. VerDouw testified that the earnings erosion Aqua Indiana will experience if the requested accounting treatment is not approved will have a major negative impact on Aqua Indiana's pre-tax earnings, as shown in Pet. Ex. 1, Attachment GMV-8.

Mr. VerDouw testified that post-in-service AFUDC equity is appropriate in this case because of the extraordinary size and length of the SIP, with its assets to be placed in service for Aqua Indiana representing 3.82% of the total original cost rate base for Aqua Indiana. Mr. VerDouw testified that disallowance of post-in-service AFUDC equity would result in a \$13,888 monthly (\$166,656 annually) erosion in earnings for Aqua Indiana until the SIP assets are fully recovered in rates, which amounts to a 2.1% erosion of earnings for Aqua Indiana if not approved and recovered—a significant amount for a utility the size of Aqua Indiana. Mr. VerDouw testified that post-in-service AFUDC equity is routinely authorized and approved for electric and gas utilities.

Mr. VerDouw testified that the SIP will provide more customer benefits immediately upon implementation and in-service, even if the SIP assets are not yet recognized in Aqua Indiana's approved rates and expenses.

B. OUCC's Evidence. With the exception of internal labor costs, Ms. Stull agreed with Aqua Indiana's overall cost of the SIP and has also agreed with the allocation of Aqua Indiana's portion of the total SIP cost; however, she stated that the OUCC does not agree that the unamortized balance of the costs should be capitalized and included in rate base. She opined that, because the costs do not result in utility assets, it is inappropriate for Aqua Indiana to earn a return on those expenditures. She testified the OUCC does not propose that Aqua Indiana may not recover

these costs, only that it not be permitted to earn a return on those costs. She opined that the appropriate treatment is deferral and amortization of such costs.

Ms. Stull described her understanding of the rules governing capitalization of software costs under generally accepted accounting practices (“GAAP”). Ms. Stull stated that the Financial Accounting Standards Board’s Accounting Standards Codification (“ASC”) Subsection 350-40, which provides guidance on intangibles, separates internal-use software costs into three development stages: (1) preliminary project stage; (2) application development stage; and (3) post-implementation operation stage. Ms. Stull testified that GAAP permits only costs for the second stage to be capitalized. She discussed an exception to GAAP for regulated operations (ASC 980), which applies if (1) rates are established by or subject to approval by an independent regulator; (2) rates are designed to recover the specific utility’s costs of providing the regulated service; and (3) it is reasonable to assume that rates set at levels that will recover the utility’s costs can be charged to and collected from customers. Ms. Stull stated that, should the Commission issue an order that specifically authorizes Aqua Indiana to recover preliminary project stage costs and post-implementation operation stage costs in rates, Aqua Indiana will not have to expense those costs.

Ms. Stull said that the OUCC’s position is that inclusion of in-house labor costs (\$446,250) in SIP for recovery would result in double recovery of these costs, and therefore, these costs should be excluded from any regulatory recovery as a project cost. Ms. Stull recommended Aqua Indiana be authorized to capitalize and include in rate base the \$1,912,500 of external costs incurred during the application development stage and that all internal labor costs (\$446,250) incurred on this project not be included in rate base or recovered through amortization, as such labor costs are already being recovered in utility rates through the corporate/parent company allocations included in annual operating expenses. She also recommended that the \$1,041,250 of external costs incurred during the preliminary project stage and the post-implementation operation stage be deferred and amortized over ten years; and that the unamortized balance of these costs should not be included in rate base and no return should be earned on these costs.

Ms. Stull disagreed with Petitioner’s proposed 10% depreciation expense rate, which she stated is contrary to Commission practice and policy. Ms. Stull testified that the SIP costs included in rate base should be depreciated using the Commission’s composite depreciation rate until the Commission has approved a depreciation study from Aqua Indiana.

