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**

<u>OUCC'S PROPOSED ORDER</u>

The Office of Utility Consumer Counselor ("OUCC"), by counsel, hereby submits its proposed order and proposed order workpaper.

Respectfully submitted

INDIANA OFFICE OF UTILITY CONSUMER COUNSELOR

Daniel M. Le Vay, Attorney No. 22184-49
Deputy Consumer Counselor
OFFICE OF UTILITY CONSUMER COUNSELOR
115 W. Washington St., Suite 1500 South
Indianapolis, IN 46204
Email: dlevay@oucc.in.gov
infomgt@oucc.in.gov

CERTIFICATE OF SERVICE

This is to certify that a copy of the ***OUCC's Proposed Order and Proposed Order Workpaper*** has been served upon the following counsel of record in the captioned proceeding by electronic service on November 4, 2022.

Mark R. Alson
ICE MILLER LLP
One American Square, Suite 2900
Indianapolis, Indiana 46282
Email: mark.alson@icemiller.com

Daniel M. Le Vay
Deputy Consumer Counselor

INDIANA OFFICE OF UTILITY CONSUMER COUNSELOR
115 West Washington Street
Suite 1500 South
Indianapolis, IN 46204
infomgt@oucc.in.gov
317/232-2494 – Phone
317/232-5923 – Facsimile

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ORDER OF THE COMMISSION

Presiding Officers:
Stefanie Krevda, Commissioner
Jennifer Schuster, Administrative Law Judge

On February 11, 2022, Aqua Indiana, Inc. ("Aqua Indiana" 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 will be included 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 Witnesses VerDouw and Hanley.

On August 19, 2022, Aqua Indiana submitted a Response to the Commission's August 18, 2022, Docket Entry Requesting Information.

The Commission set this matter for an evidentiary hearing to be held at 9:30 a.m. on August 22, 2022, in Room 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 evidence 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 public hearing for this Cause was given by the Commission as required by law. Aqua Indiana is a public utility pursuant to Ind. Code §§ 8-1-2-1 et seq. and is subject to the jurisdiction of the Commission in the manner and to the extent provided by the laws of the State of Indiana. Accordingly, 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. Aqua Indiana currently provides water and wastewater utility service to over 30,000 customers in fourteen counties through the State of Indiana. Petitioner operates as twelve 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 service improvement project, or "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 for 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 to record post-in-service AFUDC and deferred depreciation as a regulatory asset, to be amortized over ten years.

4. Evidence Presented.

a. Petitioner's Case-in-Chief.

Mr. VerDouw testified in support of Aqua Indiana's SIP, or "Service Improvement Project," which refers to the development and system-wide deployment of new, integrated IT systems and the process of implementing the new systems in a manner that properly aligns business processes with the increased capabilities of the new systems. Pet. Exh. No. 1, p. 6. Mr. VerDouw testified that SIP is a significant company-wide project of Essential Utilities, and the subsidiary operating companies, such as Aqua Indiana, will receive many of the SIP benefits. *Id.* at 7.

Mr. VerDouw and Mr. Hanley both testified that many of the current software systems Aqua Indiana uses in their daily operations are out of date and not adequate to support Aqua's growing customer and business requirements. *Id.* at 7-8; Pet. Exh. No. 2, p. 3. 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. Pet. Exh. No. 2 at 3. He testified that Aqua Indiana's aging software, much of which dates back 25 or more years, creates many issues for Aqua. *Id.* at 5. 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. *Id.* Mr. Hanley testified that this creates a heavy burden on Aqua to troubleshoot alone and to hire personnel who are able to use the accounting software. *Id.* He testified that supplementary software is needed to fill in the gaps in operations that the primary software is unable to complete. *Id.* at 5-6. Mr. Hanley testified that all these issues with Aqua's current software continue to escalate with time. *Id.* at 6. Mr. VerDouw and Mr. Hanley both testified that SIP will create a new business software platform for Aqua America and Aqua Indiana, allowing the Company to eventually retire or eliminate dependences on old, unsupported software. Pet. Exh. No. 1 at 8; Pet. Exh. No. 2 at 6.

Mr. Hanley testified that several business projects and software will be implemented as Phase One of SIP implementation in the first quarter of 2022, with the majority of the projects and software having been implemented as of January 1, 2022. Pet. Exh. No. 2 at 7. He stated that the software included in Phase One include: SAP S/4HANA Enterprise Resource Planning, WorkForce (Time Track), ADP (Payroll), Enterprise Asset Management Restructuring, PowerPlan (Asset Accounting), Budget Planning and Considerations, Compliance Wire (Training), Construction (P6), and Contract Management. *Id.* at 7-9. 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. *Id.* at 9. He stated that some of the hardware/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. *Id.* at 10-11. Mr. VerDouw provided a comprehensive SIP overview, including the need for SIP, estimated spend, and why investment in SIP makes sense for all Essential operating entities, included as Attachment GMV-2.

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. Pet. Exh. No. 1 at 8-9. Mr. VerDouw testified that Peoples Natural Gas ("PNG"), an Essential Utilities' subsidiary, has been using SAP since 2010 and PNG's experience with SAP has shown to significantly improve PNG's customer service numbers, and using SAP for SIP will also improve network reliability, backup, disaster recovery, security, and other benefits. *Id.* at 9-11.

Mr. VerDouw testified that the total planned cost for the SIP capital additions is $143.1 million to be incurred during 2020-2023. *Id.* at 12. 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. *Id.* at 12-13. Mr. VerDouw testified that the Aqua America SIP capital cost allocation of $110.7 million are being allocated 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, and that Aqua Indiana's allocation of SIP is 3.02%, or $3.4 million. *Id.* at 13. 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. Pet. Exh. No. 1, Attachment GMV-4, Line 19.

Mr. VerDouw testified that this amount is reasonably needed to be invested because Essential 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. *Id.* at 13. Mr. VerDouw explained that 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 much more to obtain similar integrated software if it were to complete this project on its own. *Id.*at 14. Mr. VerDouw further explained that the software is needed because the majority of Aqua Indiana's software has met or has exceeded its useful life. *Id.* Mr. VerDouw testified 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. *Id.* at 14-15.

Mr. VerDouw described that the SIP has progressed within budget and on time. *Id.* at 15. He stated that the major pieces of the SIP implementation went live on January 1, 2022, as planned. *Id.* Pet. Exh. No. 1, Attachment GMV-2, page 7 provides a timeline of software implementation dates for the SIP.

