238 P.U.R.4th 428, 2004 WL 3051598 (Ind. U.R.C.)

**(Publication page references are not available for this document.)**

**H**

Re **Indiana-American Water Company**, Inc.
Cause No. 42520

Indiana Utility Regulatory Commission
**November 18, 2004**

ORDER authorizing a multi-district water and sewer utility to increase its rates and charges by $564,801, or 0.4%, reflecting a cost of common equity of 9.25%, an overall weighted cost of capital of 7.17%, and a fair rate of return of 5.38%.

Commission declines to include a risk adder in the calculation of the cost of common equity, finding that the utility has since its last rate case significantly increased its size and improved its ability to attract capital as a result of its association with a large international water utility. Moreover, the commission notes that the cost of capital is substantially below that which prevailed at the time of the utility's last rate case. Commission concludes that the utility is no more risky than the proxy group of companies used in estimating the cost of common equity, and is less risky than in the past.

In designing rates the commission affirms the benefits of single tariff pricing -- i.e., a unified set of rates for each customer class served by the utility statewide. Nonetheless, it recognizes that the need to align the rate structures of several newly acquired water districts has created disparate results within some existing rate groups, with some groups moving closer to single tariff pricing and some moving further away.

Commission denies, as it did in a previous rate order, a request by the utility to recover the excess of the purchase price over the book value of an acquired water utility, Northwest Indiana Water. The ratepayer benefits associated with the acquisition did not, the commission again finds, exceed the costs of the acquisition premium requested. Moreover, the commission finds that the acquisition did not satisfy the troubled utility acquisition standard in that Northwest was not a troubled utility nor did its acquisition make possible otherwise infeasible future acquisitions of troubled utilities.

Commission reaffirms its position of allowing a return on the amortized balance, but not the unamortized balance, of a previously approved acquisition adjustment associated with the purchase of the Indiana Cities Water Corporation. The Indiana Cities acquisition was found by prior order to have resulted in cost savings in excess of the cost of capital investment needed to make those savings possible, thereby satisfying the criteria for including an acquisition premium in rate base. Commission explains that its position with respect to granting a return on the

**(Publication page references are not available for this document.)**

acquisition adjustment, but no return of the acquisition adjustment, is consistent with past practice and is fair and reasonable inasmuch as it has provided the utility with additional compensation by not applying interest synchronization to the acquisition premium.

Commission approves an adjustment to test year pension expense to reflect the use of the accrual method prescribed by Statement of Financial Accounting Standards No. 87. Previously, the utility had reflected pension expense based upon the contribution to the pension fund required under the Employee Retirement Income Security Act.

A proposed adjustment to pension expense to allow for the recovery of past pension fund losses is denied. Commission notes that the adjustment would require additional funds from ratepayers who have themselves suffered pension losses. It adds that given the recent market recovery, an allowance for past losses would create the potential for overcompensation.

Commission finds that the utility acted imprudently by abandoning its Indiana consolidated customer service center in favor of a move to an out-of-state, multi-state consolidated customer satisfaction center in Alton, Illinois. Accordingly, the commission limits the rate base allowance for the customer service function to the amount already included in rate base for the Indiana customer service center. It adds that the imprudent decision with respect to the move to an Illinois consolidated customer satisfaction center is exacerbated by the elimination of forty-seven customer service jobs in Indiana.

Commission also examines the relationship between the acquisition by the utility of enhanced customer information software for use at the Indiana customer service center and a subsequent decision by its corporate parent to move the customer service function of the utility to the consolidated customer satisfaction center in Illinois. The utility is found to have provided sufficient justification for the enhanced system software, but the commission disallows a portion of the requested expense allowance, finding that the utility failed to justify the amount of the expense or to reconcile discrepancies in the way the costs of the enhanced software are allocated by the corporate parent of the utility among the affiliated utilities participating in the Illinois customer satisfaction center.

Consistent with a prior order on security costs, the utility is authorized to amortize deferred security expenses over a five-year period.

The utility is directed to file a new depreciation case reasonably far enough in advance of its next rate case to allow updated and approved depreciation rates to be used in the next rate case.

P.U.R. Headnote and Classification

1.

RATES

s120.1

In.U.R.C. 2004

[IND.] Test period -- Historical test year -- Adjustment for changes -- Water and sewer rate proceeding.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

2.

RATES

s649

In.U.R.C. 2004

[IND.] Practice and procedure -- General rate proceedings -- Public hearing -- Statutory requirements.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

3.

VALUATION

s25

In.U.R.C. 2004

[IND.] Value for ratemaking -- Date of valuation -- Update to reflect year-end figures -- Water and sewer rate proceeding.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

4.

VALUATION

s192

**(Publication page references are not available for this document.)**

In.U.R.C. 2004

[IND.] Property included or excluded -- Appropriate level of capacity -- Factors considered.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

5.

VALUATION

s211

In.U.R.C. 2004

[IND.] Appropriate level of capacity -- Factors considered -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

6.

VALUATION

s286

In.U.R.C. 2004

[IND.] Water and sewer utility -- Appropriate level of capacity -- Factors considered.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

7.

VALUATION

s211

In.U.R.C. 2004

[IND.] Property excluded -- Excess pumping capacity -- Lack of evidence of used and usefulness -- Water utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

8.

VALUATION

s286

In.U.R.C. 2004

[IND.] Water utility -- Property excluded -- Excess pumping capacity -- Lack of evidence of used and usefulness.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

9.

VALUATION

s286

In.U.R.C. 2004

[IND.] Water utility -- Property excluded -- Inadequately supported fixed asset additions -- lack of cooperation in discovery efforts.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

10.

VALUATION

s139

In.U.R.C. 2004

[IND.] Allowance for funds used during construction -- Proposed accrual for comprehensive planning studies and tank inspections -- Grounds for denial -- Costs not components of construction -- Water utility.

**(Publication page references are not available for this document.)**

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

11.

VALUATION

s168

In.U.R.C. 2004

[IND.] Proposed charges to capital -- Costs of comprehensive planning studies and tank inspections -- Grounds for denial -- Cost not components of construction -- Water utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

12.

VALUATION

s278

In.U.R.C. 2004

[IND.] Meter replacements -- Adjustment to annual purchase costs -- Rejection of 5-year replacement schedule -- Shift to ten year change out program -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

13.

VALUATION

s67

In.U.R.C. 2004

[IND.] Ascertainment of cost -- Acquired water utility -- Purchase price in excess of book value -- Proposed recognition of acquisition premium -- Grounds of denial -- Ratepayer benefits did not exceed costs of the requested premium -- Failure to meet troubled utility standard.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

14.

CONSOLIDATION, MERGER, AND SALE

s54

In.U.R.C. 2004

[IND.] Purchase price in excess of book value -- Treatment in rate proceeding -- Denial of acquisition premium -- Ratepayer benefits did not exceed costs of premium -- Failure to meet troubled utility standard -- Water utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

15.

VALUATION

s131

In.U.R.C. 2004

[IND.] Acquisition expense -- Purchase price in excess of book value -- Proposed recognition of acquisition premium -- Grounds for denial -- Ratepayer benefits did not exceed costs of the requested premium -- Water utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

16.

EXPENSES

s37

In.U.R.C. 2004

[IND.] Water utility acquisition -- Proposed amortization of excess purchase price -- Grounds for denial -- Ratepayer benefits did not exceed costs of the requested acquisition premium -- Water utility.

**(Publication page references are not available for this document.)**

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

17.

VALUATION

s67

In.U.R.C. 2004

[IND.] Ascertainment of cost -- Acquired water utility -- Purchase price in excess of book value -- Recognition of acquisition premium -- Grounds of allowing -- Cost savings in excess of capital costs required to make those savings possible.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

18.

CONSOLIDATION, MERGER, AND SALE

s54

In.U.R.C. 2004

[IND.] Purchase price in excess of book value -- Treatment in rate proceeding -- Return on amortized balance of acquisition premium -- Cost savings in excess of capital costs required to make those savings possible -- Water utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

19.

VALUATION

s131

In.U.R.C. 2004

[IND.] Acquisition expense -- Purchase price in excess of book value -- Recognition of acquisition premium -- Grounds for allowing -- Cost savings in excess of capital costs required to make those savings possible -- Water utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

20.

EXPENSES

s37

In.U.R.C. 2004

[IND.] Water utility acquisition -- Excess purchase price -- Denial of annual amortization -- Inclusion of amortized balance in rate base -- Water utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

21.