Ms. Stull recommended that Aqua Indiana be allowed to continue to capitalize debt AFUDC, but not the equity portion. She testified that no other water or wastewater utilities have been allowed to record an equity component of post-in-service AFUDC and that, historically, the treatment of financing costs incurred during construction is different for energy utilities because of the length of the construction periods involved and the large capital expenditures involved in electric construction projects. However, on cross-examination, Ms. Stull stated that she is aware of no accounting rule which provides a dollar limit threshold to qualify for post-in-service AFUDC accounting treatment. Tr. at 22, lines 9-25 and 23, line 1. Ms. Stull also testified on cross-examination that if a water or wastewater utility had a sufficiently complex project, such water or wastewater utility could possibly be eligible for post-in-service AFUDC equity. *Id.* at 22, lines 3-8. Ms. Stull also disagreed with Aqua Indiana’s assertion that earnings erosion would occur if it

were denied post-in-service AFUDC equity. She testified that she does not believe that GAAP allows the continued capitalization of equity AFUDC once an asset is placed in service.

Ms. Stull testified that Aqua Indiana should be using a post-tax equity rate, not a pre-tax equity rate, for capitalizing AFUDC. She recommended the Commission disallow the gross-up of equity AFUDC rates when capitalizing equity AFUDC and require Petitioner to use the weighted after-tax cost of equity as approved. She testified that, if the Commission allows post-in-service equity AFUDC, she recommends Aqua Indiana be precluded from grossing-up equity AFUDC rates and be required to use the weighted after-tax cost of equity as approved.

Ms. Stull further recommended that the Commission limit the time period during which Aqua Indiana is allowed to recover post-in-service AFUDC and deferral of depreciation expense to no more than three years after the date the SIP goes into service.

Ms. Stull concluded her testimony by questioning whether a project such as the proposed SIP is an appropriate subject for pre-approval under Ind. Code § 8-1-2-23. Ms. Stull stated it was unclear how the SIP qualifies as an extension, construction, addition, or improvement of Aqua Indiana's plant and equipment. She recommended the Commission reject the request for pre-approval of the SIP.

C. Petitioner's Rebuttal. Mr. VerDouw agreed with Ms. Stull's recommendation that the Commission require Aqua Indiana to use the weighted after-tax cost of equity as approved in Aqua Indiana's most recent rate case.

In response to Ms. Stull's testimony that in-house labor costs be excluded from recovery, Mr. VerDouw testified that the total in-house labor is much lower than the \$446,250 assumed by Ms. Stull, noting that Aqua Indiana provided a supplemental data request response regarding this issue, clarifying that the SIP also includes such items as software, new servers, data storage, data back-up platform, network routers/switches, and call center phone technology. He stated that these other costs were included in each stage of SIP development, beyond consultant and in-house labor. Mr. VerDouw also stated that the in-house labor time included in building the SIP asset has been incurred by service company personnel who in the past would not have normally charged time to Aqua Indiana, meaning their time would not have been included in service company expense currently recovered in rates by Aqua Indiana's operating districts; thus, he testified that this is not a situation in which Aqua Indiana would be double recovering, and in-house labor should not be excluded from recovery of SIP costs.

In response to the Commission's docket entry, Aqua Indiana approximated that the total Information System Services Labor assumed to be embedded in the rates of all Aqua Indiana's regulated districts would be \$71,393.20. However, none of the labor included in any current Aqua Indiana rate recovery would include any internal labor incurred in the SIP asset build, and none of the labor included in the SIP asset build would be reflective of any in-house labor that Aqua Indiana currently recovers in rates.

In response to Ms. Stull's recommendation that under ASC Subsection 350-40 not all SIP costs should be capitalized and included in rate base, Mr. VerDouw stated that he agrees with Ms.

Stull that if the Commission issues an order that specifically authorizes Aqua Indiana to recover these costs in rates, Aqua Indiana will not have to expense these costs as incurred in its general purpose external financial statements. He explained that the Commission regularly approves capitalization of software used by water, gas, and electric utilities, as very little capitalized software used by utilities is pulled “out of the box” and put into service without going through any modification to meet the utility’s needs. He concluded that all costs incurred in the development and build of the SIP software be capitalized and included in rate base in future Aqua Indiana rate proceedings.