Mr. VerDouw testified that AFUDC is being accrued as part of the SIP. *Id.* at 18. He stated that SIP assets are being placed in service upon their completion. *Id.* Mr. VerDouw testified that SIP projects have been placed in service in January 2022, with other projects being placed in service later in 2022 and in 2023. *Id.*; Pet. Exh. No. 1, Attachment GMV-2. Mr. VerDouw 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 twelve regulated utility districts. *Id.* Mr. VerDouw testified that the recording of depreciation begins on the in-service date and continues over the anticipated life of the plant. *Id.* at 19. He testified that the depreciation rate that will be used for SIP assets is 10%, or 1/10 of the asset life per year for ten years. *Id*. at 20

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. *Id.* at 19. He testified that the cost is recognized during the construction period with the inclusion of AFUDC as a component of construction costs. *Id.*

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—unless the requested authorization is obtained, Aqua Indiana will suffer a negative impact on its earning during the period between the in-service date of the SIP assets and the issuance of rate orders including the assets in the Company's rate base and including depreciation on its recoverable operating expenses. *Id.* at 22. 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. *Id.*

Pet. Exh. No. 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. *Id.* at 23. 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. *Id.*

Pet. Exh. No. 1, Attachment GMV-5 demonstrates that the SIP project represents a 3.82% increase over the current total Company net original cost rate base, 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 Minimum Standard Filing Requirements. *Id.*

Pet. Exh. No. 1, Attachment GMV-6 provides the calculation Aqua Indiana is proposed to use for the Company's 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 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%. *Id.* at 23-24.

Pet. Exh. No. 1, Attachment GMV-7 is a schedule with earnings erosion with and without the requested accounting treatment; showing 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. On examination at the hearing, Mr. VerDouw would reiterate and explain the marked amount of $38,875 per month of earnings erosion that Aqua Indiana experiences as a result of the SIP asset not yet being in service. Tr. p. 87, l. 9-25, p. 88, l. 1-17. Mr. VerDouw testified that if Aqua Indiana filed rate cases for all its twelve districts so that rate orders were received from the Commission for all twelve Aqua districts as of 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. Pet. Exh. No. 1, Attachment GMV-7, Line 38.

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 the Company's pre-tax earnings, as shown in Pet. Exh. No. 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 project, with its assets to be placed in service for Aqua Indiana representing 3.82% of the total original cost rate base for Aqua Indiana. *Id.* at 27. 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. *Id.* Mr. VerDouw testified that post-in-service AFUDC-equity is routinely authorized and approved for electric and gas utilities. *Id.* Mr. VerDouw quoted OUCC Witness Wes Blakely in Cause No. 45052, who stated that post-in-service accounting treatment for AFUDC and depreciation can help utilities with their financial statements by delaying the impact of expenses until the rates are in effect. *Id.* at 28. Mr. VerDouw explained that this rationale applies to all utilities – water/wastewater, gas, or electric. *Id*. at 29.

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

b. OUCC's Evidence.

OUCC Witness Margaret Stull, is employed by the OUCC as a Chief Technical Advisor. Ms. Stull stated Aqua Indiana's requests 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 and approval of post-in-service AFUDC and deferral of depreciation.[1] Ms. Stull posited that software applications are not construction projects as contemplated by the preapproval statute or tangible property as contemplated by the Indiana fair value statute. Ms. Stull recommended any capitalization of software development costs be based on GAAP guidance. Ms. Stull identified double recovery embedded in Aqua Indiana's proposal. She recommended any authorized depreciation expense should be based on the Commission's composite depreciation rates and any authorization to defer depreciation expense or for post-in-service AFUDC be limited in time. Stull, Pub. Exhibit 1 at p. 1- 2.

Ms. Stull testified GAAP provides guidance for the measurement and recognition of computer software costs through the Financial Accounting Standards Board's Accounting Standards Codification ("ASC"), Subsection 350-40. She added ASC 350 provides guidance on intangibles in general, while ASC 350-40 provides guidance on the appropriate treatment of costs incurred to develop internal-use software. Stull, Pub. Exhibit 1 at p. 6. Ms. Stull explained that to determine whether a software cost should be capitalized or expensed, ASC 350-40 separates internal-use software costs into three development stages: (1) the preliminary project stage, (2) the

[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.

application development stage, and (3) the postimplementation-operation stage (ASC 350-40-25-1 through ASC 350-40-25-17). She testified GAAP establishes that only costs for the second stage -- application development -- should be capitalized. She stated GAAP requires the costs incurred in the other two stages be expensed as they are incurred. Stull, Pub. Exhibit 1 at p. 7. Her Table MAS-3 showed the estimated costs for each development stage.

Table MAS-3: <u>Project Costs by Development Stage</u>

	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%

Ms. Stull testified that 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. Stull, Pub. Exhibit 1 at p. 7. Ms. Stull testified that 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.) Stull, Pub. Exhibit 1 at p. 8. Ms. Stull reiterated that according to ASC 350-40-25-1, costs incurred during the preliminary stage should be expensed as they are incurred. Id.

Ms. Stull explained that the application development stage activities include planning, designing, developing, testing, and deployment. Ms. Stull noted 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. Stull, Pub. Exhibit 1 at p. 8. Ms. Stull said that 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.) Id. Ms. Stull testified that according to ASC 350-40-25-1, costs incurred during the application development stage should be capitalized. Id.

Ms. Stull explained that 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. Stull, Pub. Exhibit 1 at p. 9. Ms. Stull noted that Aqua Indiana's response to discovery indicated its request includes $850,000 (25%) in postimplementation-operation stage costs. (See OUCC Attachment MAS-1.) Id. Ms. Stull explained that according to ASC 350-40-25-1, costs incurred during the post-implementation-operation stage should be expensed as incurred. Id.

Ms. Stull testified that 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 (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. She added that 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, and thus, a utility should capitalize a cost (as a regulatory asset) or recognize an obligation (as a regulatory liability) if it is <u>probable</u> that, through the ratemaking process, there will be a corresponding increase or decrease in future revenues. Stull, Pub. Exhibit 1 at p. 10

Ms. Stull explained that a utility may capitalize all or part of an incurred cost that would otherwise be charged to expense if (1) it is probable that future revenues will result from inclusion of that cost in allowable costs for ratemaking purposes <u>and</u> (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. Stull, Pub. Exhibit 1 at p. 10 Ms. Stull explained that 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. Stull, Pub. Exhibit 1 at p. 10

Ms. Stull explained that under GAAP, "probable" is defined in ASC 450-20-20 as "likely to occur." Ms. Stull testified "probable" is a high test to meet. She said that 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. Stull, Pub. Exhibit 1 at p. 10. Ms. Stull noted that if the Commission issues an order that specifically authorizes Aqua Indiana to recover in rates the service improvement project costs incurred in the preliminary project stage (Stage 1) and the postimplementation-operation stage (Stage 3), 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. Stull, Pub. Exhibit 1 at p. 11

Ms. Stull disagreed the unamortized balance of the costs of those two stages should be capitalized and included in rate base. She explained that those costs did not result in utility assets, and it is inappropriate for Aqua Indiana to earn a return on those expenditures. She clarified that she does not propose Aqua Indiana may not recover those costs, only that it should not be permitted to earn a return on those costs. She said the appropriate treatment for those costs is deferral and amortization. Stull, Pub. Exhibit 1 at p. 11

Ms. Stull expressed concern that 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). Stull, Pub. Exhibit 1 at p. 11-12

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	

Ms. Stull explained that Petitioner's response to discovery indicated that $446,250 of the service improvement costs are for in-house labor. She added that 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. She explained that including these costs in the service improvement project costs for recovery would result in double recovery of these costs, and therefore, those costs should be excluded from any regulatory recovery as a project cost. Stull, Pub. Exhibit 1 at p. 12

