**STATE OF INDIANA**

**INDIANA UTILITY REGULATORY COMMISSION**

| | | |
|---|---|---|
| **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** |

**PUBLIC'S EXHIBIT NO. 1**

**TESTIMONY OF MARGARET A. STULL**

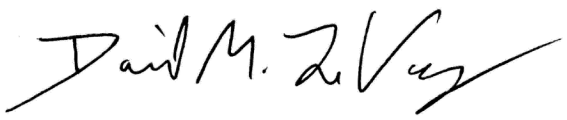
**ON BEHALF OF**

**THE INDIANA OFFICE OF UTILITY CONSUMER COUNSELOR**

**June 17, 2022**

Respectfully submitted

INDIANA OFFICE OF UTILITY CONSUMER COUNSELOR



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## CERTIFICATE OF SERVICE

This is to certify that a copy of the ***Public's Exhibit No. 1 – Testimony of Margaret A. Stull on behalf of the OUCC*** has been served upon the following counsel of record in the captioned proceeding by electronic service on June 17, 2022.

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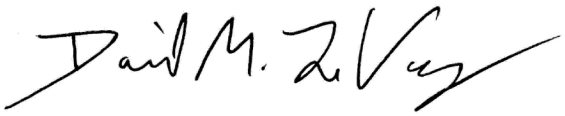

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**TESTIMONY OF OUCC WITNESS MARGARET A. STULL**
**CAUSE NO. 45675**
**AQUA INDIANA, INC.**

## I. INTRODUCTION

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

A: My name is Margaret A. Stull, and my business address is 115 W. Washington St., Suite 1500 South, Indianapolis, Indiana 46204.

**Q: By whom are you employed and in what capacity?**

A: I am employed by the Indiana Office of Utility Consumer Counselor ("OUCC") as a Chief Technical Advisor in the Water/Wastewater Division. My qualifications are set forth in Appendix A.

**Q: What is the purpose of your testimony?**

A: Aqua Indiana, Inc.'s ("Aqua Indiana" or "Petitioner") request pre-approval to expend funds and include in rate base an allocated portion of costs incurred by its parent for the design, development, and implementation of software applications. Aqua Indiana also asks for approval of post-in-service AFUDC and deferral of depreciation, which Aqua Indiana indicates should be based on a 10% annual depreciation rate.[1] I analyze the foregoing requests. I discuss that software applications are not construction projects as contemplated by the preapproval statute or tangible property as contemplated by the Indiana fair value statute. I

[1] Total costs Aqua Indiana proposes to capitalize are approximately $4,547,000 - $3,400,000 (software) + $528,000 (post-in-service AFUDC) + $619,000 (deferred depreciation). Amounts reflected in Petitioner's Exhibit GMV-7 are estimates of the amounts to be incurred for post-in-service AFUDC and deferred depreciation through June 2024.

recommend any capitalization be based on GAAP guidance with respect to what software development costs may be allocated. I identify double recovery embedded in Petitioner's proposal. I recommend that the Commission find that authorized depreciation expense should be based on the Commission's composite depreciation rates as is all of Petitioner's other utility plant in service. I recommend that any grant of authority to defer depreciation expense or for post-in-service AFUDC should be limited in time.

## II. CASE OVERVIEW

### A. Aqua Indiana Proposal

**Q: What relief does Aqua Indiana request in this Cause?**

A: According to its Petition, Aqua Indiana requests approval of costs incurred for improvements to its information technology system through the design, implementation, and development of a multi-year service improvement project. More specifically, Aqua Indiana seeks confirmation that the costs incurred for this project by its parent Essential Utilities, Inc. and allocated to Aqua Indiana will ultimately be included in rate base. Aqua Indiana also requests authority to continue the accrual of allowance for funds used during construction ("AFUDC") and to defer depreciation of these information technology system improvements once they have been deployed.

**Q: What costs does Aqua Indiana propose to include in rate base for these information technology system improvements?**

A: Essential Utilities, Inc. estimated a total investment of $143.1 million for the design, development, implementation, and system-wide deployment of its proposed

information technology system improvements. (Essential Utilities, Inc. owns Peoples Natural Gas and Aqua America. Aqua America owns water and wastewater utilities in eight jurisdictions, including Indiana, Illinois, New Jersey, North Carolina, Ohio, Pennsylvania, Texas, and Virginia.) Aqua Indiana's allocated share of the cost of these improvements is estimated to be $3.4 million, of which $2,517,594 will be allocated to regulated operations and $882,406 will be allocated to unregulated operations. (See VerDouw Direct at 12 and 13.)

**Q: Does the $3.4 million include the post-in-service AFUDC and deferred depreciation costs for which Aqua Indiana has requested recovery?**

A: No. Aqua Indiana seeks approval to record and recover additional costs arising after the service improvement project has been placed into service. Specifically, Aqua Indiana requests approval to record and recover post-in-service AFUDC, including both debt and equity financing costs, estimated to be $527,932 through June 2024. (See Petitioner's Exhibit GMV-7, Column (d).) Aqua Indiana also seeks authority to defer depreciation and record and recover an estimated $618,910 through June 2024. (See Petitioner's Exhibit GMV-7, Column (e).) Aqua Indiana proposes these costs be amortized over a ten-year period once the service improvement project has been included in rate base.

## B. Service Improvement Project and Allocation

**Q: Please describe Essential Utilities' service improvement project.**

A: The service improvement project is a new, integrated information technology system Essential Utilities is developing to replace its current non-integrated and outdated IT business systems. The service improvement project includes both

software costs and hardware/infrastructure costs developed or acquired from 2020 through 2023. Essential will own all software applications. However, two applications will be hosted by a software hosting firm, which will result in additional future operating expenses.

**Q: When will the software applications be operational?**

A: According to Aqua Indiana witness Gary M. VerDouw, "the major pieces of the SIP implementation all went live on January 1, 2022." (VerDouw Direct at page 15.) The remaining applications go-live later in 2022 and 2023. These "major pieces" of the service improvement project include the following:

- SAP S4/HANA finance;
- EAM restructuring;
- Time Tracking Integration (Workforce);
- Supplier Portal;
- Network Optimization/Integration;
- Server Management Integration;
- Help Desk/Change Control:
- Share Point Assignment;
- Enterprise Video Solution;
- Construction Integration; and
- Meter Data Management.

**Q: How will Essential allocate the $143.1 million cost of the service improvement project between Peoples Natural Gas and Aqua America?**

A: Some costs are directly attributable to either Peoples Natural Gas or Aqua America and will be charged to those entities accordingly. The remaining costs will be allocated between Peoples Natural Gas and Aqua America based on customer count. The estimated cost allocation is $32,393,319 to Peoples Natural Gas and

$110,686,767 to Aqua America. Table MAS-1 shows the cost allocation for each component of the service improvement project.

**Table MAS-1: Service Improvement Project Cost Allocation**

| Application | Peoples Natural Gas | Aqua America | Total |
|---|---|---|---|
| SAP S4/HANA Simplified Finance | $ 10,739,730 | $ 32,219,190 | $ 42,958,920 |
| SAP S4/HANA CRM&B | - | 46,043,442 | 46,043,442 |
| EAM Restructuring | 2,168,000 | - | 2,168,000 |
| Analytics/DW/Rate Case Reporting | 1,626,000 | 1,626,000 | 3,252,000 |
| Document Management (Perceptive Content) | 542,000 | 1,626,000 | 2,168,000 |
| Work Management (Ventyx) | 948,500 | 2,845,500 | 3,794,000 |
| Compliance Work Management (Essentials) | 390,240 | 3,512,160 | 3,902,400 |
| Human Resource Integration (Workday) | 3,956,600 | - | 3,956,600 |
| Customer Portal (SEW) | - | 1,897,000 | 1,897,000 |
| Time Tracking Integration (Workforce) | - | 1,951,200 | 1,951,200 |
| Supplier Portal | 677,500 | 677,500 | 1,355,000 |
| Infrastructure - Data Centers - Networks - Servers - Cyber | 9,921,999 | 16,188,525 | 26,110,525 |
| Qlik Enhancements | 338,750 | 1,016,250 | 1,355,000 |
| Intranet Rebuild | 813,000 | 813,000 | 1,626,000 |
| Enterprise Video Solution (for bus & Ask Aqua Live meetings) | 271,000 | - | 271,000 |
| Meter Data Management | - | 271,000 | 271,000 |
| | $ 32,393,319 | $ 110,686,767 | $ 143,080,087 |

**Q: How will Aqua America allocate its share of the service improvement project costs to each of its subsidiaries?**

A: Aqua America will allocate its share of the service improvement project costs ($110,686,767) to all water and wastewater utilities located in its eight-state service territory based on customer count. Aqua Indiana's estimated share of the service improvement project costs is $3,400,000 or 3.02% (VerDouw Direct at 13).[2]

[2] While Mr. VerDouw stated the allocation percentage is 3.02%, the numbers presented in Mr. VerDouw's testimony actually calculate to an allocation percentage of 3.07% ($3,400,000 / $110,686,767 = 3.07%).