Regarding Ms. Stull’s recommendation that Aqua Indiana apply the Commission’s composite depreciation rates of 2.0% per year (50 years) for water assets and 2.5% per year (40 years) for wastewater assets for the SIP, Mr. VerDouw explained that, even though Aqua Indiana currently uses the standard composite depreciation rates, it considers the SIP asset a “one-off” from those rates and determined that a ten-year depreciation rate would be more appropriate. He noted that the Commission, in Cause No. 44022, previously approved a ten-year depreciation rate for Indiana America Water’s Business Transformation SAP conversion project, which was affirmed as part of Indiana American’s most recent depreciation study approved in Cause No. 44992. Mr. VerDouw also pointed out that Ms. Stull’s ten-year recommendation for amortization for expense deferrals underscores that a ten-year depreciation rate is appropriate.

Mr. VerDouw testified that Aqua Indiana believes a ten-year depreciation rate is the most appropriate depreciation rate for SIP assets, but would be agreeable to a 15-year depreciation rate as a compromise. He testified that, if a 15-year depreciation rate is approved, Aqua Indiana would agree to a 15-year amortization of any post-in-service AFUDC and deferred depreciation approved in this Cause.

Regarding Ms. Stull’s recommendation that post-in-service AFUDC equity be denied, Mr. VerDouw opined that her reasons for denying the AFUDC equity are not applicable in this case. He stated that water/wastewater utilities such as Aqua Indiana have the same financing costs and concerns that energy utilities have when it comes to recovery of assets prior to their inclusion in authorized rate base and rates, and the same option should be afforded to water utilities as well. Mr. VerDouw testified that Ms. Stull’s argument as to why post-in-service AFUDC equity is afforded to energy utilities (because of the lengthy construction periods involved and large capital expenditures involved in construction projects) supports approving post-in-service AFUDC equity for Aqua Indiana in this case—the SIP is a large dollar project for Aqua Indiana and is a project that is being completed over a period of many years.

Mr. VerDouw testified that he disagrees with Ms. Stull’s recommendation to limit recovery of post-in-service AFUDC to a maximum of three years. He stated that doing so may force Aqua Indiana to file a rate increase for one or more of its districts sooner than it would have to if no post-in-service AFUDC time limitation been put in place, and that Aqua Indiana does its best to limit rate case filings to limit the rate increases that are passed on to its consumers.

Mr. VerDouw testified in response to Ms. Stull’s recommendation that Aqua Indiana only be allowed to recover deferred depreciation for no more than three years after the date the SIP assets go into service, stating that Aqua Indiana does not plan on timing rate case filings for all 12

of its regulated districts to have new rates approved to coincide with the in-service date of the SIP assets, and reiterated that limiting the time period to three years may force Aqua Indiana to file a rate increase for one or more of its districts sooner than it would have to if no deferred depreciation time limitation been put in place.

5. Commission Discussion and Findings.

A. Preapproval of SIP. In this Cause, Petitioner seeks preapproval of \$2,517,000 of costs allocated to it by its parent company, Essential Utilities, for the design, implementation, and development of the SIP software. Ind. Code § 8-1-2-23 provides the following:

Unless a public utility shall obtain the approval by the commission of any expenditure exceeding ten thousand dollars (\$10,000) for an extension, construction, addition or improvement of its plant and equipment, the commission shall not, in any proceeding involving the rates of such utility, consider the property acquired by such expenditures as a part of the rate base, unless in such proceeding the utility shall show that such property is in fact used and useful in the public service; Provided, that the commission in its discretion may authorize the expenditure for such purpose of a less amount than shown in such estimate.

In *American Suburban Utilities, Inc.*, Cause No. 41254 (April 14, 1999), we set forth our analytical framework for considering a request for preapproval of expenditures pursuant to Ind. Code § 8-1-2-23:

When faced with such a request, the first question we must ask is whether an expenditure of any amount is reasonably necessary to assure reasonable and adequate service. If so, we must proceed to the second question: what amount reasonably needs to be invested? Once we answer the first question affirmatively, we cannot simply deny in its entirety a request for approval of expenditures. If we did, it would mean that we would deny approval for any amount of expenditures even though we have already found that some level of expenditures is necessary for the provision of reasonable and adequate service. Such a result would be counter to our very purpose.