Ms. Stull testified that Petitioner did not incur additional labor costs to implement the service improvement project. She noted Petitioner responded to discovery that 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). As these employees were salaried and not eligible for overtime pay, no additional compensation was provided. Stull, Pub. Exhibit 1 at p. 12-13

Ms. Stull concluded that in accordance with GAAP, Aqua Indiana should be authorized to capitalize and include in rate base only the $1,912,500 of external costs incurred during the application development stage. She recommended that all in-house labor costs ($446,250) incurred on this project (all stages) should 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, she recommended 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. Stull, Pub. Exhibit 1 at p. 13

Depreciation Rate. Ms. Stull testified she did not agree with the depreciation rate Aqua Indiana planned to apply. Ms. Stull explained that, 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 (10%) depreciation rate during the life of the service improvement project. (See VerDouw Direct at p. 20). Ms. Stull testified this would be contrary to the Commission's practice and policy with respect to depreciation expense. Stull, Pub. Exhibit 1 at p. 13-14. Ms. Stull explained that for its regulated operations, 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%, and for wastewater utilities with sewage treatment plant, the composite rate is 2.5%. Stull, Pub. Exhibit 1 at p. 14.

Ms. Stull did not accept Aqua Indiana's proposal to use a 10% depreciation rate for the service improvement project costs included in rate base noting that Aqua Indiana provided no support for the ten-year assumed life of the service improvement project, which is much shorter than the composite rate it has used for all its other assets, which include both short-lived and long-lived assets. Stull, Pub. Exhibit 1 at p. 14. She added that 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. She explained that 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, she noted 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. Stull, Pub. Exhibit 1 at p. 14-15. Ms. Stull reiterated her position that 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 its utility assets supporting the use of a different depreciation rate. Stull, Pub. Exhibit 1 at p. 15.

Post in Service AFUDC. Ms. Stull responded to Aqua's request for Allowance for Funds Used During Construction by noting first that 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. She stated that GAAP also contemplates the capitalization of interest expense until an asset is placed in service. Stull, Pub. Exhibit 1 at p. 15. She noted, nonetheless, that 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 authorized by the Commission in Aqua's last rate case. This would continue until the dates of Commission rate orders for each of the Company's regulated districts that would include the project in Aqua Indiana's rate base. More specifically, Aqua Indiana requests the Commission authorize it to (1) record the debt component of post-in-service AFUDC as a regulatory asset in Account 186 - Miscellaneous Deferred Debits; (2) recognize the equity component of post-in-service AFUDC as an off-balance sheet regulatory asset; (3) 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 (4) include the unamortized portion of these regulatory assets in Aqua Indiana's rate base and allow it to earn a return. Stull, Pub. Exhibit 1 at p. 15-16.

Ms. Stull said Petitioner's witness Mr. VerDouw asserted this request is "necessary because of the magnitude of these projects." She said 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." Stull, Pub. Exhibit 1 at p. 16. Ms. Stull explained that 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%. Id.

Ms. Stull acknowledged that the debt component of post-in-service AFUDC creates additional expenses, and she agreed that, absent continued accrual of post-in-service *debt* AFUDC, some earnings erosion could occur. However, she did not agree that earnings erosion will occur from its not recovering post-in-service *equity* AFUDC because there is no expense associated with the equity portion. Stull, Pub. Exhibit 1 at p. 17. Ms. Stull explained that 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.[2] The debt portion of AFUDC offsets interest expense, and the net effect is a reduction to interest expense reflected on the income statement. She explained, however, that 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. Id.

Ms. Stull insisted that the "loss" of this equity AFUDC income is not "earnings erosion" She explained that earnings erosion can occur when interest expense is recorded after a project has been placed into service but before a project is included in the determination of a utility's rates, but 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. Stull, Pub. Exhibit 1 at p. 17-18

Looking at previous cases before the IURC, Ms. Stull noted that no water or wastewater utilities have been given authority by the Commission to record an *equity* component of post-in-service AFUDC. She noted that, while Indiana American Water Company ("IAWC") had requested authority to record post-in-service equity AFUDC, these cases were settled with IAWC withdrawing its request for post-in-service equity AFUDC. Ms. Stull acknowledged there have been some instances where the Commission allowed non-water or non-wastewater utilities to record post-in-service AFUDC on equity, she was unaware of any cases where the Commission has authorized the recovery of post-in-service equity AFUDC for a water or wastewater utility. Stull, Pub. Exhibit 1 at p. 18. Ms. Stull explained that historically, the treatment of financing costs incurred during construction has been different for energy utilities because of (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. Id.

She noted one option allowed to energy utilities to recover their financing costs 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. Ms. Stull explained that when this option is chosen, no AFUDC is recorded by the utility as it is unnecessary. Another option afforded to

[2] 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.

energy utilities is the ability to record post-in-service equity AFUDC. Ms. Stull repeated that she was unaware of any water or wastewater utilities being allowed to record post-in service AFUDC in Indiana. Stull, Pub. Exhibit 1 at p. 18 -99

Ms. Stull disagreed that if Aqua were denied post-in-service equity AFDUC it would result in sufficiently material earnings erosion to justify a deviation from the Commission's long-standing practice of not allowing this authority for water and wastewater utilities. Ms. Stull testified 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. Ms. Stull noted 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, Ms. Stull noted the Commission denied the utility's request for most of the costs requested in that Cause. Stull, Pub. Exhibit 1 at p. 19.

Ms. Stull pointed out that Essential Utilities has considerable discretion over 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. Ms. Stull concluded such reasons do not support the extraordinary relief requested, and deviation from the Commission's long-standing practice is not justified. Stull, Pub. Exhibit 1 at p. 19 -20

Ms. Stull also expressed concern that, according to Petitioner's Exhibit GMV-7, all the service improvement project costs were incurred as of January 2022. She pointed out that if all project costs have truly been incurred as of January 2022, which Petitioner's own case-in-chief contradicts,[3] 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. Stull, Pub. Exhibit 1 at p. 20

Ms. Stull testified that GAAP addresses the recovery of the equity portion of post-in-service AFUDC. ASC 980 allows an incurred cost to be capitalized as a regulatory asset. She noted that under ASC 980 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." She noted that 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 12-5.) She explained that as the equity

[3] 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.).

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.) Stull, Pub. Exhibit 1 at p. 20 -21

Ms. Stull did not consider the amount of SIP costs incurred or the construction period rose to the level that special treatment for equity AFUDC is warranted. Further, she did not agree that GAAP allows the continued capitalization of equity AFUDC once an asset is placed in service. Stull, Pub. Exhibit 1 at p. 21. Ms. Stull concluded that Aqua Indiana be allowed to capitalize debt AFUDC but not the equity portion. Id. Ms. Stull also disagreed with Aqua Indian's use of a pre-tax equity AFUDC rate when capitalizing AFUDC during construction. She also believed the Commission should not permit recovery of AFUDC to continue indefinitely in light of Aqua's historic infrequency of rate cases. Id.

Pre-tax equity rate. Ms. Stull pointed out that Aqua Indiana used a 6.47% equity rate to record AFUDC on the service improvement project, compared 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, she asserted that Aqua Indiana is using a pre-tax equity rate to record equity AFUDC. Stull, Pub. Exhibit 1 at p. 22.