**Q: How will Aqua Indiana allocate its share of the service improvement project costs among each of its subsidiaries?**

A: Aqua Indiana plans to allocate these costs across all of its regulated and unregulated operations based on customer counts. Table MAS-2 shows the estimated amounts to be allocated to each Aqua Indiana district and compares each amount to the rate base authorized in the respective district's last rate case. (See also Petitioner's Exhibits GMV-4 and GMV-5.)

**Table MAS-2: Indiana Cost Allocations**

| Aqua Indiana District | Customer Count | Percent Allocated | Allocated Cost | Rate Base | % of Rate Base |
|---|---|---|---|---|---|
| Aboite Wastewater | 15,071 | 66.2112% | $ 1,666,929 | $ 47,768,947 | 3.49% |
| Consumers - Wastewater | 852 | 3.7431% | 94,236 | 899,580 | 10.48% |
| Consumers - Water | 854 | 3.7519% | 94,457 | 899,580 | 10.50% |
| Darlington (Water) | 307 | 1.3487% | 33,956 | 1,431,946 | 2.37% |
| Heir Industries (Wastewater) | 112 | 0.4920% | 12,388 | 201,947 | 6.13% |
| Sani-Tech (Wastewater) | 124 | 0.5448% | 13,715 | 158,194 | 8.67% |
| Southeastern (Wastewater) | 97 | 0.4261% | 10,729 | 144,391 | 7.43% |
| South Haven (Wastewater) | 4,259 | 18.7110% | 471,067 | 10,817,373 | 4.35% |
| Wedgewood Park (Water | 216 | 0.9490% | 23,891 | 356,796 | 6.70% |
| White Oak (Wastewater) | 47 | 0.2065% | 5,198 | 107,974 | 4.81% |
| Wildwood Shores (Wastewater) | 99 | 0.4349% | 10,950 | 1,092,582 | 1.00% |
| Wymberly (Wastewater | 724 | 3.1807% | 80,078 | 2,081,895 | 3.85% |
| Total Regulated Operations | 22,762 | 100.0000% | $ 2,517,594 | $ 65,961,205 | 3.82% |
| Unregulated Operations | | | 882,406 | | |
| | | | $ 3,400,000 | | |

## III. RECOVERY OF SERVICE IMPORVEMENT PROJECT COSTS

### A. Capitalization of Software Costs under GAAP

**Q: Do generally accepted accounting principles ("GAAP") offer guidance for the measurement and recognition of internal-use software costs?**

A: Yes. Generally accepted accounting principles ("GAAP") provide guidance for the measurement and recognition of computer software costs in the Financial

Accounting Standards Board's Accounting Standards Codification ("ASC"), Subsection 350-40. ASC 350 provides guidance on intangibles in general. ASC 350-40 provides guidance on the appropriate treatment of costs incurred to develop internal-use software.

**Q: What accounting does GAAP require for internal-use software costs?**

A: ASC 350-40 separates internal-use software costs into three development stages and indicates whether the software cost should be capitalized or expensed. These three development stages are (1) the preliminary project stage, (2) the application development stage, and (3) the postimplementation-operation stage (ASC 350-40-25-1 through ASC 350-40-25-17). GAAP establishes that only costs for the second stage -- application development -- should be capitalized. GAAP requires the costs incurred in the other two stages to be expensed as they are incurred. Table MAS-3 shows the estimated costs for each development stage.

**Table MAS-3: Project Costs by Development Stage**

| | Project Stage | Estimated Project Costs | |
|---|---|---|---|
| Stage 1 | Preliminary Project Stage | $ 425,000 | 12.50% |
| Stage 2 | Application Development Stage | 2,125,000 | 62.50% |
| Stage 3 | Postimplementation-operation Stage | 850,000 | 25.00% |
| | | $ 3,400,000 | 100.00% |

1. **Preliminary Project Stage**

**Q: What activities occur in the preliminary project stage?**

A: Preliminary project stage activities include (1) strategic decision making; (2) determination of performance and system requirements; (3) exploration of alternatives, (4) selection of a vendor; and (4) selection of a consultant to assist in the development or installation of the software.

**Q: What are the total estimated preliminary stage costs for the service improvement project?**

A: According to Aqua Indiana's response to OUCC Data Request No. 1-10, Of the $3.4 million of costs allocated to Aqua Indiana for the service improvement project, $425,000 (12.5%) are asserted to be associated with the preliminary stage. (See OUCC Attachment MAS-1.)

**Q: What is the GAAP accounting treatment of preliminary stage costs?**

A: Again, according to ASC 350-40-25-1, costs incurred during the preliminary stage should be expensed as they are incurred.

2. **Application Development Stage**

**Q: What activities occur in the application development stage?**

A: The application development stage activities include planning, designing, developing, testing, and deployment. These are functions a company typically hires an outside consultant to perform as these tasks require special, specific knowledge that in-house employees typically do not possess.

**Q: What are the total estimated application development stage project costs?**

A: According to Aqua Indiana's response to OUCC Data Request No. 1-10, $2,125,000 (62.5%) of the $3,400,000 is for tasks preformed in the application development stage. (See OUCC Attachment MAS-1.)

**Q: What is the GAAP accounting treatment of application development stage cost?**

A: As noted above, according to ASC 350-40-25-1, costs incurred during the application development stage should be capitalized.

3. **Postimplementation-operation Stage**

**Q: What activities occur in the postimplementation-operation stage?**

A: Postimplementation-operation stage activities include training and maintenance costs. Experts are normally retained to train employees. The experts also act as a liaison between the application developer and company employees. Unforeseen coding issues are corrected, and any additional enhancements are made.

**Q: What are the total estimated postimplementation-operation stage project costs?**

A: According to Aqua Indiana's response to OUCC Data Request No. 1-10, Aqua Indiana's request includes $850,000 (25%) in postimplementation-operation stage costs. (See OUCC Attachment MAS-1.)

**Q: What is the GAAP accounting treatment of post-implementation-operation stage cost?**

A: Again, according to ASC 350-40-25-1, costs incurred during the post-implementation-operation stage should be expensed as incurred.

**B. Ratemaking Treatment**

**Q: Are there any exceptions to the GAAP guidance discussed above for regulated utilities?**

A: Yes. ASC 980 (formerly FAS #71) provides guidance for regulated operations and allows for exceptions to GAAP expense and capitalization guidelines under certain circumstances. ASC 980 applies if the following criteria are met: (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 are set at levels that will recover the utility's costs can be charged to and collected from customers. ASC 980 recognizes that a principal consideration of rate regulation is the cause-and-effect relationship of costs and revenues – an economic dimension that, in some circumstances, should affect accounting for rate-regulated utilities. Thus, a utility should capitalize a cost (as a regulatory asset) or recognize an obligation (as a regulatory liability) if it is probable that, through the ratemaking process, there will be a corresponding increase or decrease in future revenues.

**Q: What criteria does ASC 980 require for an expense to be capitalized?**

A: A utility may capitalize all or part of an incurred cost that would otherwise be charged to expense if both of the following criteria are met: (1) it is probable that future revenues will result from inclusion of that cost in allowable costs for ratemaking purposes; and (2) based on available evidence, the future revenues will be provided to permit recovery of the incurred cost rather than provide for expected levels of similar future costs.

**Q: How is an "incurred cost" defined under ASC 980?**

A: An incurred cost is defined in ASC 980-10-20 as "a cost arising from cash paid out or an obligation to pay for an acquired asset or service, a loss from any cause that has been sustained and has been or must be paid for." Also, as mentioned above, future recovery of the cost must be probable.