VALUATION

s67

In.U.R.C. 2004

[IND.] Ascertainment of cost -- Acquired water utility -- Purchase price in excess of book value -- Recognition of acquisition premium -- Return on amortized balance of acquisition premium -- No return on unamortized acquisition adjustment.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

22.

CONSOLIDATION, MERGER, AND SALE

s54

In.U.R.C. 2004

[IND.] Purchase price in excess of book value -- Treatment in rate proceeding -- Return on amortized balance of acquisition premium -- No return on unamortized acquisition adjustment -- Water utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

23.

VALUATION

s27

In.U.R.C. 2004

[IND.] Value for rate making -- Quantification of original cost rate base -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

24.

VALUATION

s286

In.U.R.C. 2004

[IND.] Water and sewer utility -- Quantification of original cost rate base.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

25.

VALUATION

s27

In.U.R.C. 2004

[IND.] Value for rate making -- Fair value rate base -- Update of prior finding -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

26.

**(Publication page references are not available for this document.)**

VALUATION

s286

In.U.R.C. 2004

[IND.] Water and sewer utility -- Fair value rate base -- Update of prior determination.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

27.

VALUATION

s40

In.U.R.C. 2004

[IND.] Value for rate making -- Reproduction cost new less depreciation -- Use as evidence in support of fair value -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

28.

VALUATION

s27

In.U.R.C. 2004

[IND.] Value for rate making -- Replacement cost less depreciation -- Use as evidence in support of fair value -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

29.

VALUATION

s27

In.U.R.C. 2004

[IND.] Value for rate making -- Fair value -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

30.

VALUATION

s286

In.U.R.C. 2004

[IND.] Water and sewer utility -- Value for rate making -- Fair value.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

31.

RETURN

s9

In.U.R.C. 2004

[IND.] Basis for computation -- Fair value of property -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

32.

RETURN

s15

In.U.R.C. 2004

[IND.] Reasonableness -- Fair return -- Legal standard.

Re **Indiana-American Water Company**, Inc.

**(Publication page references are not available for this document.)**

P.U.R. Headnote and Classification

33.

RETURN

s22

In.U.R.C. 2004

[IND.] Reasonableness -- Determining fair rate of return -- Factors considered.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

34.

RETURN

s26.4

In.U.R.C. 2004

[IND.] Reasonableness -- Cost of common equity -- Estimation methodologies -- Discounted cash flow model analyses -- Capital asset pricing model analyses -- Risk analyses -- Positions of the parties -- Water and sewer rate proceeding.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

35.

RETURN

s26.4

In.U.R.C. 2004

[IND.] Reasonableness -- Cost of common equity -- Factors considered -- Discounted cash flow analyses -- Calculation of forward dividend yield -- Estimation of growth rate -- Water and sewer rate proceeding.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

36.

RETURN

s26.4

In.U.R.C. 2004

[IND.] Reasonableness -- Cost of common equity -- Factors considered -- Capital asset pricing model -- Estimate of market risk premium -- Consideration of both arithmetic and geometric mean -- Water and sewer rate proceeding.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

37.

RETURN

s44

In.U.R.C. 2004

[IND.] Reasonableness -- Cost of common equity -- Factors considered -- Risk -- Estimate of market risk premium -- Consideration of both arithmetic and geometric mean -- Water and sewer rate proceeding.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

38.

RETURN

s26.4

In.U.R.C. 2004

[IND.] Reasonableness -- Cost of common equity -- Factors considered -- Utility-specific risk -- Water and sewer rate proceeding.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

39.

RETURN

s44

In.U.R.C. 2004

[IND.] Reasonableness -- Cost of common equity -- Factors considered -- Utility-specific risk -- Water and sewer rate proceeding.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

40.

RETURN

s26.4

In.U.R.C. 2004

[IND.] Reasonableness -- Cost of common equity -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

41.

RETURN

s26.4

In.U.R.C. 2004

[IND.] Reasonableness -- Cost of common equity -- Factors considered -- Pre-tax interest coverage ratio -- Preservation of 'A' bond rating -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

42.

RETURN

s26.1

In.U.R.C. 2004

[IND.] Reasonableness -- Capital structure -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

43.

RETURN

s26

In.U.R.C. 2004

[IND.] Reasonableness -- Cost of capital -- Individual cost elements -- Overall weighted cost -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

44.

RETURN

s115

In.U.R.C. 2004

[IND.] Water and sewer utility -- Weighted cost of capital -- Reasonableness.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

45.

RETURN

s107

In.U.R.C. 2004

[IND.] Water and sewer utility -- Weighted cost of capital -- Reasonableness.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

46.

RETURN

s9

In.U.R.C. 2004

[IND.] Basis for computation -- Fair value rate base methodology -- Determination of earnings requirement.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

47.

RETURN

s15

In.U.R.C. 2004

[IND.] Reasonableness -- Fair value rule -- Constitutional standard.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

48.

RETURN

s22

In.U.R.C. 2004

[IND.] Reasonableness -- Determination of fair rate of return -- Standards and criteria.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

49.

**(Publication page references are not available for this document.)**

RETURN

s25

In.U.R.C. 2004

[IND.] Reasonableness -- Factors considered -- Returns of enterprises with comparable risks.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

50.

RETURN

s24

In.U.R.C. 2004

[IND.] Reasonableness -- Factors considered -- Ensuring confidence in financial integrity -- Maintenance of credit -- Attraction of capital.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

51.

RETURN

s6

In.U.R.C. 2004

[IND.] Basis for computation -- Fair value rate base less historical inflation -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

52.

RETURN

s20

**(Publication page references are not available for this document.)**

In.U.R.C. 2004

[IND.] Reasonableness -- Amount to be allowed -- Fair rate of return -- Method of computation -- Removal of inflation values from proposed cost of capital -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

53.

RETURN

s115

In.U.R.C. 2004

[IND.] Water and sewer utility -- Fair rate of return -- Reasonableness.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

54.

RETURN

s107

In.U.R.C. 2004

[IND.] Water and sewer utility -- Fair rate of return -- Reasonableness.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

55.

REVENUES

s2

In.U.R.C. 2004

[IND.] Forecasts -- Residential customer usage -- Proposed normalization methodologies -- Regression analysis -- Historical averages -- Discussion of deficiencies in proposed methodologies as presented.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

56.

REVENUES

s2

In.U.R.C. 2004

[IND.] Forecasts -- Residential customer usage -- Proposed normalization adjustment -- Grounds for denial -- Deficiencies in normalization methodologies as presented -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

57.

REVENUES

s2

In.U.R.C. 2004

[IND.] Forecasts -- Adjustment for customer growth -- Residential and commercial customers -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

58.

EXPENSES

s144

In.U.R.C. 2004

[IND.] Water and sewer utility -- Purchased water -- Purchased power -- Chemicals -- Adjustment for customer growth.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

59.

EXPENSES

s138.1

In.U.R.C. 2004

[IND.] Water and sewer utility -- Purchased water -- Purchased power -- Chemicals -- Adjustment for customer growth.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

60.

REVENUES

s2

In.U.R.C. 2004

[IND.] Forecasts -- Changes in large customer consumption -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

61.

EXPENSES

s95

In.U.R.C. 2004

[IND.] Labor expense -- Adjustment to test year -- Allowance for vacancies filled -- Exclusion of vacant positions unfilled or filled through transfer -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

62.

EXPENSES

s95

In.U.R.C. 2004

[IND.] Labor expense -- Proposed adjustment for new positions -- Grounds for denial -- Duties of positions performed during test year -- Costs already included in test year -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

63.

EXPENSES

s95

In.U.R.C. 2004

[IND.] Labor expense -- Elimination of double counted position -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

64.

EXPENSES

s105

In.U.R.C. 2004

[IND.] Incentive pay -- Grounds for allowing -- Compensation level tied in part to better service -- Total compensation does not exceed reasonable level -- Portion funded by shareholders -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

**(Publication page references are not available for this document.)**

65.

EXPENSES

s49

In.U.R.C. 2004

[IND.] Pension expense -- Conversion to accrual accounting -- Conformance with Statement of Financial Accounting Standards No. 87 -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

66.

EXPENSES

s49

In.U.R.C. 2004

[IND.] Pension expense -- Proposed adjustment for fund losses -- Grounds for denial -- Potential for overcompensation -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

67.

EXPENSES

s19

In.U.R.C. 2004

[IND.] Depreciation on contributions in aid of construction -- Inclusion in rates -- Continuation of long-standing policy -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

68.

EXPENSES

s144

In.U.R.C. 2004

[IND.] Water and sewer utility -- Depreciation on contributions in aid of construction -- Inclusion in rates -- Continuation of long-standing policy.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

69.