Ms. Stull testified 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. She reasoned that, 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. Stull, Pub. Exhibit 1 at p. 22. Ms. Stull 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, Petitioner should also be precluded from grossing-up equity AFUDC rates and be required to use the weighted after-tax cost of equity as approved. Id.

Ms. Stull noted that Aqua Indiana does not file rate cases very often for its Indiana districts. She noted 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. Ms. Stull suggested that 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.[4]

Ms. Stull recommended the Commission limit the time 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 to limit the burden imposed on rate payers for any cost recovery authorized by the Commission to address "earnings erosion." Stull, Pub. Exhibit 1 at p. 23.

[4] 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).

Deferred Depreciation. Ms. Stull pointed out that Aqua Indiana is also requesting authority to modify its accounting procedures to allow it to defer $618,910 of deprecation through June 2024 at a rate of 10% until the service improvement project costs are included in rate base. Ms. Stull pointed out that Mr. VerDouw said 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." She noted Mr. VerDouw also claimed, "This accounting proposal is also necessary to assist Aqua Indiana in attracting permanent capital on reasonable terms." (See VerDouw Direct at 22.)

Ms. Stull testified that she agreed that absent deferral of depreciation expense prior to the inclusion of service improvement project in rate base, some earnings erosion could occur, but she did not agree with the depreciation rate proposed by Aqua Indiana. She added that the Commission should not permit recovery of deferred deprecation to continue indefinitely in light of Aqua's historic infrequency of rate cases.

Ms. Stull recommended Aqua Indiana be allowed to defer depreciation expense, but at the composite depreciation rate currently authorized for each Aqua Indiana district. Ms. Stull also recommended the Commission limit the time during which Aqua Indiana is allowed this recovery to no more than three years after the date the service improvement project goes into service.

Criteria for Preapproval under IC 8-1-2-23. Notwithstanding all recommendations above, Ms. Stull questioned whether a project such as Aqua's is an appropriate subject for pre-approval under IC 8-1-2-23. She noted that the expenditures addressed by IC 8-1-2-23 are for "an extension, construction, addition or improvement of its plant and equipment," and she stated 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, Ms. Stull testified its costs are not the kind of expenditure contemplated for pre-approval under this statue. She noted that 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.)

Ms. Stull referred to IC 8-1-2-6, which establishes what kind of assets may be included in rate base and provides that such values must be based on tangible assets, that is such plant that has value by virtue of construction costs. She added that 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. Stull, Pub. Exhibit 1 at p. 26.

Ms. Stull testified that 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. She suggested such an expense may 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. Stull, Pub. Exhibit 1 at p. 26.

Ms. Stull repeated her recommendation that the Commission reject Aqua Indiana's request for pre-approval of its service improvement project because it is not an appropriate subject for pre-approval under IC 8-1-2-23. She added that if, however, the Commission finds that pre-approval of this project is nonetheless appropriate, the Commission should (1) allow Petitioner to capitalize only $1,912,500 of external costs incurred during the application development stage; (2) authorize deferred recovery (non-rate base) of $1,041,250 of external costs incurred during the preliminary project stage and the postimplementation-operation stage; (3) authorize Aqua Indiana to amortize these deferred costs over ten years; (4) disallow recovery of $446,250 of in-house labor costs; (5) authorize Aqua Indiana to defer depreciation expense on its service improvement project for no more than three years after the project has been placed in service; (6) deny authorization for Aqua Indiana to record post-in-service *equity* AFUDC; and (7) authorize Aqua Indiana to record post-in-service *debt* AFUDC for its service improvement project for no more than three years after the project has been placed in service. Ms. Stull concluded her testimony by recommending 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. Stull, Pub. Exhibit 1 at p. 27.

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. Pet. Exh. No. 1-R, p. 7.

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, and Aqua Indiana had provided a supplemental data request response regarding this issue that clarified, stating that "[t]he SIP also includes such items as software, new servers, data storage, data back-up platform, network routers/switches and call center phone technology." *Id.* at 10; Pet. Exh. No. 1, Attachment GMV-1-R. Mr. VerDouw testified that these other costs were included in each stage of SIP development, beyond consultant and in-house labor. *Id.* Mr. VerDouw additionally testified 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 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. *Id.* at 11-12.

Clarifying this point, in response to 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 regulated districts would be \$71,393.20. Pet. Ex. 3. However, none of the labor included in any current Aqua Indiana rate recovery would include any in-house 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. *Id*.

In response to Ms. Stull's recommendation that not all SIP costs should be capitalized, Mr. VerDouw stated 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. *Id.* at 14. He testified 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. *Id.*

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 does currently use the standard composite depreciation rates, Aqua Indiana considers the SIP asset a "one-off" from those rates and determined that a ten-year depreciation rate would be more appropriate. Id. at 15. 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. *Id.* at 15-16. 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. *Id.* at 16.

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 deprecation rate as a compromise. *Id.* at 16-17. He testified that if a 15-year depreciation rate was approved, Aqua Indiana would be agreeable to a 15-year amortization of any post-in-service AFUDC and deferred deprecation approved in this Cause. *Id.* at 17.

Regarding Ms. Stull's recommendation that post-in-service AFUDC equity be denied, Mr. VerDouw testified that her reasons for denying the AFUDC equity are not applicable in this case. *Id.* at 18. 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. *Id.* 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—SIP is a large dollar project for Aqua Indiana and is a project that is being completed over a period of many years. *Id.*

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. *Id.* at 20. 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 and as such limit rate increases that are passed on to its consumers. *Id.*

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 twelve 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. *Id.* at 21.

5. <u>Discussion and Findings</u>.

Petitioner asks for preapproval of expenditures for the design, development, and implementation of SIP and associated assets and confirmation that approved SIP assets will be included in Petitioner's rate base in future rate cases once they have been placed in service; pursuant to IC 8-1-2-23, which provides:

> 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 <u>is</u> 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.

Pre-approval pursuant to IC8-1-2-23 is an alternative to a utility being required to provide competent evidence in its next rate case following completion of the relevant plant improvements that, in addition to the plant being placed in service and used, the plant is useful or otherwise reasonably necessary for the provision of utility service. Implicit in such a provision is that the expenditures being approved are the kind of plant that may be included in rate base pursuant to Indiana Code 8-1-2-6, the fair value statute, which states in pertinent part that:

> Except in a proceeding under IC 8-1-30, and except as provided in IC 8-1-30.3-5 and IC 8-1.5-2-6.1, all public utility valuations shall be based upon <u>tangible property</u>, that is, such property as has value by reason of construction costs, either in materials purchased or in assembling of materials into structures by the labor or (of) workers and the services of superintendents, including engineers, legal and court costs, accounting systems and transportation costs, and also including insurance and interest charges on capital accounts during the construction period. (emphasis added. IC 8-1-2-6(b).)