**Q: How is "probable" defined under GAAP?**

A: "Probable" is defined in ASC 450-20-20 as "likely to occur." This is a high test to meet. Evidence that a regulatory asset is probable, or likely to occur, include, among other things: (1) rate orders from the regulator specifically authorizing recovery of the costs in rates; and (2) previous orders from the regulator allowing recovery for substantially similar costs.

**Q: Are the service improvement project costs incurred in the preliminary project stage (Stage 1) and the postimplementation-operation stage (Stage 3) eligible for the treatment allowed under ASC 980?**

A: 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. The specific treatment allowed will depend on what recovery the Commission authorizes.

### C. OUCC's Position

**Q: What cost recovery treatment does Aqua Indiana propose for its service improvement project costs?**

A: As discussed above, Aqua Indiana proposes to capitalize these costs and earn a return on these costs through the inclusion of the unamortized balance in rate base. Aqua Indiana also proposes to recover these costs through amortization.

**Q: Do you agree with Aqua Indiana's proposal?**

A: No. While I agree Aqua Indiana should be allowed to recover the costs incurred in the preliminary project stage (Stage 1) and the postimplementation-operation stage (Stage 3) of its service improvement project, the unamortized balance of the costs of those two stages should not be capitalized and included in rate base. These costs did not result in utility assets. It is inappropriate for Aqua Indiana to earn a return on these expenditures. 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. Rather, we assert appropriate treatment is deferral and amortization of such costs.

**Q: Do you have any other concerns with Aqua Indiana's cost recovery proposal?**

A: Yes. Aqua Indiana has included both external and internal costs in the expenditures it proposes to recover. Table MAS-4 shows the detail of these costs for each phase as provided by Petitioner in response to OUCC Data Request No. 1-10 (OUCC Attachment MAS-1).

**Table MAS-4: Service Improvement Cost Detail**

| | Project Stage | Estimated Project Costs | External | Internal Labor |
|---|---|---|---|---|
| Stage 1 | Preliminary Project Stage | $ 425,000 | $ 318,750 | $ 106,250 |
| Stage 2 | Application Development Stage | 2,125,000 | 1,912,500 | 212,500 |
| Stage 3 | Postimplementation-operation Stage | 850,000 | 722,500 | 127,500 |
| | | $ 3,400,000 | $ 2,953,750 | $ 446,250 |
| | Total Costs to be Capitalized | | $ 1,912,500 | |
| | Total Costs to be Deferred | | 1,041,250 | |
| | | | $ 2,953,750 | |

**Q: Does Aqua Indiana's request include any costs that are already being recovered in current rates?**

A: Yes. According to Petitioner's response to Data Request No. 1-10, $446,250 of the service improvement costs are for in-house labor. In-house labor is included in the corporate or parent company cost allocations included in the annual operating expenses being recovered through each Aqua Indiana district's revenue requirement. Including these costs in the service improvement project costs for recovery would result in double recovery of these costs. These costs should be excluded from any regulatory recovery as a project cost.

**Q: Did Petitioner incur additional labor costs to implement the service improvement project?**

A: No. In response to OUCC Data Request No. 2-12, Petitioner stated no additional employees were hired and that employees involved in the service improvement project conducted their work in addition to their normal workload (OUCC Attachment MA2). These employees were salaried and not eligible for overtime pay. No additional compensation was provided.

**Q: Please summarize your recommendations regarding recovery of service improvement project costs.**

A: In accordance with GAAP, I recommend Aqua Indiana be authorized to capitalize and include in rate base the $1,912,500 of external costs incurred during the application development stage. I recommend that all internal labor costs ($446,250) incurred on this project (all stages) 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. Finally, I recommend the $1,041,250 of external costs incurred during the

preliminary project stage and the postimplementation-operation stage be deferred and amortized over ten years. The unamortized balance of these costs should not be included in rate base and no return should be earned on these costs.

## IV. DEPRECIATION RATE

**Q: Aqua Indiana proposes to earn a return of its capitalized investment through depreciation expense. Do you agree with the proposed depreciation expense rate Aqua Indiana's witnesses indicated will apply?**

A: No. Although Aqua Indiana does not actually ask for the Commission to set the depreciation rate in this case, Aqua Indiana's witnesses indicated it would apply a ten percent depreciation rate during the life of the service improvement project. According to Mr. VerDouw, Aqua Indiana assumes the project costs will have a ten-year life and, thus, the depreciation rate will be 10% (VerDouw Direct at p. 20). This would be contrary to the Commission's practice and policy with respect to depreciation expense.

**Q: What depreciation rate does Aqua Indiana use for its regulated operations?**

A: Aqua Indiana uses the Commission's composite depreciation rates for each of its regulated water and wastewater utilities. For water utilities with water treatment plant, the composite rate is 2.0%. For wastewater utilities with sewage treatment plant, the composite rate is 2.5%.

**Q: Why does Aqua Indiana consider the Commission's composite depreciation rate does not apply to the service improvement project?**

A: In response to OUCC Data Request No. 2-22, Petitioner indicated it considered the service improvement project to be a "one-off" from other asset classes and, as such,

does not feel a composite depreciation rate is appropriate. No further evidence or explanation was provided. (See Attachment MAS-3.)

**Q: Do you accept Aqua Indiana's proposal to use a 10% depreciation rate for the service improvement project costs ultimately included in rate base?**

A: No. First of all, Aqua Indiana provided no support for the ten-year assumed life of the service improvement project. This rate is much shorter than the composite rate it has used for all of its other assets, which include both short-lived and long-lived assets. Moreover, the composite rate developed by the Commission takes into consideration short-lived assets, such as vehicles and computers, as well as long-lived assets, such as transmission mains. If these information technology assets are to be depreciated at a faster rate than the composite depreciation rate, then the rate applied to Aqua Indiana's remaining assets should be correspondingly reduced to adjust for this deviation from the composite rate. Finally, as demonstrated in the testimony of Aqua Indiana witness Brian K. Latham, Aqua Indiana has historically used its information technology assets much longer than ten years and, therefore, even if a shorter depreciation period than the composite rate were to be approved, it should be longer than the ten years proposed by Petitioner.

**Q: What do you recommend regarding the appropriate depreciation rate for the service improvement project costs?**

A: For the reasons stated above, the service improvement project costs ultimately included in rate base should be depreciated using the Commission's composite depreciation rate until such time as the Commission has approved a depreciation study Aqua has submitted for all of its utility assets supporting the use of a different depreciation rate.

## V. ALLOWANCE FOR FUNDS USED DURING CONSTRUCTION

### A. Petitioner's Proposal

**Q: What are the rules regarding the capitalization of AFUDC?**

A: The National Association of Regulatory Utility Commissioners ("NARUC") Uniform System of Accounts contemplates that, unless the Commission otherwise orders, the capitalization of AFUDC (both debt and equity) shall terminate on the date the project is placed in service. Similarly, GAAP allows the capitalization of interest expense until an asset is placed in service.

**Q: What is Aqua Indiana's request in this Cause with respect to AFUDC?**

A: Aqua Indiana requests authority to modify its accounting procedures to allow it to continue to capitalize AFUDC at a rate equal to the weighted cost of capital using the current capital structure and the cost of common equity utilized by the Commission in its last rate case until the dates of Commission rate orders for each of the Company's regulated districts including the project fully in Aqua Indiana's rate base. More specifically, Aqua Indiana requests the Commission authorize it to --

- Record the debt component of post-in-service AFUDC as a regulatory asset in Account 186 - Miscellaneous Deferred Debits;
- Recognize the equity component of post-in-service AFUDC as an off-balance sheet regulatory asset;
- Amortize these regulatory assets as a recoverable expense for ratemaking purposes over a ten-year period commencing on the dates of the respective rate orders including the service improvement project costs in rate base; and
- Include the unamortized portion of these regulatory assets in Aqua Indiana's rate base and allow it to earn a return.

**Q: Why is Aqua Indiana requesting this authority?**

A: Mr. VerDouw stated this request is "necessary because of the magnitude of these projects." Mr. VerDouw asserted 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 these assets in the Company's rate base." Mr. VerDouw added "This accounting proposal is also necessary to assist Aqua Indiana in attracting permanent capital on reasonable terms." (See VerDouw Direct at 22.)