Id. at 14.

The OUCC claims that the SIP asset is not appropriate for pre-approval under Ind. Code § 8-1-2-23. The expenditures addressed by Ind. Code § 8-1-2-23 are for “an extension, construction, addition or improvement of [a public utility’s] plant and equipment.” The OUCC has argued that it is unclear how the acquisition and development of the SIP software qualifies as “an extension, construction, addition or improvement of its plant and equipment.” Ms. Stull stated that, although software improvement appears to be necessary, such costs are not the kind of expenditure contemplated for pre-approval under this statute. We disagree. The evidence of record shows that the SIP platform is not a simple, out-of-the-box software program. Rather, this asset is a platform that requires significant customization and implementation. The record also included undisputed

evidence that the SIP asset includes such items as software, new servers, data storage, a data back-up platform, network routers/switches, and call center phone technology. Based on the evidence of record, we find that the SIP constitutes plant or equipment that qualifies for pre-approval under Ind. Code § 8-1-2-23.

Petitioner's evidence demonstrates the undeniable need for improvements to its existing software platform. Testimony from Mr. Hanley and Mr. VerDouw show that many of the current software systems Aqua Indiana uses in its daily operations are extremely out of date and not adequate to support Aqua Indiana's growing customer and business requirements. Mr. Hanley testified that many of Aqua Indiana's current IT business systems, including its financial and customer billing systems, are not fully integrated, and the systems that are currently in use are reaching the end of their useful life and are not or will not continue to be supported by the companies who own and service the software. Some of Aqua's software is no longer supported by the software company, which poses challenges for Aqua Indiana's daily operations, personnel management, and service to its customers. Mr. Hanley testified that there are no known operating manuals for Aqua Indiana's accounting software, and because the software is no longer supported, Aqua Indiana has had to use supplementary software to complete its basic accounting operations. The SIP implementation will allow Aqua Indiana to implement a proven, fully integrated system that is designed to be flexible and allow for growth for many years. We note that the OUCC did not challenge the necessity of the SIP.

The total planned cost for the SIP capital additions is \$143.1 million to be incurred during 2020 through 2023, with \$110.7 million attributed to Aqua America. Of that \$110.7 million, Aqua America has allocated SIP capital cost to each of Aqua America's operating units based on the percentage of their customer counts to the overall utility customer counts of Aqua America. Aqua Indiana's allocation of SIP costs is 3.02%, or \$3.4 million. The total SIP capital investment allocated to Aqua Indiana's regulated customers is \$2,517,593, which is the amount for which Petitioner seeks preapproval in this Cause. Except for in-house labor costs, the OUCC agrees with the overall cost of the SIP and does not object to the allocation of Aqua Indiana's portion of the total SIP cost.

The OUCC recommends in-house labor costs not be recovered, claiming these costs are already included in Petitioner's rates through corporate/parent company allocations included in annual operating expenses and should not be recovered again through the SIP. Mr. VerDouw countered that inclusion of these costs would not constitute double recovery because the labor costs from its parent company currently included in Aqua Indiana's rates are based on time allocated to Aqua Indiana by service company personnel for work specifically done on behalf of Aqua Indiana in the past and that very little IT time is included in that amount and thus recovered via rates. The in-house labor time included in the SIP asset has been incurred by service personnel who would not have normally charged time to Aqua Indiana, and therefore, their time would not be currently recovered in rates by Aqua Indiana.

While Petitioner estimated in response to the Commission's docket entry question that the total information systems in-house labor currently embedded in Aqua Indiana's rates is approximately \$71,393.20, Mr. VerDouw explained that the internal labor time included in the SIP

asset is time that would not be currently recovered in rates by Aqua Indiana. Therefore, we deny proposing an adjustment to remove internal labor costs in this Cause.