Mr. VerDouw testified that Aqua Indiana's SIP, or "Service Improvement Project," refers to the development and system-wide deployment of new, integrated IT systems and the process of implementing the new systems in a manner that properly aligns business processes with the increased capabilities of the new systems. *Petitioner's proposed order pp.2-3 citing Pet. Exh. No. 1, p. 6.* Petitioner's project as described is broad and it is difficult to discern from the evidence presented what aspects and the extent of the project, if any, that may properly be included in rate base in a manner consistent with Indiana Law and its requirements that rates be based on property that is tangible and has value by reason of construction costs. As we have discussed elsewhere in this order, for instance, expenditures in the "post-implementation operations" stage cannot logically be considered the construction of a tangible asset.

There seems to be little question that utilities need to have information technology and attendant physical assets. There has been no evidence provided in this case that suggests Aqua Indiana is an exception to this. Were the purpose of IC 8-1-2-23 to determine explicitly whether an operating expense should be considered reasonable and amortized over a reasonable period, Petitioner would likely have made its case. However, the question before us is whether the project as a whole should be included in rate base, and we are unable to find that the project *as a whole* qualifies for preapproval and inclusion in rate base. Yet it lies within our function to parse what portions of the project may be includable in rate base and what may be recovered through other means if and as appropriate.

a. <u>In-house Labor Costs Embedded in Rates.</u>

The OUCC noted that Aqua Indiana has included $446,250 of in-house labor costs in the expenditures it proposes to recover, and in-house labor is already 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, resulting in double recovery of these costs. As the OUCC noted, Petitioner indicated it did not incur additional labor costs to implement the service improvement project. Petitioner responded to discovery that 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). Further, these employees were salaried and not eligible for overtime pay so no additional compensation was provided. Stull, Pub. Exhibit 1 at p. 12-13

On page 10 of his rebuttal testimony, Mr. Verdouw stated that the in-house labor included in the SIP is much lower than the $446,250 Ms. Stull excluded. During cross-examination by Petitioner, Ms. Stull noted the OUCC had conducted discovery after Petitioner's rebuttal and determined that the estimate of what Petitioner would incur on in-house labor was just under $350,000. Hr. Tr. p.9. In fact, according to OUCC cross-examination exhibit CX-3, Petitioner's response to OUCC's DR 3-1, 3-3, and 3-4, Petitioner estimated a total in house labor of $342,045 (total) of which $253,274 would be attributed to Petitioner's regulated utilities.

The OUCC proposes approximately $342,045 (of which $253,274 is allocated to Aqua Indiana regulatory utilities) of in-house labor should be excluded from any regulatory recovery as a project cost. Removing in-house labor costs of $342,045 (of which $253,274 is attributed to Aqua Indiana's regulated utilities) results in $1,146,733 ($849,120 attributed to regulated utilities) of external costs incurred during the preliminary project stage and the postimplementation-operation stage be deferred and amortized over ten years. The OUCC asserted that to avoid double recovery, the unamortized balance of these costs should not be included in rate base and there should be no return on or return of these costs. Id. at p. 13

On August 18, 2022, the Commission issued a docket entry noting that Mr. VerDouw testified that total in-house labor is much lower than the $446,250 assumed by Ms. Stull. The Commission asked Petitioner to state the amount of in-house labor costs already allocated to Aqua Indiana and embedded in the rates of Aqua Indiana districts. Petitioner responded that based on its review of data, "the portion of Contracted Services – Management (Service Company costs) that is attributable specifically to in-house labor relative to Information System Services cannot be determined with precision." Petitioner indicated it endeavored to determine "an approximate total of Contracted Services – Management that is attributable specifically to in-house labor relative to Information System Services, a review of Contracted Services – Management costs included in the most recent rate case for Aqua Indiana's Aboite Wastewater Division, docketed as Cause No. 44752, and approved on January 18, 2017. Aqua Indiana indicated it used that proceeding to approximate the amount of <u>Information System Services labo</u>r that is embedded in the rates of all Aqua Indiana districts. Petitioner extrapolated that the total <u>Information System Services Labor</u> assumed to be embedded in the rates of all Aqua Indiana regulated districts would be $71,393.20. Petitioner then asserted that "None of the labor included in any current Aqua Indiana rate recovery would include any in-house 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."

Petitioner's conclusion is unsupported and contrary to a reasonable interpretation of this Commission's docket entry request. First, Petitioner's analysis is based on a piling of inferences, which are not justified or corroborated. Moreover, Petitioner only looked at the amount of Information System Services labor, not Aqua Indiana's total labor expense embedded in the rates of its several utilities. Information System Services in not the only department charging time to the SIP project. Moreover, the $342,045 ($253,274 attributed to regulated utilities) of estimated in-house labor represents costs incurred over a three-to-four-year period, while the $71,393.20 is an amount incurred over one year. Finally, and dispositively, Petitioner's response to discovery from the OUCC indicated Petitioner did not incur additional in-house labor costs to implement the service improvement project.

> 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. <u>No additional compensation was provided for employees utilized for the SIP implementation.</u> 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.
>
> Petitioner's Response to OUCC DR 2-12 (OUCC Attachment MA2) (emphasis added.)

Based on the foregoing, we find that Petitioner's asserted SIP in-house labor cost of $342,045 ($253,274 regulated) should be excluded from any costs Petitioner is authorized to recover in rates.

b. Capitalization of SIP Costs.

While Petitioner seeks to include $3.4 million of its share of the cost of the SIP in its rate base, OUCC witness Margaret Stull testified that according to GAAP's Financial Accounting Standards Board's Accounting Standards Codification ("ASC") only $1,911,222 ($1,415,200 to Petitioner's regulated utilities) may be capitalized. Ms. Stull indicated that, after removing the double recovery she identified with respect to internal labor, that would allow $849,120 to be recovered from the regulated utilities through amortization over a ten-year period. Ms. Stull testified that to determine whether a software cost should be capitalized or expensed, 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 postimplementation-operation stage (ASC 350-40-25-1 through ASC 350-40-25-17). She testified GAAP establishes that only costs for the second stage -- application development -- should be capitalized. She stated GAAP requires the costs incurred in the Preliminary Project Stage and the Postimp0lementation-operation stage should be expensed as they are incurred. Stull, Pub. Exhibit 1 at p. 7.

Ms. Stull testified that Aqua indicated $425,000 (12.5% of $3.4 million) are associated with the preliminary stage and $850,000 (25% of $3.4 million) are associated with the postimplementation-operation stage costs leaving $2,125,000 (62.5% of the $3.4 million) that may be capitalized as costs for tasks preformed in the application development stage. (See OUCC Attachment MAS-1.)

Ms. Stull testified that ASC 980 (formerly FAS #71) allows for exceptions to GAAP expense and capitalization guidelines 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 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, and 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. Ultimately, GAAP would not *guide* Petitioner to expense the costs as incurred associated with the preliminary and postimplementation-operation stages, if it was probable that this Commission would allow it to otherwise recover such expenses through rates.

The OUCC's witness stated that if the Commission issues an order that specifically authorizes Aqua Indiana to recover in rates the service improvement project costs incurred in the preliminary project stage (Stage 1) and the postimplementation-operation stage (Stage 3), 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 this Commission authorizes. Stull, Pub. Exhibit 1 at p. 11.