**Q: What post-in-service AFUDC rate does Aqua Indiana propose?**

A: Aqua Indiana proposes to use its weighted cost of debt as of the date the AFUDC is recorded and the pre-tax cost of equity authorized in the most recent rate order for each of Aqua Indiana's twelve regulated operating districts. Petitioner's Exhibit GMV-6 shows the estimated weighted average cost of capital calculation as of December 31, 2021, reflecting a weighted cost of debt of 1.91% and a pre-tax weighted cost of equity of 6.62%, for a total weighted cost of capital of 8.53%.

**B. <u>OUCC's Position</u>**

**Q: Do you agree Aqua Indiana should be granted its request with respect to AFUDC?**

A: Not entirely. I agree that absent continued accrual of post-in-service *debt* AFUDC, some earnings erosion could occur. However, I do not agree that the same is true for failing to recover post-in-service *equity* AFUDC. While the debt component of post-in-service AFUDC creates additional expenses for Aqua Indiana after the

service improvement project is placed in service, the equity component does not, which I discuss below.

**Q: What is the income statement effect of recording AFUDC?**

A: The entry to record AFUDC is a debit to utility plant in service with a corresponding credit to an interest expense account, which is reflected below-the-line.[3] The debt portion of AFUDC offsets interest expense, and the net effect is a reduction to interest expense reflected on the income statement. However, the equity portion of AFUDC does not have a corresponding offset and the effect of recording equity AFUDC is the *creation* of income on a utility's income statement, not *preservation* of income.

**Q: Is the "loss" of this equity AFUDC income the same thing as "earnings erosion"?**

A: No. Earnings erosion can occur when interest expense is recorded after a project has been placed into service but before project is included in the determination of a utility's rates. There are no corresponding expenses related to equity AFUDC and, therefore, no earnings erosion occurs. As mentioned above, recording equity AFUDC creates below-the-line income for a utility.

**Q: Have other water or wastewater utilities been given authority to record an equity component of post-in-service AFUDC in prior cases before this Commission?**

A: No. While Indiana American Water Company ("IAWC") had requested authority to record post-in-service equity AFUDC, these cases were settled with IAWC

[3] A utility income statement is typically divided into an "above-the-line" and "below-the-line" format, with utility operating results presented above-the-line and nonutility operations and interest charges presented below-the-line.

withdrawing its request for post-in-service equity AFUDC. I am unaware of any cases where the Commission has authorized the recovery of post-in-service equity AFUDC for a water or wastewater utility.

**Q: Has the Commission allowed non-water/wastewater utilities to record an equity component of post-in-service AFUDC?**

A: Yes. Mr. VerDouw notes this treatment for non-water/wastewater utilities in his testimony. (See VerDouw Direct at 25 and 26.) Historically, the treatment of financing costs incurred during construction is different for energy utilities for two reasons: (1) the lengthy construction periods involved, lasting several years in some cases, and (2) the large capital expenditures involved in electric construction projects, which can be billions of dollars. For these reasons, the Commission has allowed energy utilities more favorable treatment for its financing costs.

**Q: What are some of the options allowed energy utilities to recover their financing costs?**

A: One option allowed is to include construction work in progress in rate base or in a capital tracker and begin earning a return on this investment prior to the project being placed in service. When this option is chosen, no AFUDC is recorded by the utility as it is unnecessary. Another option afforded to energy utilities is the ability to record post-in-service equity AFUDC. But, as I stated above, I am unaware of any water or wastewater utilities being allowed to record post-in service AFUDC in this jurisdiction.

**Q: Do you agree with Petitioner's assertion that the earnings erosion that would occur if it were denied post-in-service equity AFDUC is material enough in this case to warrant a deviation from the Commission's long-standing practice of not allowing this authority for water and wastewater utilities?**

A: No. Petitioner argues that the length of time spent on developing and implementing the service improvement project, as well as the costs incurred on the project, are justifications for requesting the Commission abandon its long-standing practice to deny the authorization of a post-in-service equity AFUDC component. The service improvement project is simply not in the same category as the large, complicated energy construction projects for which the Commission has allowed this treatment in Cause No. 45052 discussed by Mr. VerDouw on page 28 of his testimony. The projects in that case were estimated to cost nearly $1.0 billion and were being constructed over approximately 5 years. Further, the projects were either non-discretionary costs to comply with EPA requirements or costs related to the utility's integrated resource plan. Finally, the Commission denied the utility's request for the majority of the costs requested in that Cause.

Essential Utilities has a considerable amount of discretion over both the length of time spent on the service improvement project as well as the timing of when the project would go into service, as well as the costs expended on the project; discretion that Vectren South did not have over its project in Cause No. 45052. Further, the size of this project and the costs incurred are a direct result of Essential Utilities' delay in dealing with its outdated information technology systems. These reasons do not support the extraordinary relief requested. Deviation from the Commission's long-standing practice is not justified.

**Q: Do you have any other concerns with Petitioner's request?**

A: Yes. According to Petitioner's Exhibit GMV-7, all the service improvement project costs were incurred as of January 2022. If all project costs have truly been incurred as of January 2022, which Petitioner's own case-in-chief contradicts,[4] then any delay in rate base treatment of these costs is entirely at Petitioner's discretion and any "earnings erosion" is of its own design. On the other hand, if all project costs have not been incurred as of January 2022, then the calculations of earnings erosion due to post-in-service AFDUC are overstated as a portion of the AFDUC can still be capitalized until the rest of the project costs are incurred and the remainder of the project is placed in service. But once the project is fully in service, the same issue remains – any delay in seeking inclusion of these costs in rate base is entirely under Petitioner's control and of its own design.

**Q: Does GAAP address the recovery of the equity portion of post-in-service AFUDC?**

A: Yes. ASC 980 allows an incurred cost to be capitalized as a regulatory asset. An "incurred cost" is defined as "a cost arising from cash paid out or an obligation to pay for an acquired asset or service, a loss from any cause that has been sustained and has been or must be paid for." However, an equity return (or an allowance for earnings on shareholders' investment) is not an incurred cost that would otherwise be charged to expense. (See Accounting for Public Utilities, Section 12.02, page

[4] See Mr. Latham's testimony where he discusses the implementation of Phase One of the service improvement project, implying there are subsequent phases (Latham direct at 7.) See also Petitioner's response to OUCC Data Request No. 2-10, which indicates that 32% ($45,738,044 / $143,080,087) of budgeted costs remain to be spent as of 3/31/2022 (OUCC Attachment MAS-1.).

12-5.) As the equity portion of post-in-service AFUDC does not qualify as an incurred cost, these costs are not eligible for the alternative treatment provided under ASC 980. Therefore, no equity AFDUC may be recorded once an asset has been placed in service. (See OUCC Attachment MAS-4.)

**Q: Do you consider that Aqua Indiana qualifies for authority to record post-in-service equity AFUDC"**

A: No. I do not believe the amount of costs incurred or the construction period rise to the level that special treatment for equity AFUDC is warranted. Further, I do not believe GAAP allows the continued capitalization of equity AFUDC once an asset is placed in service.

**Q: What do you recommend regarding recovery of post-in-service AFUDC?**

A: I recommend Aqua Indiana be allowed to continue to capitalize debt AFUDC but not the equity portion.

### C. Additional Concerns

**Q: Do you have any other concerns regarding Petitioner's request for post-in-service AFUDC?**

A: Yes. I disagree with Aqua Indian's use of a pre-tax equity AFUDC rate when capitalizing AFUDC during construction. I also believe the Commission should not permit recovery of AFUDC to continue indefinitely in light of Aqua's historic infrequency of rate cases.

1. **Pre-Tax Equity Rate**

**Q: Is Aqua Indiana using a pre-tax equity rate to record AFUDC?**

A: Yes. Based on Aqua Indiana's response to OUCC Data Request no. 2-21, a 6.47% equity rate as used to record AFUDC on the service improvement project (OUCC Attachment MAS-5). This compares to the 6.67% pre-tax weighted cost of equity and the 4.88% post-tax weighted cost of equity reflected in Petitioner's Exhibit GMV-6. Based on this comparison, it appears Aqua Indiana is using a pre-tax equity rate to record equity AFUDC.

**Q: Is the use of a pre-tax equity rate appropriate when capitalizing AFUDC?**

A: No. There is no need to gross-up the authorized equity rate to account for taxes and fees. Any income "created" by recording equity AFDUC is not taxable for income tax purposes and represents a permanent difference between book and tax. Because there are no taxes to be paid, there is no need to record additional equity AFUDC to cover these non-existent taxes and other expenses.