After reviewing the evidence of record, we find that the SIP capital investment costs are reasonably necessary to assure reasonable and adequate service, and that the amount being allocated is reasonable. Aqua Indiana's current software systems have met or exceeded their useful life, and we find that this IT investment is both a needed improvement and reasonably calculated to ensure Petitioner is able to continue to provide adequate utility service to its customers. Further, we find that Aqua America's allocation methodology is reasonable and allows Aqua Indiana to benefit from the larger expense and investment of its parent company. Aqua Indiana is greatly benefiting from the combined effort by Essential, Aqua America, and PNG in the development of the SIP software and would undoubtedly spend more to obtain similar integrated software if it were to complete this project on its own. Accordingly, we approve Petitioner's request for preapproval of the \$2,517,593 in allocated costs related to SIP capital investment, pursuant to Ind. Code § 8-1-2-23.

B. "Return On" Deferred Expenditures. Petitioner recommends the entire \$2,517,593 of SIP costs allocated to Aqua Indiana's regulated utilities be capitalized and amortized over a ten-year period, with any unamortized balance included in rate base. The OUCC recommends that Aqua Indiana only be allowed to capitalize and include in rate base \$1,912,500 of its SIP costs, with the remaining \$1,041,250 incurred during the preliminary project stage and post-implementation operation stage be deferred as a regulatory asset and amortized over ten years, but not included in rate base.¹ The OUCC's recommendation is based on two accounting standards. ASC 350-40 separates internal-use software costs into three development stages: (1) the preliminary project stage; (2) the application development stage; and (3) the post-implementation operation stage. The guidance provided in ASC 350-40 suggests that the costs incurred in the preliminary project stage and the post-implementation operation stage should be expensed as they are incurred, and the costs incurred in the application development stage should be capitalized. However, under ASC 980, the incurred cost, if authorized by the Commission, for the preliminary project stage and post-implementation operation stage can be deferred to allow for the full cost recovery in rates. Ms. Stull proposed that the preliminary project stage and post-implementation operation stage costs be deferred and rate recovery be granted over a ten-year amortization period.

In rebuttal, Mr. VerDouw explained that very little capitalized software used by utilities is pulled "out of the box" and put into service without going through any modification to meet the utility's needs. He noted that most software used by utilities goes through some form of the three development stages to make the software work as required by the utility. Petitioner argued that the entire \$2,517,593 of SIP costs allocated to Aqua Indiana's regulated utilities be capitalized, but stated that Aqua Indiana would agree to amortize the costs over a 15-year period as a compromise, with any unamortized balance included in rate base.

Aside from the internal labor costs discussed above, both parties agree that recovery of SIP costs should be granted and we so find. The parties also agree that the unamortized SIP costs associated with the "development stage" shall be included in rate base. The remaining dispute relates to whether Petitioner should be allowed to rate base the unamortized costs associated with

¹ The OUCC's analysis includes the allocation of SIP costs associated with Aqua Indiana's unregulated businesses.

the preliminary project and post-implementation operation stages of Essential Utilities' SIP costs allocated to Aqua Indiana's regulated operations. We agree with Petitioner that most software used by utilities is not pulled out of the box. No one disputed that the three stages discussed under ASC 350 were required by Essential Utilities to make the SIP software work as required. Therefore, we find that the deferred expenses associated with the preliminary and post-implementation stages are linked to the development of the SIP software and associated with an asset includable in utility plant. Thus, we find Petitioner shall defer the expenses associated with the preliminary and post-implementation stages as a regulatory asset and be allowed a return on the unamortized expense included in rate base.

C. Depreciation. Depreciation allows utilities to recover the original cost of assets that are used and useful in providing service at a level that spreads recovery of the cost over the estimated life of the assets. As a result, each generation of customers pays its fair share of cost according to their use of the assets.