The OUCC maintained that the unamortized balance of the costs of those two stages should not be capitalized and included in rate base because those costs did not result in the creation of utility assets, and, therefore, it is inappropriate for Aqua Indiana to earn a return on those expenditures as rate base items. However, the OUCC did propose those costs be recovered through amortization.

We agree with this approach. Indiana is a fair value jurisdiction and we are guided by IC 8-1-2-6, which states in pertinent part that "Except in a proceeding under IC 8-1-30, and except as provided in IC 8-1-30.3-5 and IC 8-1.5-2-6.1, all public utility valuations shall be based upon tangible property, that is, such property as has value by reason of construction costs, either in materials purchased or in assembling of materials into structures by the labor or (of) workers and the services of superintendents, including engineers, legal and court costs, accounting systems and transportation costs, and also including insurance and interest charges on capital accounts during the construction period." This language establishes in relevant part here that, in order to be included in a utility's rate base, costs and expenses must ultimately result in used and useful tangible property. Petitioner's witness, Mr. VerDouw, who testified in support of Aqua Indiana's SIP, said the "Service Improvement Project" refers to the "development <u>and system-wide deployment</u> of new, integrated IT systems and <u>the process of implementing</u> the new systems in a manner that properly aligns business processes with the increased capabilities of the new systems." (emphasis added.) *Petitioner's proposed order pp.2-3 citing Pet. Exh. No. 1, p. 6.* Thus, the SIP is not simply a software system created by the effort of its external and internal efforts, it is also the identification of the need for the system on one end and the implementation of that system on the other.

In other regulatory contexts, the Commission has determined that the capitalization of costs should be tied to the actual development of the asset. In 1997 in Cause No. 40703, the Commission determined that the cost of comprehensive planning studies should be included in rate base because it represented a part of the cost of bringing Indiana American's property to its present state of efficiency, which is a component of the rate base pursuant to Ind. Code § 8-1-2-6. <u>See</u>, <u>L.S. Ayres & Co. v. Indianapolis Power & Light Co.</u>, 169 Ind. App. 652, 687-89, 351 N.E.2d 814, 837-38 (1976). Order, Cause No. 40703, p. 22. However, in its 2004 order in Cause No. 42520, the Commission found that Indiana American should not be permitted to include the cost of its comprehensive planning studies in rate base because it agreed that comprehensive planning studies and tank inspection reports are not components of construction and, therefore, should neither be capitalized nor accrue AFUDC. <u>In Re Indiana-Am. Water Co., Inc.</u>, 238 P.U.R.4th 428 (Nov. 18, 2004). Order, Cause No. 42520, p.19. In making this finding, the Commission acknowledged that these costs are 'engineering functions" that ultimately *lead* to capital projects, but that these engineering functions are used to evaluate what Petitioner's system may or may not need. Id. The Commission expressed the concept that comprehensive plans are for planning and a Preliminary Engineering Report ('PER') may be developed from this plan, but it is the PER that is part of the construction project. It noted that neither a comprehensive plan nor a tank inspection report is ever placed in service, and it considered it is unreasonable to suggest that AFUDC should accrue on planning tools that may identify the need to develop a project in the future. Id.

More recently, in its order in Cause 43680, the Commission declined to reverse the finding it made in its 2004 Rate Order in Cause No. 42520 noting that Indiana American's comprehensive planning studies contain engineering functions that lead to capital projects and contain maintenance functions to ensure reliable operations, but that Indiana American did not delineate those items in its comprehensive planning studies between the planning of capital projects and to maintenance functions. The Commission stated that "while Accounting Instruction 19 of the USOA is useful in guiding the Commission as to whether construction costs should be capitalized, based on the evidence presented, the Commission is unable to determine whether Indiana American's comprehensive planning studies should be capitalized at this time. "Petition of Indiana-Am. Water Co., Inc. for Auth. to Increase Its Rates & Charges for Water & Sewer Util. Serv., Cause No. 43680, 2010 WL 1806474 (Apr. 30, 2010), Order Cause No. 43680, pp. 114 – 115.

Finally, in Cause No. 43957, Petition of Twin Lakes Utilities, Inc. for Auth. to Increase Its Water & Sewer Rates & Charges & for Approval of A New Schedule of Rates & Charges Applicable Thereto, No. 43957, 2012 WL 641631 (Feb. 22, 2012) the Commission declined to include master planning studies in rate base because it did "not believe that master planning studies, or facility plans in this instance unrelated to construction work qualify as a capital cost under Instruction 19." Order, Petition of Twin Lakes Utilities, Inc. for Auth. to Increase Its Water & Sewer Rates & Charges & for Approval of A New Schedule of Rates & Charges Applicable Thereto, Cause No. 43957, p. 16 (Feb. 22, 2012). In support of its conclusion that the master planning studies should not be included in rate base, the Commission added that "while these documents provide some basic engineering information such as component sizing and gross level cost estimates, the final information needed for construction is ultimately included in the final design plans and construction documents. Id.

In extending this principle to the creation of the development of software to be used in a utility's operations, we must also be mindful of the nature of the project in this cause and the significant departure from the process of creating actual tangible plant. Without regard to that consideration, we find that Stage 1 expenditures are analogous to comprehensive planning studies, which do not themselves result in creating of plant. We find that Stage 3 expenditures are analogous to those parts of the costs of comprehensive planning studies addressing maintenance functions to ensure reliable operations, which the Commission considered not appropriate for inclusion in rate base.

We find that the \$425,000 (reg portion of \$382,244) (12.5% of \$3.4 million) associated with the preliminary stage and \$850,000 (reg portion of \$764,489) (25% of \$3.4 million) associated with the postimplementation-operation stage shall not be included in Petitioner's rate base. After subtracting disallowed in-house labor costs that are already embedded in rates, Petitioner shall be permitted to recover through amortization over ten years \$283,040 (after internal labor costs have been removed) and \$566,080 (after internal labor costs have been removed) for a total of \$849,120. We further find that the amortization of these costs for each district will commence upon the date of the next rate order that address the inclusion of SIP Improvements in Petitioner's rate base for the district.

c. **Depreciation Rate**.

Aqua Indiana's petition in this Cause did not request this Commission approve a specific depreciation rate to be applied to its SIP assets. However, the evidence presented by Petitioner in this Cause indicated it would apply a ten-year depreciation rate to its SIP assets. The OUCC's testimony and proposed finding is that if we grant any depreciation expense, Aqua should be required to depreciate its SIP at the same rate it is authorized and required to depreciate all its plant including its current information technology assets and that is using the Commission's composite depreciation rates.

Depreciation expense 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 assets. Depreciation rates are best determined through a depreciation study conducted specifically for a particular utility. However, depreciation studies can be cost prohibitive for many water and wastewater utilities. Therefore, the Commission has determined reasonable composite depreciation rates for water or wastewater utilities to apply when no depreciation study was conducted. A composite depreciation rate is a weighted average depreciation rate that is applied to all groups of utility assets. The current composite rates for water and wastewater utilities with treatment plants are 2% and 2.5%, respectively.

In its prior base rate cases, Petitioner opted to apply the Commission's composite depreciation rates rather than conduct its own depreciation study. With respect to Petitioner's various regulated utility operations, the Commission has applied its composite depreciation rates to all utility assets, including the information technology system assets that will be replaced by the SIP.