**Q: What do you recommend regarding the appropriate equity AFUDC rate to be used by Petitioner?**

A: I recommend 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. If the Commission allows post-in-service equity AFUDC, I recommend that Petitioner also be precluded from grossing-up equity AFUDC rates and be required to use the weighted after-tax cost of equity as approved.

2. **Termination of Authorized Recovery of AFUDC**

**Q: Please explain your concerns in light of the infrequency of Aqua Indiana's rate case filings.**

A: Aqua Indiana does not file rate cases very often for its Indiana districts. I note that Aqua Indiana has owned its South Haven wastewater utility since 2008 (stock purchase) and last filed a rate case in 2010 (Cause No. 43974), eleven years ago. Similarly, Heir Industries (Cause No. 43949-U) and Consumers Water (Cause No. 43962-U) also filed their last rate cases in 2010, eleven years ago. Wymberly last filed a rate case in 2006, fifteen years ago. If Aqua Indiana maintains this rate case frequency, based on the calculations presented in Petitioner's Exhibit GMV-7, the amount of post-in-service AFUDC recorded for some of its districts could equal or exceed the service improvement project costs recorded to rate base.[5]

**Q: What do you recommend?**

A: I recommend the Commission limit the time period during which Aqua Indiana is allowed to recover post-in-service AFUDC to no more than three years after the date the service improvement project goes into service in order to limit the burden imposed on rate payers for any cost recovery authorized by the Commission to address "earnings erosion."

[5] According to Petitioner's Exhibit GMV-7, annual post-in-service AFUDC is $214,752 ($17,986 x 12 months) or 8.33% of service improvement costs ($214,752 / $2,517,593). Therefore, a delay of approximately 12 years would result in doubling the costs Aqua Indiana seeks to earn a recovery on and of.

## VI. DEFERRED DEPRECIATION

### D. Petitioner's Proposal

**Q: What is Aqua Indiana requesting in this Cause?**

A: Aqua Indiana is requesting authority to modify its accounting procedures to allow it to defer depreciation expense until the service improvement project costs are included in rate base.

**Q: Why is Aqua Indiana requesting this authority?**

A: Mr. VerDouw states this request is "necessary because of the magnitude of these projects." Mr. VerDouw further states: "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 these assets in the Company's rate base." Mr. VerDouw also claims "This accounting proposal is also necessary to assist Aqua Indiana in attracting permanent capital on reasonable terms." (See VerDouw Direct at 22.)

**Q: What depreciation rate is Aqua Indiana proposing to use?**

A: Aqua Indiana proposes to use a 10% annual depreciation rate.

**Q: What amount of deferred deprecation does Aqua Indiana estimate will be recorded?**

A: According to Petitioner's Exhibit GMV-7, Aqua Indiana estimates $618,910 of deferred deprecation through June 2024.

### E. OUCC Position

**Q: Do you agree with Aqua Indiana's request in this case?**

A: I agree that absent deferral of depreciation expense prior to the inclusion of service improvement project in rate base, some earnings erosion could occur, but I do not agree with the depreciation rate proposed by Aqua Indiana. I also believe the Commission should not permit recovery of deferred deprecation to continue indefinitely in light of Aqua's historic infrequency of rate cases.

**Q: What do you recommend regarding deferral of depreciation expense?**

A: I recommend Aqua Indiana be allowed to defer depreciation expense, but the Commission limit the time period during which Aqua Indiana is allowed this recovery to no more than three years after the date the service improvement project goes into service. I also recommend the depreciation rate used should be the composite depreciation rate currently authorized for each Aqua Indiana district.

## VII. OTHER MATTERS

**Q: Do you have any other concerns with Aqua's request?**

A: Yes. Notwithstanding all recommendations above, the OUCC questions whether a project such as Aqua's is an appropriate subject for pre-approval under IC 8-1-2-23. The expenditures addressed by IC 8-1-2-23 are for "an extension, construction, addition or improvement of its plant and equipment." It is unclear how the acquisition and development of the service improvement project software qualifies as "an extension, construction, addition or improvement of its plant and equipment." Although software improvement appears to be necessary, of its costs are not the kind of expenditure contemplated for pre-approval under this statue.

In terms of authorizing an expenditure, the statute speaks in terms of physical plant:

> Sec. 23. The commission shall keep itself informed of all new construction, extensions and additions to the property of such public utility and shall prescribe the necessary forms, regulations and instructions to the officers and employees of such public utilities for the keeping of construction accounts which shall clearly distinguish all operating expenses and new construction. 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 in any proceeding involving the rates of such utility, consider the property acquired by such expenditures as 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. (Emphasis added.)

**Q: Do any other Indiana statutes speak to this issue?**

A: Yes. IC 8-1-2-6, which establishes what kind of assets may be included in rate base, provides that such values must be based on tangible assets, that is such plant that has value by virtue of construction costs. Therefore, even though GAAP indicates that some of these project costs may be capitalized, IC 8-1-2-6 indicates only tangible assets may be included in rate base. Software developed by a parent and licensed to the utility does not fit the definition of a tangible asset that has value by reason of construction costs.

**Q: What is the alternative to filing under Ind. Code § 8-1-2-23?**

A: Petitioner is in the best position to determine an alternative proposal that will allow it to recover its operating expense or meet its costs of developing and sharing in the cost of developing its parent's software applications. It may be that such an expense

should be treated in a manner similar to periodic maintenance that does not involve Aqua earning a return on an intangible asset. In any case, the fact that the development of software may not fall easily into other mechanisms of recovery does not make it an allowed rate base item under Indiana law.

## VIII. RECOMMENDATIONS

**Q: Please summarize your recommendations.**

A: I recommend the Commission reject Aqua Indiana's request for pre-approval of its service improvement project as this project is not an appropriate subject for pre-approval under IC 8-1-2-23.

However, if the Commission finds that pre-approval of this project is nonetheless appropriate, I recommend the following:

(1) The Commission grant authorization for Aqua Indiana to capitalize (rate base) $1,912,500 of external costs incurred during the application development stage.

(2) The Commission grant authorization for Aqua Indiana to defer (non-rate base) $1,041,250 of external costs incurred during the preliminary project stage and the postimplementation-operation stage. I also recommend the Commission grant authorization for Aqua Indiana to amortize these deferred costs over ten years.

(3) The Commission disallow recovery of $446,250 of internal labor costs.

(4) The Commission grant authorization for Aqua Indiana to defer depreciation expense on its service improvement project for no more than three years after the project is placed in service.

(5) The Commission deny authorization for Aqua Indiana to record post-in-service equity AFUDC.

(6) The Commission grant authorization for Aqua Indiana to record post-in-service debt AFUDC for its service improvement project for nor more than three years after the project is placed in service.

Finally, I recommend the Commission disallow the gross-up of equity AFUDC rates and require Aqua Indiana to use the weighted after-tax cost of equity as approved in its most recent rate case.

**Q: Does this conclude your testimony?**

A: Yes.

# APPENDIX A - QUALIFICATIONS

**Q: Please describe your educational background and experience.**

A: I graduated from the University of Houston at Clear Lake City in August 1982 with a Bachelor of Science degree in Accounting. From 1982 to 1985, I held the position of Gas Pipeline Accountant at Seagull Energy in Houston, Texas. From 1985 to 2001, I worked for Enron in various positions of increasing responsibility and authority. I began in gas pipeline accounting, was promoted to a position in financial reporting and planning, for both the gas pipeline group and the international group, and finally was promoted to a position providing accounting support for infrastructure projects in Central and South America. In 2002, I moved to Indiana, where I held non-utility accounting positions in Indianapolis. In August 2003, I accepted my current position with the OUCC. In 2011, I was promoted to Senior Utility Analyst. In 2018, I was promoted to Chief Technical Advisor.

Since joining the OUCC I have attended the National Association of Regulatory Utility Commissioners ("NARUC") Eastern Utility Rate School in Clearwater Beach, Florida, and the Institute of Public Utilities' Advanced Regulatory Studies Program in East Lansing, Michigan. I have also attended several American Water Works Association and Indiana Rural Water Association conferences as well as the National Association of Utility Consumer Advocates ("NASUCA") Water Committee Forums. I have participated in the NASUCA Water Committee and the NASUCA Tax and Accounting Committee, including serving as chair for the Tax and Accounting Committee from 2016 – 2021. In June

2022, I received the NASUCA Service Award in recognition of my contributions to the organization.