Here, Petitioner proposed a ten-year depreciation rate for SIP assets in its case-in-chief, but suggested a 15-year amortization period in rebuttal as a compromise. The OUCC has recommended use of the Commission's composite depreciation rates of 2.0% per year (50 years) for water assets and 2.5% per year (40 years) for wastewater assets as they are placed in service. The Commission has the responsibility pursuant to Ind. Code § 8-1-2-19 to ascertain and determine the proper and adequate rates of depreciation of the several classes of property of each public utility. Historically, the Commission's composite rate is used, unless the Commission decides that a utility's proposed rate schedule is more proper and adequate for the public utility's property. To be approved, Petitioner's proposed depreciation rates need to be proper and adequate per the statute and more accurately reflect the expense for depreciation than the Commission-developed depreciation rates.

In Cause No. 44022, where Indiana American Water specifically requested a depreciation rate be established for its SAP Software Conversion Assets, we found that "Petitioner [did] not have an appropriate, currently effective rate that applies to this asset." We approved a ten-year depreciation accrual rate but limited our finding to the appropriate depreciation rate for the BT project. *Indiana American Water*, Cause No. 44022, at 114 (June 6, 2012). In this case, Petitioner has made a similar request. Aqua proposes its SIP assets will have a ten-year life and proposes its deferred depreciation and amortization be based upon a 10% depreciation rate. In rebuttal, Petitioner explained it would be agreeable to a 15-year depreciation rate as a compromise. However, we note that Mr. Hanley explained that Petitioner's current software is, in some cases, over 25 years old. In this instance, the evidence of record justifies a departure from the composite rates of 50 or 40 years. The evidence of record demonstrates that Aqua Indiana has historically used its IT assets much longer than ten years. Even though Petitioner presented the use of a 15-year service life as a compromise, the record supports that a 15-year service life is more reasonable and therefore in the public interest. Thus, we find a 15-year amortization period shall be used for the SIP costs.

D. Post-in-Service AFUDC. AFUDC is the cost of funds, both equity and debt, used to finance projects. AFUDC accrues during the construction period and is capitalized as part of the total cost of the asset. AFUDC captures the capital costs of constructing the asset

during the period of construction, and normally, a utility receives no compensation for this until it files for a rate increase and includes the capitalized AFUDC in rate base. The post-in-service accounting treatment for AFUDC and depreciation aids utilities with their financial statements by delaying the impact of expenses until the rates are in effect. Petitioner estimated a monthly earnings erosion of \$13,888 and \$4,007 for post-in-service AFUDC equity and debt, respectively.

In this case, as an initial matter, the OUCC supported Petitioner's request for post-in-service AFUDC debt. But the OUCC challenged Petitioner's request to receive post-in-service AFUDC equity accounting treatment, primarily on the grounds that post-in-service equity AFUDC is a creation of income because there is no offset of an expense. Ms. Stull explained that no other water/wastewater utility in Indiana receives post-in-service AFUDC equity.

However, we note that post-in-service AFUDC equity has been provided in the past in several non-settled energy utility proceedings. *See, e.g., S. Ind. Gas & Elec. Co.*, Cause No. 45052 (April 24, 2019); *Indianapolis Power & Light Co.*, Cause No. 44540 (July 29, 2015); *Indianapolis Power & Light Co.*, Cause No. 44339 (May 14, 2014); *S. Ind. Gas & Elec. Co.*, Cause No. 43839 (April 27, 2011). The OUCC claimed that the standard in cases where post-in-service AFUDC equity has been approved was that the lengthy construction periods involved and the sizable capital expenditures incurred during construction projects for energy utilities supported the inclusion of post-in-service AFUDC equity. However, the Commission has not actually stated such a standard in any of these cases.