The OUCC noted that all of Petitioner's assets earn depreciation expense at the Commission's composite depreciation rate and recommended the Commission deny Petitioner's request to make piecemeal exceptions to the application of that rate. The OUCC noted Petitioner provided no support for its proposed ten-year SIP depreciation rate. In response to discovery, Petitioner stated that the Commission's composite depreciation rates should not apply to SIP assets because the SIP should be considered a "one off" from other asset classes and, as such, a composite depreciation rate is not appropriate. When it developed the composite rates, the Commission took into consideration both short-lived assets, such as vehicles and computers, as well as long-lived assets, such as transmission mains that may be expected to last longer than 40 (2.5%) or 50 (2%) years. The OUCC asserted that, if the SIP 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 depreciation methodology. The OUCC has described in most basic terns what would be a depreciation study, which Aqua Indiana has not elected to perform and submit for approval. We would also question whether such a study would establish a ten-year life for the SIP because, as the OUCC noted, Aqua Indiana has historically used its information technology assets much *longer* than ten years.

In its proposed order, Petitioner argues that approving a 50-year depreciation rate on an asset that very likely will not be serviceable for even half that amount of time would be unreasonable and inconsistent with the matching principle of depreciation accounting and states that approving a 10-year depreciation rate is much more reasonable and realistic. We do not agree that continuing the application of the Commission's composite depreciation rate is unreasonable. A composite depreciation method, by its very definition, is a weighted average rate based on all asset groups, whether short-lived, as in the case of the SIP, or long-lived, as in the case of transmission mains and treatment plants. Because a composite deprecation rate is a weighted average, some assets will be depreciated over a longer period than the asset group's typical useful life and some assets will be depreciated over a shorter period. But the composite depreciation rate represents the overall weighted average useful life of all of a water or wastewater utility's assets. When a composite depreciation rate is used, one cannot evaluate one asset group in isolation and declare the composite rate to be unreasonable for that asset group. A composite depreciation rate is a weighted average and does not necessarily represent the actual useful life of any one particular asset group. Rather, it represents the weighted average useful life of all of a utility's assets. One must assess the total depreciation expense provided by the composite depreciation rate to determine reasonableness. Applying a different depreciation rate to a particular asset or asset group contradicts the purpose of a composite depreciation rate. Either a utility performs a depreciation study to determine the useful life of each of its asset groups or it uses the composite depreciation rate, which should be applied to all of a utility's assets. The Commission's approved composite depreciation rates have been reviewed in this context and found to be reasonable for those utilities that choose not to conduct a depreciation study. Further, this issue has been considered and addressed in Cause No. 43957, where we rejected Twin Lakes Utilities, Inc.'s proposal to change the depreciation rates for only vehicles, computer equipment and software systems, explaining that the Commission's composite rate takes into consideration the total plant. *Twin Lakes Utilities, Inc., Final Order dated February 22, 2012 in Cause No, 43957 at p. 21.* This Commission directed Twin Lakes Utilities, Inc. to use the Commission-developed depreciation rates for water and wastewater and "if Petitioner believes that a composite rate provides inaccurate information, it should have conducted and submitted for Commission approval its own depreciation study to more accurately reflect the expense." *Id.*

In its proposed order, Petitioner also argues that a 10-year depreciation period is consistent with our findings for Indiana American Water Company's ("IAWC") Business Transformation SAP conversion project in Cause No. 44022 (approved June 6, 2012), in which a ten-year depreciation rate was used for a similar asset. While a ten-year depreciation period may have been approved for IAWC, the facts and circumstances applicable to Petitioner in this Cause and to IAWC in Cause No. 44022 are very different. IAWC has always relied on its own depreciation study to support its proposed depreciation rates and has never used or relied on the Commission's composite depreciation rates to determine its authorized depreciation expense. On the other hand, Petitioner has always relied upon the Commission's composite depreciation rates to determine its authorized depreciation expense. And the depreciation rate approved in Cause No. 44022 was ultimately supported by a full depreciation study conducted specifically for Indiana American Water Company, based on its specific system and the useful life it has experienced for its specific assets. It is Petitioner's choice whether it avails itself of the Commission's composite depreciation rates or conducts a depreciation study of its own based on its specific systems and the useful life it has experienced for its specific assets. But any depreciation study presented should be conducted for all of Petitioner's asset groups.

The Commission has the responsibility pursuant to Ind. Code § 8-1-2-19 to ascertain and determine the proper and adequate rates of depreciation for each public utility. Historically, the Commission's composite depreciation rates are used unless the public utility has conducted a Commission approved depreciation study. Deviations from this practice to approve Petitioner's proposed 10-year depreciation rate for its SIP assets would be contrary to and undermine the Commission's carefully constructed rationale underlying the composite depreciation rates we established. We find that Petitioner shall depreciate its SIP assets using the Commission's approved composite depreciation rates.

d. <u>Post-in-Service AFUDC.</u>

AFUDC is the cost of funds used to finance the construction of utility assets and generally consists of both a debt and an equity component. Under both the National Association of Regulatory Utility Commissioners ("NARUC") Uniform System of Accounts ("USoA") and US Generally Accepted Accounting Principles ("GAAP"), the costs of funds used to construct an asset are capitalized during the construction period as part of the total cost of the asset. However, US GAAP requires that the capitalization of these costs be discontinued once the asset is placed in service. The NARUC USoA also requires that the capitalization of these costs be discontinued unless a Commission otherwise issues an order allowing the continued capitalization of AFUDC. There can be a significant period between when an asset is placed in-service and when an order is issued including this asset in rate base.

Petitioner requests authority to modify its accounting procedures to allow it to continue to capitalize AFUDC for its SIP assets after the SIP assets have been placed in service 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. The proposed continuation of capitalization would continue 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.

The OUCC agrees that, absent continued accrual of post-in-service *debt* AFUDC, some earnings erosion could occur. But the OUCC disagrees that the same is true for *equity* AFUDC. The OUCC noted that, unlike debt AFUDC, there are no corresponding operating expenses related to equity AFUDC and, therefore, no earnings erosion results from discontinuing the capitalization of equity AFUDC once an asset is placed in service. The OUCC further explained that US GAAP (ASC 980) does not allow a utility to record post-in-service AFUDC and include it in its external financial statements, even if a regulatory body has authorized recovery of post-in-service equity AFUDC. Due to the infrequency with which Petitioner files rate cases, the OUCC further recommended that the Commission limit the number of years during which Petitioner is allowed to recover any post-in-service AFUDC to no more than three years after the date the SIP assets are placed into service.

Petitioner argues that post-in-service *equity* AFUDC has been allowed in the past in several non-settled energy utility proceedings. The OUCC explained that this extraordinary treatment has been allowed for some electric utilities because of the lengthy construction periods, which can span several years, and the large capital expenditures involved in electric construction projects, which can be billions of dollars. For these reasons, this Commission and other regulatory bodies in other jurisdictions have allowed energy utilities more favorable treatment for its financing costs.