**Q: Have you previously testified before the Indiana Utility Regulatory Commission?**

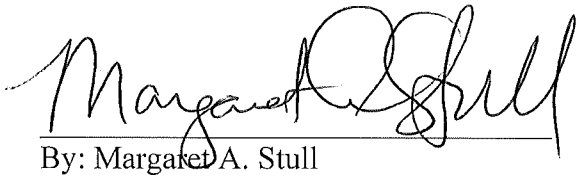
A: Yes. I have testified before the Commission as an accounting witness in various causes involving water, wastewater, electric, and gas utilities.

**Q: Have you held any professional licenses?**

A: Yes. I passed the CPA exam in 1984 and was licensed as a CPA in the State of Texas until I moved to Indiana in 2002.

**AFFIRMATION**

I affirm the representations I made in the foregoing testimony are true to the best of my knowledge, information, and belief.



By: Margaret A. Stull
Cause No. 45675
Office of Utility Consumer Counselor (OUCC)

Date: June 17, 2022

**OUCC Data Request 1-10**

**DATA REQUEST**
**Aqua Indiana, Inc.**

**Cause No. 45675**

**Information Requested:**

Please identify the costs related to each of the following stages of completion and what percentage of the costs was billed by a consultant versus in-house labor.

a. Stage 1. Preliminary stage which includes determining performance requirements, conducting supplier demonstrations, evaluating technology, and selection of a vendor;
b. Stage 2. Application development stage which includes coding, hardware installation, and testing;
c. Stage 3. Post-implementation stage which includes training and maintenance costs?

**Information Provided:**

Based on Aqua Indiana's budgeted and allocated SIP cost in the amount of $3,400,000 (which includes $2,517,593 to be allocated to Aqua Indiana Regulated Operations and $882,407 to be allocated to Aqua Indiana Unregulated Operations), the Company states the following:

Stage 1 (Prep) – Total cost of this stage is $425,000 (12.5% of total SIP costs). Approximately 75% of this cost is consultant time and 25% is in-house labor.

Stage 2 (Build) – Total cost of this stage is $2,125,000 (62.5% of total SIP costs). Approximately 90% of this cost is consultant time and 10% is in-house labor.

Stage 3 – Total cost of this stage is $850,000 (25% of total SIP costs). Approximately 85% of this cost is consultant time and 15% is in-house labor.

**SIP Spend as of 3/31/2022**



**Aqua Indiana, Inc.**
**Response to OUCC Data Request Number 2-10**
**Annual SIP Spend by Year, Broken Down Between Water and Gas, as of March 31, 2022**

| Project # | SIP Project Name | 2020 Actuals | | 2021 Actuals | | 2022 Actuals (through 3/31/2022) | | 2023 Actuals | | Total Spend | Original Budget | Left to Spend |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Water | Gas | Water | Gas | Water | Gas | Water | Gas | | | |
| 1 | SAP S4/HANA Projects | $ 22,455,585 | $ 3,236,741 | $ 24,986,401 | $ 1,128,253 | $ 5,840,512 | $ 366,328 | $ - | $ - | $ 58,013,820 | $ 89,192,312 | $ 31,178,492 |
| 2 | PowerPlan | - | | 725,258 | 4,060,881 | 405,026 | - | - | - | 5,191,165 | - | (5,191,165) |
| 3 | EAM Restructuring | 13,006 | 3,615,555 | 166,798 | 187,072 | - | - | - | - | 3,982,431 | 2,168,000 | (1,814,431) |
| 4 | Analytics/DW/Rate Case Reporting | - | | - | - | - | - | - | - | - | 3,250,000 | 3,250,000 |
| 5 | Document Management (Perceptive Content) | - | | - | - | - | - | - | - | - | 2,168,000 | 2,168,000 |
| 6 | Work Management Scheduling | - | | - | - | - | - | - | - | - | 3,794,000 | 3,794,000 |
| 7 | PM/CU/WO/PO/INV FIORI Dev | - | | 813 | 3,074,073 | 62,234 | 1,246,928 | - | - | 4,384,048 | 3,900,000 | (484,048) |
| 8 | Vertical Asset Management Lifecyle System (VALMS) | - | | 1,149 | 671,485 | - | 141,810 | - | - | 814,444 | - | (814,444) |
| 9 | Human Resource Integration (Workday) | - | | - | 420,208 | - | 4,245 | - | - | 424,453 | 3,956,600 | 3,532,147 |
| 10 | Customer Portal (SEW) | - | | - | - | - | - | - | - | - | 1,897,000 | 1,897,000 |
| 11 | Time Tracking Integration (Workforce) & ADP | 429,406 | | 2,769,855 | - | 457,933 | - | - | - | 3,657,194 | 1,951,091 | (1,706,103) |
| 12 | Supplier Portal-Contract Mgmt | | 17,136 | - | 243,378 | - | 2,633 | - | - | 263,147 | 1,354,000 | 1,090,853 |
| 13 | Network | 531,099 | 460,071 | 336,680 | 252,733 | 42,036 | - | - | - | 1,622,619 | 26,098,084 | 24,475,465 |
| 14 | Data Center Consol | 316,219 | | 4,913,414 | 1,891,657 | 364,230 | 14,726 | - | - | 7,500,246 | - | (7,500,246) |
| 15 | Powerplan Buildout (included in PP project above) | - | | - | - | - | - | - | - | - | - | - |
| 16 | Cyber | 670,091 | 877,412 | 312,874 | 2,713,875 | 169,776 | 506,713 | - | - | 5,250,741 | - | (5,250,741) |
| 17 | Water contact center | 102,753 | | 2,446,773 | - | 364,651 | - | - | - | 2,914,177 | - | (2,914,177) |
| 18 | Office Systems | | 1,055,170 | 286,149 | 382,970 | 108,536 | 29,795 | - | - | 1,862,620 | - | (1,862,620) |
| 19 | Other (Service Desk/Sharepoint/etc.) | - | | - | - | 5,013 | - | - | - | 5,013 | - | (5,013) |
| 20 | Qlik Enhancements | - | | 1,167,859 | - | 125,083 | - | - | - | 1,292,942 | 1,355,000 | 62,058 |
| 21 | Intranet Rebuild | - | | 80,168 | - | 57,693 | 25,122 | - | - | 162,983 | 1,626,000 | 1,463,017 |
| 22 | Enterprise Video Solution | - | | - | - | - | - | - | - | - | 100,000 | 100,000 |
| 23 | Meter Data Management | - | | - | - | - | - | - | - | - | 270,000 | 270,000 |
| | Company Total | $ 24,518,159 | $ 9,262,085 | $ 38,194,191 | $ 15,026,585 | $ 8,002,723 | $ 2,338,300 | $ - | $ - | $ 97,342,043 | $ 143,080,087 | $ 45,738,044 |

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Annual Total | $ 33,780,244 | | $ 53,220,776 | | $ 10,341,023 | | $ - | | $ 97,342,043 | | |

**OUCC Data Request 2-12**

**DATA REQUEST**
**Aqua Indiana, Inc.**

**Cause No. 45675**

**Information Requested:**

In response to OUCC Data Request No. 1-15, Petitioner stated "The workload to implement SIP for subsidiary or affiliate employees that are involved in SIP implementation is in addition to their existing workload."

a. Were these employees full-time employees? Please explain.
b. For these employees, please explain whether implementation of SIP displaced other job responsibilities of these employees. If so, please explain whether and how such other job responsibilities were met.
c. Were these employees paid over-time or other additional compensation in exchange for time spent implementing SIP. Please explain.
d. If paid overtime or additional compensation, how much overtime or other additional compensation costs are included in the budgeted SIP costs?
e. Please provide any communication provided to these employees explaining their responsibilities with respect to SIP implementation.
f. Please provide any communication provided to these employees explaining how responsibilities with respect to SIP implementation is to be coordinated with other job responsibilities.
g. Were additional employees hired to work on SIP implementation? Please explain. If so, please provide the job descriptions of such employees. Please provide the advertisement for the position.