VALUATION

s286

In.U.R.C. 2004

[IND.] Water and sewer utility -- Out-of-state, multi-state consolidated call center -- Limit on rate base allowance -- Imprudent abandonment of Indiana call center.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

70.

VALUATION

s202

In.U.R.C. 2004

[IND.] Imprudently abandoned property -- Indiana consolidated call center -- Replacement with out-of-state, multi-state consolidated call center -- Limit on rate base allowance -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

71.

VALUATION

**(Publication page references are not available for this document.)**

s202

In.U.R.C. 2004

[IND.] Jointly used property -- Out-of-state, multi-state consolidated call center -- Limit on rate base allowance -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

72.

EXPENSES

s81

In.U.R.C. 2004

[IND.] Office expense -- Enhanced customer information system -- Software costs -- Relationship of expense allowance to subsequent decision to move to out-of-state, multi-state call center -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

73.

EXPENSES

s83

In.U.R.C. 2004

[IND.] Allocation of costs by corporate parent -- Enhanced customer information system software -- Relationship of expense allowance to subsequent decision to move to out-of-state, multi-state call center -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

74.

EXPENSES

s39

In.U.R.C. 2004

[IND.] Purchased power -- Adjustment for fixed, known, and measurable electric rate increase -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

75.

EXPENSES

s145

In.U.R.C. 2004

[IND.] Water utility -- Purchased water -- Exclusion of purchases from municipal utility -- Costs not fixed, known, and measurable.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

76.

EXPENSES

s60

In.U.R.C. 2004

[IND.] Group insurance -- Shifting of portion of costs to management fees -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

77.

EXPENSES

s84

In.U.R.C. 2004

[IND.] Payments to parent -- Management fees -- Inclusion of group insurance costs associated with shift in customer service positions -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

78.

EXPENSES

s49

In.U.R.C. 2004

[IND.] Postretirement benefits other than pensions -- Use of six-year average -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

79.

EXPENSES

s60

In.U.R.C. 2004

[IND.] Insurance -- General liability -- Auto liability -- workers' compensation -- Retrospective premium expenditures -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

80.

EXPENSES

s84

In.U.R.C. 2004

[IND.] Payments to parent -- Management fees -- Exclusion of cost of internal audit of affiliate -- Inadequate documentation -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

81.

PROCEDURE

s16

In.U.R.C. 2004

[IND.] Discovery -- Effect of failure to produce available evidence -- Matters within scope of discovery request.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

82.

EXPENSES

s105

In.U.R.C. 2004

[IND.] Employee benefits -- Employee investment plan -- Inclusion of known costs in advance of qualification ruling by Internal Revenue Service -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

83.

EXPENSES

s144

In.U.R.C. 2004

[IND.] Water and sewer utility -- Maintenance -- Reinstatement of curtailed expenses.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

84.

EXPENSES

s138.1

In.U.R.C. 2004

[IND.] Water and sewer utility -- Maintenance -- Reinstatement of curtailed expenses.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

85.

EXPENSES

s89

In.U.R.C. 2004

[IND.] Regulatory expense -- Limit on allowance to amounts presented in case-in-chief -- Exclusion of increased costs presented during rebuttal testimony -- Lack of certainty regarding increase -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

86.

EXPENSES

s81

In.U.R.C. 2004

[IND.] General office expense -- Inclusion of short-term, line-of-credit fee -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

238 P.U.R.4th 428, 2004 WL 3051598 (Ind. U.R.C.)

**(Publication page references are not available for this document.)**

87.

EXPENSES

s109

In.U.R.C. 2004

[IND.] Property tax -- Use of updated tax rates -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

88.

EXPENSES

s109

In.U.R.C. 2004

[IND.] Utility receipts tax -- Exclusion of wholesale sales -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

89.

EXPENSES

s114

In.U.R.C. 2004

[IND.] Federal and state income taxes -- Rejection of proposed deduction for parent company interest -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

90.

EXPENSES

s144

In.U.R.C. 2004

[IND.] Water and sewer utility -- GIS services -- Actual test year costs.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

91.

EXPENSES

s84

In.U.R.C. 2004

[IND.] Payments to parent -- Management fees -- Disallowed cost elements -- Charitable contributions -- Lobbying expenses -- Non-recurring items -- Expenditures with no proven material benefit to ratepayers -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

92.

EXPENSES

s105

In.U.R.C. 2004

[IND.] Employee benefits -- Adjustment to reflect labor expense findings -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

93.

EXPENSES

s26

In.U.R.C. 2004

[IND.] Advertising -- Partial disallowance -- Ratepayer benefits test -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

94.

EXPENSES

s46

In.U.R.C. 2004

[IND.] Charitable contributions -- Exclusion from rates -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

95.

EXPENSES

s26

In.U.R.C. 2004

[IND.] Community relations -- Exclusion from rates -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

96.

EXPENSES

s88

In.U.R.C. 2004

[IND.] Lobbying expense -- Disallowance -- Ratepayer benefits test -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

97.

EXPENSES

s11

In.U.R.C. 2004

[IND.] Deferred security costs -- Amortization -- Water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

98.

EXPENSES

s144

In.U.R.C. 2004

[IND.] Water and sewer utility -- Deferred security costs -- Five-year amortization of deferred costs -- Reflection of decreasing expenditure in annual expense allowance.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

99.

RATES

s595

In.U.R.C. 2004

[IND.] Water utility -- Adjustment to produce reasonable return -- Authorized increase.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

100.

RATES

s501

In.U.R.C. 2004

[IND.] Sewer utility -- Adjustment to produce reasonable return -- Authorized increase.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

101.

APPORTIONMENT

s41

In.U.R.C. 2004

[IND.] Water and sewer utility -- Allocation of costs to customers -- Base-Extra Capacity method.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

102.

RATES

s143

In.U.R.C. 2004

[IND.] Reasonableness -- Cost of service -- Single tariff pricing goal -- Movement toward unified set of rates for each class statewide -- Acceptable disparities -- Multi-district water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

103.

RATES

s171

In.U.R.C. 2004

[IND.] Reasonableness -- Uniformity -- Single tariff pricing goal -- Movement toward unified set of rates for each class statewide -- Acceptable disparities -- Multi-district water and sewer utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

104.

RATES

s595

In.U.R.C. 2004

[IND.] Water rate design -- Single tariff pricing goal -- Movement toward unified set of rates for each class statewide -- Acceptable disparities -- Multi-district utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

105.

RATES

s501

In.U.R.C. 2004

[IND.] Sewer rate design -- Single tariff pricing goal -- Movement toward unified set of rates for each class statewide -- Acceptable disparities -- Multi-district utility.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

106.

DEPRECIATION

s70

In.U.R.C. 2004

[IND.] Water and sewer utility -- Rates study -- Filing requirements.

Re **Indiana-American Water Company**, Inc.

P.U.R. Headnote and Classification

107.

DEPRECIATION

s81

In.U.R.C. 2004

[IND.] Water and sewer utility -- Rates study -- Filing requirements.

Re **Indiana-American Water Company**, Inc.

Before McCarty, Landis, Ripley, and Ziegner, commissioners, And Divine, administrative law judge.

BY THE COMMISSION:

I. BACKGROUND

On September 30, 2003, **Indiana-American Water Company**, Inc. ('Petitioner,' 'Indiana-American' or 'Company') filed its Petition and Notice of Intent to File in Accordance with Minimum Standard Filing Requirements ('Petition') with the Indiana Utility Regulatory Commission ('Commission '), seeking authority to increase its rates and charges for water and sewer service and for approval of new schedules of rates and charges applicable thereto. Petitioner's notice of its intent to file in accordance with the Commission's rules on minimum standard filing requirements ('MSFRs') was given pursuant to 170 IAC § 1-5-1 et seq. (2000).

Pursuant to notice and as provided in 170 IAC § 1-1.1-15 (2000), a Prehearing Conference was convened in this Cause on November 6, 2003, at 9:30 a.m. EST, in Room E306, Indiana Government Center South, Indianapolis, Indiana. Proofs of publication of the notice of the Prehearing Conference have been incorporated into the record and placed in the official files of the Commission. Attending the Prehearing Conference were Petitioner and the Indiana Office of Utility Consumer Counselor ('OUCC' or 'Public'). The procedural, scheduling, and other matters determined at the Prehearing Conference were memorialized in the Commission's

Prehearing Conference Order approved and issued on November 20, 2003.

Petitions to intervene in this Cause were filed on November 14, 2003, by the Town of Schererville; on December 12, 2004, by a group of industrial customers of Indiana-American ('Industrial Group'); and on February 13, 2004, by the Town of Merrillville. These petitions to intervene were granted by Docket Entries issued on December 5, 2003, December 29, 2003, and February 24, 2004, respectively, thereby making these entities parties to this Cause.