Authorization to continue recording AFUDC after an asset has been placed in service, but before that asset has been included in a utility's rate base, is predicated on the need to alleviate any earnings erosion that may occur as a result. Both parties agree that earnings erosion will exist absent Commission authority to record post-in-service *debt* AFUDC. We agree and find that Petitioner is allowed to record post-in-service AFUDC on its debt expense from the date its SIP assets are placed in service until the date an order has been issued that makes a rate base finding with respect to the SIP assets, subject to the limitations discussed below. We further find that during the Interim Period, post-in-service AFUDC on the SIP Improvements should be capitalized at an annualized rate equivalent to Petitioner's weighted cost of long-term debt for the accrual and capitalization of such post-in-service AFUDC, using the capital structure in place as of the date of the accrual; that the post-in-service AFUDC should be recorded as a regulatory asset in Account 186, Miscellaneous Deferred Debits; that such deferred amounts should be amortized using the applicable composite depreciation rate; and that in rate cases the amortization should be treated as a recoverable expense and the unamortized portion of the regulatory asset should be included in Petitioner's rate base.

We further find that there are no costs related to Petitioner's *equity* funded capital and, therefore, no earnings erosion will result. Further, US GAAP (ASC 980) recognizes this fact and does not allow a utility to include post-in-service AFUDC in its external financial statements even if it is authorized by a regulatory body. Allowing post-in-service AFUDC simply provides "bonus bucks" to utilities to the detriment of that utility ratepayers. For these reasons, Petitioner's request to record post-in-service *equity* AFUDC is denied.

We next address the OUCC's recommendation to limit recovery of post-in-service AFUDC to three years from the date the SIP has been placed in service. Petitioner has complete control over when it files its next base rate cases seeking to include its SIP Improvements in rate base. Therefore, Petitioner controls the period during which it needs to record post-in-service debt AFUDC to avoid earnings erosion. The OUCC noted the infrequency with which Petitioner has filed rate cases for its various districts, with some districts last rate case filed 10 or even 15 years ago. We agree with the OUCC that it is unreasonable for Petitioner to be able to continue the accrual of post-in-service *debt* AFUDC for such an unlimited number of years. However, we consider the OUCC's proposal to limit this interim period to three years to be unreasonably short. Therefore, we find that Petitioner's authorization to record post-in-service *debt* AFUDC is limited to the earlier of the date of a respective Commission rate order including SIP Improvements in the rate base of each of Petitioner's districts or five years from the date the SIP Improvements are placed in service. While limiting the inclusion of deferred deprecation to a maximum of five 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, we believe such a finding is in the public interest and balances the interests of both Petitioner and its customers.

e. <u>Deferred Depreciation</u>.

Petitioner requested approval to defer depreciation expense to a regulatory asset in Account 186, Miscellaneous Deferred Debits. Petitioner further requested that this regulatory asset be amortized over ten-years, which is the service life it estimated for the SIP improvements and that the amortization of this regulatory asset commence on the date the Commission issues a rate order that has included the SIP improvements in rate base. The OUCC acknowledged that, absent deferral of depreciation expense prior to the inclusion of SIP improvements in rate base, some earnings erosion related to depreciation expense could occur. However, the OUCC opposed the depreciation rate Petitioner proposed and recommended that the depreciation rate should be the Commission's composite depreciation rate currently applied to each Aqua Indiana district. The OUCC also did not agree that Petitioner should be permitted recovery of deferred depreciation indefinitely considering Aqua's historic infrequent filing of rate cases, and it recommended Petitioner be authorized to defer depreciation and record a regulatory asset when an order is issued no later than three years after the date the SIP improvements go into service.

We agree with the OUCC that in the absence of a depreciation study approved by this Commission, deferral of depreciation should occur at the Commission's composite rate currently applicable to each Aqua Indiana utility. We also agree that our authorization to defer depreciation should not continue indefinitely. Significant time could elapse between when Petitioner's SIP asset is placed in-service and when its various districts file their next rate cases to place the allocated SIP asset in rate base. When Petitioner files its base rate cases is entirely within Petitioner's control. If Petitioner experiences earnings erosion beyond its ability to defer depreciation it may file a rate case.

We find that depreciation expense on the SIP Improvements should be deferred and capitalized; that the deferred depreciation should be recorded as a regulatory asset in Account 186, Miscellaneous Deferred Debits; that such deferred amounts should be amortized over the estimated remaining service life of the SIP Improvements commencing on the date of the first rate order including the SIP Improvements in Petitioner's rate base; and that in rate cases the amortization should be treated as a recoverable expense and the unamortized portion of the regulatory asset should be included in Petitioner's rate base.

Based on our findings above, the depreciation rate to be used to record deferred depreciation on the SIP improvements should be the authorized composite depreciation rate currently applicable to each Aqua Indiana district.

For the same reasons that we limited recovery of post-in-service AFUDC, we also limit Petitioner's deferred depreciation to the earlier of the date of a respective Commission rate order including SIP improvements in the rate base of each of Petitioner's districts or five years from the date the SIP improvements are placed in service. While limiting the inclusion of deferred deprecation to a maximum of five 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, we believe such a finding is in the public interest and balances the interests of both Petitioner and its customers.

6. **Confidentiality.** Aqua Indiana filed a motion for protection and nondisclosure of confidential and proprietary information 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 REGULATORY COMMISSION that:

1. Pursuant to Ind. Code § 8-1-2-23, Petitioner's request for preapproval of expenditures for the SIP assets is approved and granted up to $1,415,593, and once the SIP has 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.

1. Limited to the amount authorized in ordering paragraph 1 ($1,415,593), Petitioner is authorized to continue the accrual and capitalization of AFUDC for the cost of debt associated with the SIP beyond the date SIP assets are placed in service. For each district, amortization shall be at the applicable composite depreciation rate for that district. For each district, the authorized capitalization of AFUDC shall terminate once a rate order has been issued that makes a rate base finding with respect to the SIP assets.

2. Petitioner's request for authority to continue the accrual and capitalization of AFUDC for the cost of equity associated with the SIP assets beyond the in-service date is hereby denied.

3. Limited to the amount authorized in ordering paragraph 1 ($1,415,593), Petitioner is authorized to defer depreciation expense related to the SIP asset from its in-service dates until the dates of respective Commission rate orders approving recovery of SIP assets in Petitioner's rate base and to amortize the deferred depreciation regulatory assets as a recoverable expense for ratemaking purposes at the district specific applicable depreciation rate at the time of this order. Amortization shall commence once a rate order has been issued that makes a rate base finding with respect to the SIP assets.

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

5. For all SIP assets once placed in service, Petitioner is authorized to use the composite depreciation accrual rate applicable to each of its regulated operations.

6. Petitioner shall be authorized to recover its Stage 1 ($283,040) and Stage 3 ($566,080) external project costs totaling $849,120, which recovery shall be amortized over ten years, as allocated to each regulated district.

7. The information submitted under seal in this Cause pursuant to Petitioner's request for confidential treatment is determined to be confidential trade secret information.

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

<u>HUSTON, FREEMAN, KREVDA, VELETA, AND ZIEGNER CONCUR</u>

APPROVED:

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

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**Dana Kosco
Secretary of the Commission**