**Objection**:

Petitioner objects to the extent that providing communications with employees is overly broad, unduly burdensome, and not relevant. Petitioner further objects to the extent this request would encompass Essential subsidiaries other than Aqua Indiana, and as such, are not relevant to this proceeding. Subject to and without waiving such objections, Petitioner provides the following response.

**Information Provided:**

Full-time employees were utilized for the SIP implementation. No additional employees were hired. Employees involved in the SIP conducted their SIP work in addition to the normal workload. These employees are salaried; therefore, they are exempt from overtime pay. No additional compensation was provided for employees utilized for the SIP implementation. Communications, both written and oral, provided to these employees explaining their responsibilities with respect to SIP implementation are continuous throughout this type of project and providing all communications is overly broad, unduly burdensome, and irrelevant.

**OUCC Data Request 2-23**

**DATA REQUEST**
**Aqua Indiana, Inc.**

**Cause No. 45675**

**Information Requested:**

Did Essential Utilities increase number of full-time equivalents as a result of implementation of SIP? If so, please explain and identify the workforce changes that were made to implement SIP.

**Information Provided:**

No. Please see the response to OUCC Data Request 2-12 for further information.

**OUCC Data Request 2-24**

**DATA REQUEST**
**Aqua Indiana, Inc.**

**Cause No. 45675**

**Information Requested:**

Did payroll costs for Essential Utilities increase due to SIP? If so, please quantify and explain how. If so, identify whether any increased payroll costs were incurred at the corporate level or at the subsidiary level.

**Information Provided:**

No. Please see the response to OUCC Data Request 2-12 for further information.

**OUCC Data Request 2-22**

**DATA REQUEST**
**Aqua Indiana, Inc.**

**Cause No. 45675**

**Information Requested:**

Aqua Indiana uses the Commission's composite depreciation rate. Why would the Commission's composite depreciation rate not apply to SIP?

**Information Provided:**

Aqua Indiana considers the Service Improvement Project to be a "one-off" from other asset classes and, as such, does not feel a composite depreciation rate is appropriate.

statements for public utilities and other companies with regulated operations that meet criteria set forth in the standard.

Some believe that this effort accomplished little because ASC 980 generally follows the basic tenets of the Addendum. Other observers, including the authors, believe this effort was beneficial for two reasons. First, it focused attention on the *type* of regulation required for there to be a departure from GAAP as applied to industry in general. Second, it provided clearer direction on when rate decisions provide a basis for special accounting treatment. Even with this clarification, however, there is still room for accounting judgment in application of ASC 980.

Although ASC 980 provided clearer direction and responded to various concerns, subsequently developed regulatory actions required additional guidance. The FASB, its Emerging Issues Task Force (EITF) and the SEC's staff have issued guidance and a number of other pronouncements that have amended, interpreted, supplemented or affected the provisions of ASC 980. The most significant of these pronouncements and SEC staff guidance today are:

(1) ASC 980-360 (SFAS 90, *Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs*)

(2) ASC 980-340 (SFAS 92, *Regulated Enterprises—Accounting for Phase-In Plans*)

(3) ASC 980-20 (SFAS 101, *Regulated Enterprises—Accounting for the Discontinuation of Application of SFAS Statement No. 71*)

(4) ASC 360-10 (SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*)

(5) ASC 980-715 (EITF Issue 93-4, *Accounting for Regulatory Assets*)

(6) ASC 980-20 (EITF Issue 97-4, *Deregulation of the Pricing of Electricity—Issues Related to the Application of FASB Statements No. 71 and 101*)

(7) Correspondence from the SEC staff (May 29, 1998) addressing impairment computations

## § 12.02 Accounting for the Effects of Certain Types of Regulation

ASC 980 applies to general purpose external financial statements of utilities that have regulated operations if all of the following criteria, as set forth in ASC 980-10-15-2 (SFAS 71, paragraph 5), are met:

(1) "The entity's rates for regulated services or products provided to its customers are established by or are subject to approval by an independent, third-party regulator or by its own governing board empowered by statute or contract to establish rates that bind customers.

(2) The regulated rates are designed to recover the specific entity's costs of providing the regulated services or products. This criterion is intended to be applied to the substance of the regulation, rather than its form. If an entity's regulated rates are based on the costs of a group of entities and the entity is

so large in relation to the group of entities that its costs are, in essence, the group's costs, the regulation would meet this criterion for that entity.

(3) In view of the demand for the regulated services or products and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover the entity's costs can be charged to and collected from customers. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs. This last criterion is not intended as a requirement that the entity earn a fair return on shareholders' investment under all conditions; an entity can earn less than a fair return for many reasons unrelated to the ability to bill and collect rates that will recover allowable costs. For example, mild weather might reduce demand for energy utility services. In that case, rates that were expected to recover an entity's allowable costs might not do so. The resulting decreased earnings do not demonstrate an inability to charge and collect rates that would recover the entity's costs; rather, they demonstrate the uncertainty inherent in estimating weather conditions. This requirement must also be evaluated in light of the circumstances. For example, if the entity has an exclusive franchise to provide regulated services or products in an area and competition from other services or products is minimal, there is usually a reasonable expectation that it will continue to meet the other criteria. Exclusive franchises can be revoked, but they seldom are. If the entity has no exclusive franchise but has made the very large capital investment required to provide either the regulated services or products or an acceptable substitute, future competition also may be unlikely."

The application of ASC 980 is not an elective option. If the above criteria are met by a utility, ASC 980 should be applied. If some of a utility's operations are regulated and meet the above criteria, ASC 980 should be applied to only that portion. When rates that are indexed to general cost indices rather than the specific entity costs for extended periods of time (e.g., longer than 5 years) without resetting the utility's rates based on its specific costs, the scope criteria above generally would not be met.

In general, the type of regulation covered by ASC 980 permits rates to be set at levels intended to recover the estimated costs of providing regulated services or products, including the cost of capital. The cost of capital consists of interest and a provision for earnings on shareholders' investments.

GASB Codification Section Ut5.112 provides that state and local proprietary activities and enterprise funds that meet the scope criteria of ASC 980-10-15-2 may apply ASC 980 and related pronouncements that were issued on or before November 30, 1989. Amendments of FASB pronouncements related to regulated operations issued after that date can be applied as long as they do not conflict with or contradict other GASB pronouncements (GASB Statement 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, Summary).

ASC 980 recognizes that a principal consideration introduced by rate regulation is

the cause-and-effect relationship of costs and revenues—an economic dimension that, in some circumstances, should affect accounting for rate-regulated utilities. Thus, a utility should capitalize a cost (as a regulatory asset) or recognize an obligation (as a regulatory liability) if it is probable that, through the ratemaking process, there will be a corresponding increase or decrease in future revenues.

ASC 980-340-25-1 (SFAS 71, paragraph 9) states that the "rate actions of a regulator can provide reasonable assurance of the existence of an asset. An entity shall capitalize all or part of an incurred cost that would otherwise be charged to expense if both of the following criteria are met:

(1) It is probable (as defined in ASC 450) that future revenues in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for ratemaking purposes.

(2) Based on available evidence, the future revenue will be provided to permit recovery of the incurred cost rather than to provide for expected levels of similar future costs. If the revenue will be provided through an automatic rate-adjustment clause, this criterion requires that the regulator's intent clearly be to permit recovery of the previously incurred cost."

An incurred cost is defined in ASC 980-10-20 (SFAS 71) as "a cost arising from cash paid out or obligation to pay for an acquired asset or service, a loss from any cause that has been sustained and must be paid for." Equity return (or an allowance for earnings on shareholders' investment), however, is not an incurred cost that would otherwise be charged to expense.

ASC 980 requires a rate-regulated utility to capitalize as a regulatory asset an incurred cost that would otherwise be charged to expense if future recovery in rates is probable. Probable is defined in ASC 450-20-25-1 (SFAS 5, *Accounting for Contingencies*) as "likely to occur," which is a high test to meet. If a regulatory asset is recorded, but in a subsequent accounting period no longer meets the above criteria, the cost should then be charged to earnings. Thus, ASC 980-340-25-1 has a continuous probability standard to be met at each balance sheet date in order for a regulatory asset to remain recorded. Evidence that a regulatory asset is probable of recovery is a matter of professional judgment based on the facts and circumstances of each case. Utility management's positive representation is required that each regulatory asset is probable of recovery in future rates. Evidence that could support future recovery and corroborates utility management's representation includes:

(1) Rate orders from the regulator specifically authorizing recovery of the costs in rates.