While no earnings erosion would occur if we were to deny Petitioner post-in-service AFUDC equity, we have allowed energy utilities this accounting treatment, which to be consistent should be afforded to all utilities, not just energy utilities. We have never indicated that water/wastewater utilities should be ineligible for this accounting treatment. Therefore, we believe the equity portion of post-in-service AFUDC should be available to Aqua Indiana in this case as well. The SIP is a significant rate base increase for Aqua Indiana and is a project that is being completed over a period of many years. We find no reason that the accounting treatment to allow post-in-service AFUDC equity for a water/wastewater utility such as Aqua Indiana should be categorically denied. Accordingly, we approve Petitioner's request for post-in-service AFUDC debt and post-in-service AFUDC equity for SIP assets in this Cause from the SIP in-service date until the date of respective Commission rate orders which include SIP assets in the Petitioner's districts' rate bases. Aqua Indiana's post-in-service AFUDC rate will be based on the use of its weighted cost of capital using the capital structure in place as of the date the AFUDC is recorded, and the cost of equity used in the most recent rate order for each of Aqua Indiana's 12 regulated operating districts.

E. Deferred Depreciation. We approve Petitioner's request to defer the accrual of depreciation expense from its in-service date until the date of respective Commission rate orders including SIP assets in the Petitioner's districts' rate bases. For the same reasons that we decline to limit post-in-service AFUDC, we also decline to limit Petitioner's deferred depreciation to three years after the date the SIP assets go into service. Limiting the inclusion of deferred depreciation to a maximum of three years may force Aqua Indiana to file a rate increase for one or more of its districts sooner than it would have otherwise done so. However, it would be

unreasonable to allow an annual accrual to result in more than a doubling of SIP costs. Therefore, we strongly encourage Petitioner to file for rate relief when needed.

6. Confidentiality. Aqua Indiana filed a motion for protection and nondisclosure of confidential and proprietary information (“Motion”) on February 11, 2022. A docket entry was issued on February 23, 2022, finding such information to be preliminarily confidential and protected from disclosure under Ind. Code §§ 8-1-2-29 and 5-14-3-4. The confidential information was subsequently submitted under seal. The Commission finds the information for which Aqua Indiana seeks confidential information is confidential trade secret information, is exempt from public access and disclosure by Indiana law, and shall continue to be held by the Commission as confidential and protected from public access and disclosure.

IT IS THEREFORE ORDERED BY THE INDIANA UTILITY REGULATORY COMMISSION that:

1. Pursuant to Ind. Code § 8-1-2-23, Petitioner’s request for preapproval of expenditures for the SIP assets, in the amount of up to \$2,517,593, is approved and granted. Once such assets have been placed in service and related expenses incurred, such amount shall be included in the rate base of Petitioner’s regulated operations as determined in subsequent respective rate orders.

2. Petitioner is authorized to continue the accrual and capitalization of AFUDC (both debt and equity) from the SIP asset in-service dates until the dates of respective Commission rate orders including the SIP assets in Petitioner’s district rate bases and to amortize the AFUDC regulatory assets as a recoverable expense for ratemaking purposes over a 15-year accrual rate commencing on the dates of the respective rate orders including the SIP assets in rate base.

3. Petitioner is authorized to defer depreciation expense related to the development, implementation, and deployment of the SIP assets from its in-service dates until the dates of respective Commission rate orders approving recovery of SIP assets in Petitioner’s districts’ rate bases and to amortize the deferred depreciation regulatory assets as a recoverable expense for ratemaking purposes over a 15-year accrual rate commencing on the dates of the respective rate orders including SIP assets in rate base.

4. Petitioner is authorized to include the unamortized portion of the post-in-service AFUDC and deferred depreciation regulatory assets for SIP assets in rate base upon which it is permitted to earn a return.

5. The information submitted under seal in this Cause pursuant to Petitioner’s Motion is determined to be confidential trade secret information pursuant to Ind. Code §§ 5-14-3-4 and 24-2-3-2 and shall continue to be held as confidential and exempt from public access and disclosure pursuant to Ind. Code §§ 5-14-3-4 and 8-1-2-29.

6. This Order shall be effective on and after the date of its approval.

HUSTON, FREEMAN, KREVDA, VELETA, AND ZIEGNER CONCUR:

APPROVED: JAN 18 2023

**I hereby certify that the above is a true
and correct copy of the Order as approved.**

**Dana Kosco
Secretary of the Commission**