Pursuant to notice published as required by law, a public Evidentiary Hearing commenced on January 13, 2004, at 9:30 a.m. EST, in Room TC-10 of the Indiana Government Center South, Indianapolis, Indiana. Proofs of publication of the notice of such hearing were incorporated into the record of this proceeding by reference. During the Evidentiary Hearing conducted on January 13 and 14, 2004, evidence constituting Indiana-American's case-in-chief was offered and admitted into the record and its witnesses were offered for cross-examination.

On January 14, 2004, the Evidentiary Hearing was continued to January 27, 2004, for the purpose of conducting, pursuant to Ind. Code § 8-1-2-61(b), a public field hearing in the City of Gary, which is the largest municipality in Petitioner's service area. During this public field hearing, members of the public provided oral and/or written testimony in this Cause. On January 27, 2004, the Evidentiary Hearing was continued to February 18, 2004, for the purpose of conducting an additional public field hearing in the City of Jeffersonville, at which time members of the public provided oral and/or written testimony in this Cause. On February 18, 2004, the Evidentiary Hearing was continued to February 25, 2004, for the purpose of conducting, in the City of Muncie, a third public field hearing, at which time members of the public provided oral and/or written testimony in this Cause.

On February 25, 2004, the Evidentiary Hearing was continued to March 5, 2004, the date established in the Prehearing Conference Order for the parties to present any settlement and evidence in support thereof. The parties advised that they had not reached any settlement and, on March 5, 2004, the Evidentiary Hearing was continued to April 19, 2004. During the Evidentiary Hearing conducted on April 19, 20 and 21, 2004, evidence constituting the respective cases-in-chief of the Public and the intervening parties was offered and admitted into the record and their witnesses were offered for cross-examination. In addition, Petitioner's rebuttal evidence was offered and admitted into the record, and Petitioner's rebuttal witnesses were offered for cross-examination. The Evidentiary Hearing in this Cause was adjourned on April 21, 2004.

Having considered all of the evidence presented in this proceeding, and based on the applicable law, the Commission now finds:

II. NOTICE AND JURISDICTION

Due, legal and timely notice of the Petition filed in this Cause was given and

**(Publication page references are not available for this document.)**

published by Petitioner as required by law. Proper and timely notice was given by Petitioner to its customers summarizing the nature and extent of the proposed changes in its rates and charges for water and sewer service. Due, legal and timely notices of the Prehearing Conference and the other public hearings in this Cause were given and published as required by law. Petitioner is a 'public utility' within the meaning of that term in Ind. Code § 8-1-2- 1(a)(2) 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, this Commission has jurisdiction over Petitioner and the subject matter of this proceeding.

III. PETITIONER'S CHARACTERISTICS

Petitioner is an Indiana corporation engaged in the business of rendering water utility service to approximately 272,000 customers in twenty-one (21) counties in the State of Indiana. Petitioner provides water service by means of water utility plant, property, equipment and related facilities owned, leased, operated, managed and controlled by it, which are used and useful for the convenience of the public in the production, treatment, transmission, distribution and sale of water for residential, commercial, industrial, sale for resale and public authority purposes. Petitioner also provides public and private fire service. In addition, Petitioner provides sewer utility service in Wabash County in Somerset, Indiana and in Delaware County in or near Muncie, Indiana.

IV. CORPORATE HISTORY

Indiana-American was formed in 1983 from the merger of five (5) Indiana water utility subsidiaries of American Water Works Company, Inc. ('American'). In 1993, Indiana-American acquired the common stock of Indiana Cities Water Corporation ('Indiana Cities'). Indiana Cities subsequently was merged into Indiana-American. In 1999, American acquired the common stock of the parent company of Northwest Indiana Water Company ('Northwest'). Northwest was merged into Indiana-American on January 1, 2000. On February 1, 2000, Indiana-American acquired the common stock of United Water West Lafayette Inc. and United Water Indiana Inc. (collectively 'United'), and on the same day United was merged into Indiana-American. Petitioner also has made a number of smaller acquisitions in recent years.

In addition, American was acquired recently by an international water company. American is a holding company that owns the common stock of subsidiaries (such as Indiana-American) which provide water utility services, wastewater utility services and other water resource management services to approximately fifteen (15) million people in twenty-eight (28) states and three (3) Canadian provinces. In 2003, American was acquired by Thames Water Aqua Holdings GmbH ('Thames Water'), a subsidiary and the water division of RWE AG, an international, multi-utility service provider, organized under the laws of the Federal Republic of Germany. RWE AG's core businesses are in electricity, water, gas, waste management and utility-related services. RWE AG is active in more than 120 countries on six (6) continents.

V. EXISTING RATES

Petitioner's existing basic rates and charges for water and sewer service were established pursuant to the Commission's Orders in Cause No. 42029 dated November 6, 2002; January 22, 2003; and December 30, 2003 ('2002 Rate Order '). Petitioner also implemented a Distribution System Improvement Charge pursuant to Ind. Code § 8-1-31 and the Commission's Order in Cause No. 42351-DSIC 1, dated February 27, 2003. Since its last rate case, Indiana-American also has implemented public fire protection surcharges in four (4) communities pursuant to Ind. Code § 8-1-2-103(d) and the Commission's Orders in Cause Nos. 42285, 42470, 42449 and 42566.

VI. RELIEF REQUESTED

Petitioner originally proposed that its rates be increased by 14.31%. (Petitioner's Exhibit JLC-1, Sched. 1, line 36.) Prior to the final hearing, Petitioner filed supplemental direct testimony and exhibits reducing the requested increase to 10.55% to reflect a rate base true-up, Petitioner's capital structure at December 30, 2003, the issuance of the Order in Cause No. 42029 dated December 30, 2003, regarding Petitioner's security expenses, and the receipt of some updated property tax information. (Petitioner's Exhibit JLC-1-UA, Sched. 1, line 36.) The requested increase was further reduced as a result of the filing by Petitioner of final property tax rates available from the Department of Local Government Finance as of the close of the record. These updated rates covered all counties where Petitioner has property except for Clark County. The effect of the updated property tax information is discussed in the Property Tax section of this Order. (See Sect. IX. B. 14.) In addition, Petitioner proposes further movement toward common rates in this proceeding.

VII. TEST YEAR

[1] As provided in the Prehearing Conference Order, the test year to be used for determining Petitioner's actual and pro forma operating revenues, expenses and operating income under present and proposed rates is the twelve (12) months ended June 30, 2003. The financial data for this test year, when adjusted for changes as provided in the Prehearing Conference Order, is a proper basis for fixing new rates for Petitioner and testing the effect thereof.

VIII. TESTIMONY FROM FIELD HEARINGS IN GARY, JEFFERSONVILLE AND MUNCIE

[2] The Commission conducted three (3) public field hearings in this proceeding as forums for affected ratepayers to express their views about Petitioner's proposed rate increase. These field hearings were conducted in the northern part of the State in the City of Gary, in the southern part of the State in the City of Jeffersonville, and in the central part of the State in the City of Muncie. Below are summaries of the testimony presented in each of these field hearings.

A. City of Gary Field Hearing

**(Publication page references are not available for this document.)**

This field hearing, conducted on January 27, 2004, at Indiana University Northwest, 3400 Broadway, Gary, Indiana, satisfied the requirement of Ind. Code § 8-1-2-61(b), which states:

In any general rate proceeding under subsection (a) which requires a public hearing and in which an increase in revenues is sought which exceeds the sum of two million five hundred thousand dollars ($2,500,000), the commission shall conduct at least one (1) public hearing in the largest municipality located within such utility's service area.

Lawful notice of this public field hearing was published in newspapers serving Johnson, Lake and Marion Counties. Attending the hearing were representatives of the Petitioner, the OUCC, the Commission and members of the public. At the hearing, members of the public shared their concerns regarding Indiana-American's proposed rate increase, the Company's quality of customer service and water quality. In addition to the oral and written testimony received at the hearing, some individuals not in attendance at the field hearing mailed or electronically mailed comments to the OUCC, which were later filed with the Commission.