(2) Previous rate orders from the regulator allowing recovery for substantially similar costs.

(3) Written approval from the regulator approving future recovery in rates.

(4) Analysis of recoverability from internal or external legal counsel.

It should be noted that under the FERC accounting guidelines, regulatory assets are

recorded for regulatory reporting purposes if the incurred cost is "expected" to be authorized for future rate recovery-a lower standard than under GAAP.

An incurred cost that does not meet the asset recognition criteria in ASC 980-340-25-1 at the date the cost is incurred should be recognized as a regulatory asset when it meets those criteria at a later date. Under ASC 980-340-35-1 (SFAS 71, paragraph 10, as amended), previously disallowed costs that are subsequently allowed by a regulator to be recovered should be recorded as an asset, consistent with the classification that would have resulted had the cost initially been included in allowable costs. This provision applies to disallowed plant costs and regulatory assets created by actions of a regulator.

ASC 980-340-35-1 also concludes that a regulator can reduce or eliminate the value of an asset. If a regulator disallows recovery of part of a regulatory asset, that part of the asset is to be written off. Although special rules apply to disallowances of a recently completed utility plant, any write-down in the value of other assets is limited to the amount appropriate under GAAP, as applied by enterprises in general. Regulatory assets should be amortized over future periods consistent with the related increase in customer revenues.

ASC 980-405-25-1 (SFAS 71, paragraph 11) also recognizes that the rate actions of a regulator can impose a liability on a utility, usually to its customers. The following are examples of ways in which regulatory liabilities can be imposed:

(1) A regulator can require refunds to customers.

(2) A regulator can provide current recovery in rates for costs not yet incurred.

(3) A regulator can require that a gain be given to customers by amortizing amounts to reduce future rates.

ASC 980-405-40-1 (SFAS 71, paragraph 12) notes that "actions of a regulator can eliminate a liability only if the liability was imposed by actions of the regulator." Thus, a rate-regulated enterprise's balance sheet should include all liabilities and obligations that an enterprise in general would record under GAAP, such as for capital leases, pension plans, compensated absences and income taxes. The SEC's staff, in Topic 10F, *Utility Companies—Presentation of Liabilities for Environmental Costs*, clarified that such liabilities should not be offset with corresponding regulatory assets. Regulatory liabilities should be amortized over future periods consistent with the related decrease in customer revenues.

ASC 980 also sets forth specific standards for a few isolated accounting issues. ASC 980-835-25-1 (SFAS 71, paragraph 15) allows the capitalization of an AFUDC, if the regulator prescribes this method, rather than capitalizing interest on funds used during construction in accordance with the guidelines provided in ASC 835-20 (SFAS 34, *Capitalization of Interest Cost*). This includes capitalization of the equity component of AFUDC. The FASB provided further guidance on the capitalization of AFUDC and on the capitalization of an equity return in nonconstruction circumstances in ASC 980-360 (SFAS 90) and ASC 980-340 (SFAS 92). ASC 980-340-25-5 through 25-6 (SFAS 92, paragraph 9) does not permit capitalization of an equity return in

general-purpose financial statements other than during construction or as part of accounting for phase-in plans and plant abandonments. The amount of any equity return capitalized for ratemaking purposes but not capitalized for financial reporting is required to be disclosed.

ASC 980-810-45-1 (SFAS 71, paragraph 16) provides that intercompany profits on sales to regulated affiliates should not be eliminated in general-purpose financial statements if the sales price to the regulated enterprise is reasonable and it is probable that future revenues allowed in the ratemaking process will provide for the recovery of such amounts.

ASC 980 (SFAS 71, paragraph 18) originally did not allow the reporting of flowed-through impacts of current income taxes on the balance sheet but, instead, required disclosure in the notes to the financial statements of the net cumulative amounts of income tax timing differences for which an enterprise did not provide deferred income taxes. However, ASC 980 (SFAS 71, paragraph 18) was modified in February 1992 by ASC 740 (SFAS 109, *Accounting for Income Taxes*) (See § 17.02 [3]). ASC 740 requires the "liability" method of accounting for deferred income taxes. Because accumulated deferred income taxes are viewed as a liability under ASC 740, an income tax liability must be recorded for *all* temporary differences. As noted above, however, ASC 980 recognizes that rate actions of regulators can create assets. (In other words, if a regulator defers a cost for future recovery and the future recovery through rates is probable, these costs are to be capitalized as regulatory assets rather than expensed.) Assuming that a utility has concluded that future recovery through rates is probable, it would record a corresponding regulatory asset or liability in recognition of future recovery of income taxes related to temporary differences not provided in current rates.

ASC 980-605-50-1 (SFAS 71, paragraph 19) addresses the issue of accounting for significant refunds of revenue recognized in prior periods. ASC 980 conforms to the requirements of ASC 250-10 (SFAS 16, *Prior Period Adjustments*), which precludes recording these refunds as restatements of prior years. However, adjustments to prior interim periods of the current fiscal year for utility refunds is one of the restatement exceptions contained in ASC 250-10-45-25 (SFAS 16, paragraph 13) if certain criteria are met:

(1) The effect is material.

(2) All or part of the refund is directly related to activities of specific prior interim periods.

(3) The amount could not be reasonably estimated prior to the current interim period.

ASC 980 calls for disclosure of the effects on net income for the period in which the refund is recognized and also requires disclosure of the years in which the related revenue was previously recognized.

ASC 980 does not contain a specific standard on the issue of lease accounting. However, accounting for lease transactions is a good example of the application of the

conclusion reached in ASC 980-405-40-1 (i.e., a regulator can eliminate only a liability it imposes). ASC 980-840-45-2 (Appendix B to SFAS 71) addresses accounting for leases directly and concludes that the regulator cannot affect the classification of a lease liability on the balance sheet. Therefore, when a lease is capitalizable under ASC 840-10 (SFAS 13, *Accounting for Leases*) but is treated as an operating lease for ratemaking purposes, the balance sheet should still reflect the capitalizable asset and the related lease liability, but differences in expense recognition between ratemaking and GAAP should generally be reflected in the financial statements as regulatory assets or liabilities.

Other situations and their treatments based on the general standards of ASC 980 are described in Subtopics within ASC 980. Every accountant involved in utility regulation and the preparation or audit of utility financial statements should read these Subtopics.

In summary, ASC 980 provides a clearer definition of the types of regulation to which it is to be applied and more detailed explanations of the types of transactions covered, as well as appropriately provides for the recognition of the effects of various regulatory actions.

## § 12.03 Accounting for Abandonments and Disallowances of Plant Costs

On December 31, 1986, the FASB issued ASC 980-360 (SFAS 90), which amended SFAS 71 to specify the accounting for plant abandonments and disallowances of certain cost recovery of recently completed plants.

### [1] Accounting Requirements

#### [a] Abandonments

ASC 980-360 concluded that when a plant is abandoned, its character changes. The abandoned plant is no longer a physical asset capable of generating revenue; it is essentially a monetary asset resembling a long-term receivable. When the abandonment of an asset under construction or an operating asset becomes probable, that asset must be removed from construction work in progress (CWIP) or plant in service. The recoverable costs of the abandoned asset then must be recorded as a new asset (presumably a regulatory asset). ASC 980-360 provides the following guidelines for determining the value of that new asset.

(1) If the regulator is likely to provide a *full return* on the recoverable costs, the new asset value should equal the original carrying value of the abandoned asset less any disallowed costs. (The FERC has generally adopted a policy of fifty-fifty sharing between ratepayers and shareholders of the cost of abandoned construction projects, with a full return being provided on the portion recoverable from ratepayers. In this case, the abandonment asset would equal 50 percent of the construction costs at the time of the abandonment.)

(2) If the regulator is likely to provide a *partial return* or *no return,* the new asset value should equal the present value of the future revenues expected to be provided to recover the allowable cost of the abandoned plant and any return

**OUCC Data Request 2-21**

**DATA REQUEST**
**Aqua Indiana, Inc.**

**Cause No. 45675**

**Information Requested:**

Please provide the AFUDC rate or rates used to calculate AFUDC for the SIP, including the debt rate and equity rate.

**Information Provided:**

The debt rate is 1.97%.
The equity rate is 6.47%.