A majority of the oral and written testimony remarked on the frequency of Indiana-American's rate increases and the high rates of increase on Lake County consumers and those in the surrounding service area. Witnesses testified that most households have had two (2) water use and sewer rate increases in the last three (3) years, while other users cited three (3) rate increases. The consumers stated their water use rates were 38% higher than before Indiana-American purchased Northwest; another increase of approximately 14% would create a difficult burden on them and would be particularly hard on those individuals with fixed incomes. Witnesses remarked that any increase by the water utility would be unbearable, particularly given the broad increase in property taxes on Lake County residents. An individual consumer questioned the need for increased rates since the water sources were close to the service areas. Also, a representative of a municipal fire department noted that Indiana-American's proposed Public and Fire Protection rate increase appeared high and did not reflect the trend of minimal hydrant use in the community.

In addition, consumers maintained that the Commission should not order a rate increase to help the utility finance its increasing insurance costs, refinance the debt from facility acquisitions or improve employee benefits and pensions -- priorities stated in the Company's informational materials included in billing statements. First, ratepayers asserted that Indiana-American should absorb these costs as part of doing business and not ask for additional funds from consumers to meet expected and predictable increases in operating and acquisition expenses. Reflecting on their own positions, ratepayers living on fixed pensions or Social Security benefits noted that they are expected to pay their increasing insurance and other financial obligations without seeking additional funds. Second, small business owners and local and state government representatives asserted that the parent company and Indiana-American's shareholders, not the ratepayers, should finance these expenses by reducing the anticipated rate of return on the company's investment or exercising more effective fiscal discipline. Many residents do not believe that consumers should compensate the company for acquiring investment property through higher rates.

While some individual consumers acknowledged Indiana-American's investments in the Northwest facility, other consumers noted better customer service and a better water product prior to the company's acquisition of Northwest and the other small water utilities. Concerned with water quality, many consumers reported having to purchase bottled water to drink due to their tap water's high chlorination and chemical odor and taste, all while paying higher water rates. Some residents complained of receiving very low estimated water use and sewer bills for months prior to receiving a significantly higher bill based on metered readings. One municipal entity stated that Indiana-American's lack of communication and cooperation when the municipality made road repairs resulted in additional road expenses after an underground water pipe burst.

B. City of Jeffersonville Field Hearing

This field hearing was conducted on February 18, 2004, at KYE's, 400 Missouri Avenue, Jeffersonville, Indiana. Lawful notice of the hearing was published in newspapers serving Clark, Floyd, Johnson and Marion Counties. Attending the hearing were representatives of the Petitioner, the OUCC, the Commission and members of the public. Witness testimony focused on the proposed rate increase, Indiana-American's presence in southern Indiana and ratepayers' water quality.

A majority of individuals testifying voiced concerns over Indiana-American's proposed rate increase. Citing Indiana-American's approved rate increase in 2002, individual ratepayers observed that Indiana-American waited less than two (2) full years before seeking another rate increase and that the Company's current proposal represents a distressing trend. Individuals expressed concern with the projected amount of the increase, which they perceived to be nearly three (3) times as great as the 2002 actual rate increase. One individual, recalling that Indiana-American promised that consumers would receive benefits and savings achieved through the Company's acquisition of other water utilities and building economies of scale, questioned the need for a rate increase before consumers received the promised savings. Other individual users stated that a rate increase, so soon after the last increase, combined with additional county assessments on water treatment and water run-off would further stress household budgets -- budgets already burdened by the statewide, court-ordered property tax reassessment. Many individuals in attendance voiced their opposition to increased rates that would allow Indiana-American to improve employee benefit and pension plans and pay for existing facilities when the company will not improve water quality, be more responsive to customers and those with billing inquiries, implement a satisfactory complaint process or aid individuals on fixed incomes as permitted under Indiana law.

Witnesses offered mixed assessments of Indiana-American's impact on and presence in southern Indiana. Two individuals representing not-for-profit organizations promoting business interests in the region complimented Indiana-American's major investments in improving regional water distribution, installing new water mains and expanding water service to small communities. They acknowledged that Indiana-American's investments aided economic growth by improving the infrastructure necessary to retain and attract commercial users, and concluded that Indiana-American should be permitted to make a return on the company's investment. However, small business owners testified that the past rate increases and those proposed in this Cause would further burden their businesses and make it more difficult to compete against like businesses serviced by other, locally-owned water providers charging lower water usage and sewer rates. A business owner anticipated that another rate increase to support Indiana-American's facilities and employee pension and benefits packages would negatively impact his own plant and facility and employee salaries and benefits. An owner of a property management company, who had a negative experience with Indiana-American's Alton, Illinois Customer Satisfaction Center ('Customer Satisfaction Center,' 'Alton CSC,' 'Alton Center ') in November and December 2003, did not believe his needs were adequately addressed by an out-of-state representative.

Lastly, individual homeowners and private landlords commented on the poor water quality coming from their home water taps. Those testifying asserted that their tap water smelled of chlorine for as few as two (2) to three (3) days per month to having a continuous odor. They claimed they did not drink their tap water, consuming bottled water instead. Also, they commented that they did not complete common household tasks (i.e., laundry) using tap water when the water was heavily chlorinated. One witness at the hearing would favorably consider Indiana-American's proposed rate increase if the water quality improved.

C. City of Muncie Field Hearing

The final field hearing in this Cause was conducted on February 25, 2004, at City Hall, 300 North High Street, Muncie, Indiana. Lawful notice of the hearing was published in newspapers serving Delaware, Johnson and Marion Counties. Attending the hearing were representatives of the Petitioner, the OUCC, the Commission and members of the public. At the hearing, attendees shared their concerns regarding Indiana-American's proposed rate increase and the Company's inadequate response to sewer problems in Farmington Meadows, a Muncie residential development. In addition to the oral and written testimony received at the hearing, some individuals not in attendance at the field hearing mailed or electronically mailed comments to the OUCC, which were later filed with the Commission.

Like residents at the prior field hearings, those attending the Muncie hearing voiced their strong disapproval of Indiana-American's recent proposal for water and sewer rate increases within two (2) years of filing the Company's last request. Echoing the comments of consumers in Gary and Jeffersonville, some Muncie area residents urged the Commission to deny Indiana-American's proposed 15% to 19% rate increase to finance the company's increasing insurance costs, refinance the debt from facility acquisitions and improve employee benefits and pensions. Consumers stated that Indiana-American should pay for these expenses out of existing corporate funds and assets, such as anticipated profits, and not rely on consumers repeatedly to finance anticipated corporate expenses and planned acquisitions. Lastly, senior citizen and single-adult household consumers with limited incomes, particularly those living in the Farmington Meadows subdivision in Muncie, expressed their difficulty paying present high sewer and water rates, noting that increased rates by Indiana-American would strain their fixed budgets already pressured by increased taxes and rising insurance and health costs.

Residential consumers attending the field hearing reminded the Commission that Indiana-American provides all water service to Muncie residents, but only a portion of Muncie's sewer service, in the Farmington Meadows subdivision; the Muncie Sanitary District ('MSD') provides sewer service to residences surrounding Farmington Meadows and beyond. The president of the Farmington Meadows Association and many members of the Association supplied testimony and written comments noting that that Indiana-American has been aware of a problem with one of the sewer lines from the subdivision but has failed to identify, communicate precisely or remedy the problem. The utility's failure to communicate and act has resulted in subdivision residents paying a flat monthly rate for sewer service that amounts to more than double the amount an average resident is charged by MSD. Farmington Meadows residents voiced displeasure with their current high sewer and water rates and strongly opposed any increase in sewer or water rates without dramatically improved customer service and maintenance.

IX. RATE BASE

A. Original Cost

[3] In its case-in-chief, Petitioner presented the actual plant balances at the end of June 2003 and August 2003 and a pro forma rate base reflecting projected changes in Petitioner's rate base components. Petitioner's proposed rate base in its proposed order also reflects the retirement of the old water intake tunnel in the Northwest Operation and the retirement of computers no longer being used. In its supplemental direct testimony and exhibits, Petitioner updated its rate base to reflect actual balances as of December 31, 2003, and the actual cost of the Enhanced Customer Information System ('E-CIS ') project. The amount included for the E-CIS project in the original filing was estimated. For the purpose of our consideration of the E-CIS project, we find that it meets the definition of 'major project' in the MSFRs and was placed in service on March 8, 2004, which is more than ten (10) business days before the final hearing. However, we also note the OUCC maintains that the E-CIS project was purchased by Indiana-American's parent company and Indiana-American's allocated portion should be considered an operating cost and part of Indiana-American's costs of participating in the Alton Customer Satisfaction Center.

There were five (5) contested differences between Petitioner's original cost rate base and that of the OUCC. The OUCC proposed the following exclusions from rate base: (1) the cost of one well in the Seymour Operation and one high service pump in the Southern Indiana Operations and Treatment Center ('SIOTC '), (2) the E-CIS project [FN1] , (3) certain assets for which it said it could not find sufficient detail, (4) certain replacement meters and (5) the Company's building in Richmond. There is a sixth difference resulting from the OUCC's proposal to change our policy of allowing depreciation expense on contributions in aid of construction ('CIAC') and the OUCC's corresponding amortization of CIAC, which we shall address in our discussion of operating expenses. (See, Sect. XI. B. 4. Depreciation Expense on Contributions in Aid of Construction.) The Company did not contest the OUCC's elimination of acquisition adjustments for the Turkey Creek and Westwood acquisitions. No other party presented evidence on original cost rate base.

1. Excess Capacity

[4-6] OUCC's Position. Roger A. Pettijohn, a Utility Analyst for the OUCC's Sewer/Water/Rates Division, proposed to remove from Petitioner's rate base as excess capacity one of the five (5) wells used by Petitioner to provide service in the Seymour Operation. (Public's Exhibit 4, p. 10, lines 9-19.) Mr. Pettijohn testified that Seymour's peak day usage is approximately four (4) million gallons per day ('MGD'). Because each of the five (5) wells is individually capable of producing 1,100 gallons per minute or 1.54 million gallons per day, Mr. Pettijohn believed only three (3) of the five (5) wells are needed to meet the peak day usage for Seymour. (Id. at p. 10, lines 13- 15.) Mr. Pettijohn proposed a similar adjustment for the SIOTC, removing as alleged excess capacity one high service pump. (Id. at p. 10, line 20 through p. 11, line 3.) Mr. Pettijohn testified that according to the Recommended Standards for Waterworks only four (4) high service pumps were necessary to meet peak demand with the largest pumping unit out of service. (Id. at p. 10, lines 20-23.) As a result of Mr. Pettijohn's recommendations, the OUCC proposed to remove $987,967 from utility plant in service and $253,441 from accumulated depreciation.

Petitioner's Rebuttal. Petitioner's witness Alan J. DeBoy, Vice President of Engineering for Indiana-American, explained why it was necessary to construct five (5) wells in Seymour and five (5) high service pumps at the SIOTC. (Petitioner's Exhibit AJD-R, p. 4, lines 5-8; p. 5, lines 17-19.) With respect to Seymour, Mr. DeBoy testified that if the total nominal capacity of three (3) of the five (5) wells is simply summed, it would suggest those three (3) wells have capacity to supply enough water to meet the Seymour peak day usage. However, this ignores the impact each well has on the others. He testified that the actual capacity of the wells is below the simple sum of the nominal capacities when three (3) or more are running simultaneously. (Id. at p. 4, lines 5-8, 11-12.) Mr. DeBoy explained that this is because the wells have an influence on each others' individual capacity due to pumping level impact (aquifer characteristics) and hydraulic condition changes under different flow rates. (Id. at lines 14-17.) Mr. DeBoy noted that historical operating data indicates that when various combinations of three (3) wells in Seymour operate simultaneously, the combined output ranges from 3.9 MGD to 4.1 MGD, which is below the maximum day of 4.3 MGD recorded in August 2002. (Id. at lines 17-23.) Consequently, four (4) simultaneously operating wells are necessary to satisfy the current maximum day demand leaving one well for back-up should a failure occur in one of the other wells. (Id. at p. 5, lines 1- 3.)

Mr. DeBoy also testified that Mr. Pettijohn had not taken into account the design and construction characteristics of the SIOTC clear water reservoir in evaluating the number of high service pumps necessary to meet Petitioner's peak demand. (Id. at lines 17-19.) Mr. DeBoy explained that the SIOTC clear water reservoir was designed to include two (2), one million gallon compartment areas so that either of the one million gallon compartments can be removed from service for maintenance or rehabilitation. (Id.) Three (3) pumps serve the west reservoir and have a total capacity of 28 MGD, and two (2) serve the east reservoir and have a total capacity of 22 MGD. (Id. at p. 5, line 22 through p. 6, line 5.) Mr. DeBoy testified that all five (5) of the pumps are necessary to ensure that Petitioner can meet its peak demand with one of the reservoirs out of service.

[7, 8] Commission Discussion and Findings. In the rate order we approved for Petitioner in 1997, we listed factors that must be addressed in considering the appropriate level of capacity:

(1) The prudence of the decision to construct the new plant;

(2) The reasonableness of the demand forecasts;

(3) Whether there were changed circumstances during construction necessitating a reevaluation of the decision to continue with construction;

(4) The lead time to construct new facilities;

(5) The necessity to provide adequate and reliable utility service;

(6) The utility's need for a margin of safety or reserve;

(7) The financial impact on the utility of a finding of excess capacity and the long-term effect on the ratepayers; and

(8) The risk that changes in demand projections will impact the utility's reserves and ability to serve its customers.

N. Ind. Pub. Serv. Co., Cause No. 37458, 67 PUR4th 396, 401-02 (PSCI, Date Issued June 19, 1985). To this we will add another factor particularly important for water utilities -- the utility's need to comply with the requirements of environmental agencies.

Ind.-Am. Water Co., Cause No. 40703, 15-16 (Indiana Utility Regulatory Commission, Order Issued Dec. 11, 1997) ('1997 Rate Order').

In its rebuttal testimony, with respect to the Seymour wells, Petitioner explains that the simultaneous running of the various wells results in a capacity level that is less than the sum of each individual well's capacity. The OUCC's contention that only four (4) wells are necessary is based on the sum of each individual well's capacity. Petitioner explains that four wells would need to run

**(Publication page references are not available for this document.)**

simultaneously in order to achieve the historical daily maximum capacity of 4.3 MGD, even though the nominal capacity of each well is 1.54 MGD. Under such circumstances, Petitioner would have only one backup well. We find that Petitioner has demonstrated an appropriate level of capacity with respect to its five (5) Seymour wells.

Regarding the five (5) pumping units at the SIOTC, the OUCC relies on the recognized expertise of Recommended Standards for Waterworks to demonstrate that Petitioner has excess pumping capacity of 15.7 MGD with its largest pumping unit out of service. Petitioner attempts to rebut this contention by discussing an isolation feature in the clear water reservoir associated with the high service pumps in question. This feature is explained as the ability to divide the reservoir into two (2), one million gallon compartments, and to take one compartment out of service for rehabilitation and maintenance work while the other compartment is in service. According to Mr. DeBoy, each compartment should have pumping capacity to meet peak day demand, and therefore, no excess capacity currently exists.

Mr. DeBoy's rebuttal testimony indicates that this feature has not yet been used but will be needed 'at some point in the future.' The non-contradicted evidence established that Petitioner, with the largest unit out of service, has 15.7 MGD more capacity than the required 22 MGD. Since Petitioner's case to reject the alleged excess capacity is founded on justifying the need to have this reservoir-isolation technique, we thus need to determine whether this feature is used and useful. Mr. DeBoy's testimony on this point is limited to testifying that reservoir maintenance will be needed at some point in the future. We note that this is the first time this specific feature has been brought to our attention and has not been a contested issue in Petitioner's previous cases. Therefore, we shall make our decision based on the evidence of record that we now have before us. We find that Petitioner did not provide evidence to support the time frame within which this engineering feature will be used and useful. Further, we find Petitioner's evidence lacked information that we deem necessary in order to allow this plant in rate base, this information includes but is not limited to:

. the frequency that the reservoir maintenance occurs,

. the amount of time necessary to carry out the maintenance of the reservoir,

. the time of year when Petitioner plans to carry out the maintenance of the reservoir,

. whether Petitioner could implement the reservoir maintenance during non-peak months, and

. whether Petitioner needs five (5) pumps at the SIOTC if the reservoir's maintenance could be implemented during non-peak months.

We find that Petitioner's rate base should be reduced by $753,378 for excess capacity at the SIOTC and that the accumulated depreciation should be also reduced by $232,248.

2. Miscellaneous Rate Base Reductions

[9-11] OUCC's Position. OUCC Utility Analyst Dana M. Lynn proposed several adjustments based on two (2) issues that resulted in a reduction to Petitioner's proposed original cost rate base of $179,994. The first issue raised by the Public was Petitioner's failure to provide adequate support for the level of costs it proposed to include in rate base. Ms. Lynn testified that Petitioner added over $149 million in fixed asset additions over the last three (3) years. She testified that she made numerous attempts to review a small percentage of Petitioner's utility plant. She explained that, on numerous occasions, she addressed questions to Indiana-American employees James L. Cutshaw, a Senior Financial Analyst for Petitioner; William J. Wolf, Petitioner's Director of Rates and Planning; and Ms. Sharon Keeney, Mr. DeBoy's Assistant. She also provided both informal and formal discovery to attempt to review fixed asset records. (Public's Exhibit 3, p. 18, lines 22 through p. 19, line 8.) She testified that the documentation Petitioner ultimately provided almost two (2) months later through a formal request was still inadequate. (Id. at p. 17, lines 21-23.) Ms. Lynn stated that Petitioner's delay substantially limited the amount of time for the OUCC's review. (Id. at p. 22, lines 26 through p. 23, line 2.) Ms. Lynn pointed out that it took Petitioner several attempts to provide the detail that it purported would support her request. Ms. Lynn testified that of the ten (10) fixed asset additions she ultimately reviewed, Petitioner provided adequate support for only one-half of those. The OUCC has proposed that the remaining five (5) assets be reduced from Petitioner's rate base by $170,703, which is the amount that Petitioner failed to support. (Public's Exhibit 3, Sched. DML-1, p. 1.) Ms. Lynn stated that none of Petitioner's staff could successfully retrieve full information from Petitioner's computerized accounting system. (Public's Exhibit 3, p. 19, lines 16-20.)

The second issue raised by the Public was Petitioner's accrual of Allowance For Funds Used During Construction ('AFUDC') on comprehensive planning studies, amendments to comprehensive plans and tank inspections reports. Ms. Lynn proposed to reduce Utility Plant in Service and Accumulated Depreciation by $13,380 and $4,089, respectively. Ms. Lynn further testified that Petitioner accrued AFUDC in excess of the cost of the tank inspection reports Petitioner capitalized in 2002. She explained that Accounting Instruction 19 in the 1996 National Association of Regulatory Utility Commissioners' ('NARUC') Uniform System of Accounts for AFUDC states that 'AFUDC includes the net cost for the period of construction of borrowed funds used for construction purposes and a reasonable rate on other funds when so used.' (Id. at p. 24, lines 1-3.) She stated that comprehensive planning studies and tank inspections are not considered a capital asset under NARUC's description of components of construction. (Id. at lines 7-13.) Ms. Lynn stated that these costs are more properly considered maintenance costs and should not be included as a component of rate base. She stated that Petitioner defines maintenance costs by referring to the NARUC Uniform System of Accounts:

-- Inspecting, testing, and reporting on condition of plant specifically to determine the need for repairs, replacements, rearrangements and changes, and inspecting and testing the adequacy of repairs which have been made.

-- Work performed specifically for the purpose of preventing failure, restoring serviceability or maintaining life of plant.

Id. at lines 16-24.

Ms. Lynn explained that comprehensive planning and tank inspections are clearly defined as maintenance costs and Petitioner should not capitalize these costs and, moreover, should not accrue AFUDC. The net effect of Ms. Lynn's adjustment is a recommended reduction to rate base of $9,291.

Petitioner's Rebuttal. Petitioner's witness DeBoy testified that he reviewed the specific projects where Ms. Lynn recommended rate base adjustments due to recorded expenditures that were not fully supported and stated he was able to substantiate and verify the appropriateness of all costs booked for these projects. (Petitioner's Exhibit AJD-R, p. 8, lines 21-23.) He stated copies of the supporting information for these assets are found in Petitioner's Exhibit AJD-R1. Mr. DeBoy explained in step-by-step fashion how the supporting information was retrieved from Petitioner's computerized accounting system. Mr. DeBoy testified that additional assistance can be provided to the OUCC in the future to satisfy its audit process. (Petitioner's Exhibit AJD-R, p. 9, lines 10-12.) As to Petitioner not supporting the cost of a building in Richmond that had been used to house Petitioner's call center, Mr. Cutshaw testified that once Petitioner responded to the Public that it did not have the purchase agreement for the Richmond Building, he did no further research until the Public filed its testimony and exhibits which excluded the building purchased in 1994. (Petitioner's Exhibit JLC-R, p. 3, lines 12-17.) In its rebuttal testimony, Petitioner provided a warranty deed and a memo memorializing the terms of the agreement. Mr. Cutshaw testified that only $435,332 of the purchase price has been included in rate base since Cause No. 40103 (Cause No. 40103, 169 PUR4th 252 (Indiana Utility Regulatory Commission, Date Issued May 30, 1996), '1996 Rate Order').

Petitioner's witness Mr. Wolf explained why Petitioner was unable to provide the data requested by the OUCC. He testified that the fixed asset records requested by Ms. Lynn are not routinely accessed by Petitioner's finance staff. Instead, the Petitioner's field personnel are proficient at navigating this part of Petitioner's J.D. Edwards accounting system because they use it on a daily basis. Mr. Wolf testified that in future cases, Petitioner's finance staff will undergo further training so as to be more helpful. (Tr. pp. H-66-H-67.)

Mr. DeBoy also responded to the accrual of AFUDC. He testified the comprehensive planning studies and tank inspections are engineering functions that ultimately lead to capital projects. Since engineering functions which lead to capital projects are typically capitalized and AFUDC accrued, Mr. DeBoy testified that Ms. Lynn's adjustment should be rejected. (Petitioner's Exhibit AJD-R, p. 9, lines

**(Publication page references are not available for this document.)**

18-22.) Commission Discussion and Findings. Our concern about Petitioner's fixed asset records not being accessible to the Public was previously discussed in our Order in Cause No. 42029, wherein we stated the following:

We are troubled by the uncontroverted revelations of Ms. Lynn, wherein she noted the difficulties that Public encountered in attempting to confirm the accuracy of fixed asset additions due to the conversion of data in October 1998 to a new J.D. Edwards accounting system and supporting detail not being easily accessible. When Petitioner made this conversion, it combined each fixed asset account into one amount. Petitioner's staff stated that detail existed at a location off-site in the form of ledger books and detailed report binders and that the hiring of additional personnel would be necessary to retrieve the information requested for review. As a result, all supporting detail could not be produced without an exhaustive effort by Petitioner's staff as well as OUCC audit staff. Ms. Lynn did not adjust rate base for $41,588 in interior design fees[;] $194,477 in cubicles, countertops, overhead cabinets, filing cabinets and electrical services, associated with the displaced employees from the shared service initiative[;] and $241,362 for office remodeling for the Gary location that she could not reconcile due to inadequate documentation.

Ind.-Am. Water Co., Inc., Cause No. 42029, 22-23 (Indiana Utility Regulatory Commission, Date Issued Nov. 6, 2002).

It appears that our concern raised in Order Nos. 42029 and 42043 about the adequacy and accessibility of Petitioner's fixed asset records has not been fully addressed. (See 2002 Rate Order and Ind.-Amer. Water Co., Cause No. 42043 (Indiana Utility Regulatory Commission, Date Issued Nov. 20, 2002).) Petitioner has added over $149 million in fixed assets over the last three (3) years and requests that we include these improvements in rates. Petitioner did not dispute any of the difficulties raised by Ms. Lynn and in fact concurred that they could not provide her the documentation she needed to review fixed assets. (See Petitioner's Exhibit WJW-R; Tr. p. H-66, lines 9-12.)

A review of the documentation provided by Mr. DeBoy to rebut Ms. Lynn's adjustment suggests, for the most part, a lack of adequate documentation. For example, the documentation Petitioner provided to support the $70,458 for the tank painting located at Interstate 65 includes $24,246 identified as a monthly allocation of CWIP overhead and an additional $30,709 in engineering fees that are supported by nothing more than a print screen from Petitioner's J. D. Edwards system. There is nothing to explain why these costs were necessary and what was included in these costs. Furthermore, it appears from Petitioner's documentation that at times it charges engineering costs based on monthly allocations and not as direct charges. Also, for example, the credit card statement for Jeff G. Robinson does not add to the reconciliation provided by Petitioner. There are no references that tie any of the task order numbers to the asset numbers identified by Ms. Lynn, and it appears that certain assets have more than one task order number. Finally, Petitioner paid over $3,800 in sales tax for a piece of equipment that is used in the provision of providing water, thus, sales tax should not have been paid.

Given this recurrence of the OUCC's inability to fully obtain needed information from Petitioner, it seems reasonable to conclude that Indiana-American has been unwilling to fully cooperate in allowing the OUCC to carry out its responsibility to protect the public interest when a public utility is seeking a rate increase. A full review of the OUCC's testimony on this issue reveals unacceptable responsive conduct by Petitioner to discovery requests made by the OUCC. Petitioner has presented no acceptable reason as to why any of the information sought by the OUCC, whether in electronic or paper form, should not be readily available, organized and, if needed, explainable. What confounds Petitioner's conduct all the more is, first, that the OUCC's responsibility as the public advocate in a proceeding such as this is well explained by statute, including its right to examine Petitioner's records. Second, by filing for relief under the Commission's MSFRs, Petitioner is seeking a resolution to its request for a rate increase within an expedited timeframe. This expedited timeframe does not allow for any party to have to endure an unreasonable lack of cooperation in its discovery efforts. Petitioner has stated that it can be more helpful in future cases. We hope so. In the meantime, having reviewed the OUCC's frustration as well as the information actually provided and not provided by Petitioner, we find, with the exception of the Richmond building, that Petitioner has not adequately supported the costs associated with the assets Ms. Lynn removed from rate base and find that these assets should be removed from Petitioner's proposed rate base. With respect to the Richmond building, we find the warranty deed provided by the Petitioner adequately supports the amount included in the rate base.

Finally, we agree with the Public that Comprehensive Planning Studies and Tank Inspection Reports are not components of construction and, therefore, should neither be capitalized nor accrue AFUDC. Petitioner claimed these costs are 'engineering functions' that ultimately lead to capital projects, and we agree. (Petitioner's Exhibit AJD-R, p. 9, line 19.) These engineering functions are used to evaluate what Petitioner's system may or may not need. A comprehensive plan is typically a current and projected analysis of a utility system's needs, and tank inspections are performed to evaluate the condition of a tank. Both tank inspections and comprehensive plans involve inspections, testing and reporting on the condition of plant specifically to determine the need for repairs, replacements, rearrangements and changes. These types of engineering functions can also be performed specifically for the purpose of preventing failure, restoring serviceability or maintaining life of plant. Based on Petitioner's definition of maintenance expense and the Accounting Instruction contained in the NARUC Uniform System of Accounts that defines AFUDC, tank inspections and comprehensive planning studies should not be considered a component of construction and, thus, should not be included as a capitalized cost that accrues AFUDC. We believe 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. Neither a comprehensive plan nor a tank inspection report is ever placed in service. It is unreasonable to suggest that AFUDC should accrue on planning tools that may identify the need to develop a project in the future.

Accordingly, we accept the OUCC's net adjustment, and reduce rate base by $9,291. We direct Petitioner for all future costs associated with tank inspections and comprehensive planning to expense these costs as they occur.

The Public has raised another issue associated with Petitioner's Tank Inspection Reports that merits discussion. According to the OUCC, Petitioner's early retirement of these assets allows Petitioner to forever earn a return on the undepreciated balance of the asset retired. Public's Exhibit 3, Attachment No. 13, page 1, offered by Ms. Lynn, shows that Petitioner recorded $62,301 for its 2002 tank inspection costs in account #339600 -- Other P/E CPS Post 1997, shown in the Asset Cost Subsidiary column. The annual depreciation would equal $12,460 ($62,301/5-years), with a depreciation accrual rate for this account of 20% or five-years. It was undisputed that the tank inspections costs were retired within a year of being recorded in Utility Plant in Service.

Thus, Petitioner will earn a return on assets that are no longer used and useful in the provision of Petitioner's water utility service. It is unreasonable for Petitioner to accrue AFUDC in excess of the cost for any asset. The Public provided undisputed evidence that Petitioner accrued $40,623 in AFUDC on its 2002 tank inspection reports that cost only $21,678. Petitioner capitalized these costs and then retired them the following year. Petitioner has over 100 tanks that it inspects and the Public only looked at one year in which five (5) tank inspections were completed. This is a valid issue raised by the OUCC, and further justifies our direction to the Petitioner to not capitalize these costs, but to expense them as they occur.

3. Muncie Meters

[12] OUCC's Position. OUCC witness Roger Pettijohn testified that Muncie operations manager, Randy Moore, informed him that Petitioner is replacing meters every five (5) years in Muncie. Mr. Pettijohn testified that a ten (10) year replacement program is more reasonable because Muncie water meters undergo no unusual conditions with respect to water quality, pressure or volume. Mr. Pettijohn testified Petitioner spent $773,264 over a two (2) year period for meters, and that $353,989 was designated as new meters for new installation. Mr. Pettijohn proposed an adjustment to Petitioner's meter purchases pursuant to implementing a ten (10) year replacement program. He proposed that Indiana-American's annual meter allotment of $386,000 should be reduced by half ($193,000). The OUCC also proposed to reduce accumulated depreciation by $71,772.

Petitioner's Rebuttal. In rebuttal, Duane D. Cole, Vice President of Operations for Indiana-American, disagreed with Mr. Pettijohn's proposed adjustment, asserting that it is based on incorrect or misunderstood information. Mr. Cole testified that Petitioner's policy for meter replacement for all of its operations, including Muncie, is ten (10) years. Mr. Cole claimed that Muncie operations manager, Randy Moore, said that the ten (10) year replacement policy has been and currently is being followed. Mr. Cole stated that there is no need to adjust the annual meter purchases because the ten (10) year replacement program that the OUCC supports is already in effect. (Petitioner's Exhibit DDC-R, pp. 4-5.)

Commission Discussion and Findings. Petitioner and the OUCC seem to agree that Muncie spent an average of approximately $383,000 on meters in calendar years 2002 and 2003; that Muncie spends approximately $50 for a 5/8 inch meter (Public's Exhibit 1, Attach. RAP-6); and that a ten (10) year change-out program is advisable for Muncie. Since Muncie has a residential base of approximately 24,000 services, a ten (10) year meter change out program would require 2,400 meters per year at a cost of approximately $120,000 per year. With the $383,000 per year Muncie actually incurred for meter replacement, Muncie would have purchased 7,660 meters ($383,000 / 50) in each of the last two (2) years.

In rebuttal, Petitioner did not challenge any of the OUCC's calculations, but confined its rebuttal testimony to disputing the OUCC's assertion that the Muncie operation employs a five (5) year meter replacement program. In a post-hearing reply brief to the OUCC's proposed Order, Petitioner argued that had it known the OUCC's testimony with respect to the amounts spent for meter replacement were relative to the Muncie operation it would have submitted rebuttal testimony that these are total company numbers. We find this argument to be unreasonable. The whole of the OUCC's direct testimony on this issue is found within a discreet discussion titled the 'Muncie Water District.' We have no hesitation in concluding that the OUCC was presenting testimony confined to meter replacement in Muncie. If Petitioner thought the OUCC was discussing amounts attributable to all of Petitioner's meter replacements, it should have been obvious that a recommendation by the OUCC to reduce by half the total Company amount for meter replacements was misplaced in the context of a concern limited to the Muncie Water District. Based on the evidence presented, we find that a ten (10) year meter replacement program has not been but should be put into place. Therefore, we approve the OUCC's proposed adjustment to Petitioner's annual meter purchases in the Muncie district.

B. Acquisition Adjustments

1. Northwest Acquisition Adjustment

[13-16] Prior to its merger into Petitioner, Northwest was a public utility providing water utility service to approximately 65,000 retail customers in Lake and Porter Counties. Northwest also provided wholesale service to various communities and utilities in those counties. On June 25, 1999, Northwest's ultimate parent company, National Enterprises, Inc. ('NEI'), was acquired by American for stock valued at $475 million. (Petitioner's Exhibit JEE, p. 21.) Of that amount, $48,752,000 was allocated to the Northwest acquisition. (Id. at p. 22.) It has been Petitioner's contention that this exceeded the book value of Northwest's equity by $21.472 million. Pursuant to approval granted by the Commission in its December 15, 1999 Order in Cause No. 41484, Northwest was merged into Petitioner effective January 1, 2000, with Petitioner being the surviving corporation. Thereafter, Petitioner commenced service in the areas and to the customers previously served by Northwest.

**(Publication page references are not available for this document.)**

On February 1, 2000, one month after the Northwest merger, Petitioner acquired all of the common stock of United, and on the same date these two companies were merged into Petitioner. (Petitioner's Exhibit JEE, p. 23.) The United acquisitions resulted in the creation of another acquisition adjustment in the amount of $12,405,032. (Id. at p. 25.)

In Cause No. 42029, Petitioner proposed that the revenue requirement used to set its rates includes a fair value increment to net operating income ('NOI ') reflecting a return on the Northwest and United acquisition adjustments, as well as a much smaller acquisition adjustment relating to Petitioner's acquisition of the Cementville system from Watson Rural Water Company; Petitioner sought an acquisition adjustment for Watson Rural consistent with the Commission's treatment of the Indiana Cities acquisition adjustment. In support, Petitioner submitted evidence on the aggregate cost savings achieved by the Northwest and United acquisitions and non-monetary benefits from the acquisitions, including improved service.

Our analysis in the 2002 Rate Order concluded that Petitioner should not be allowed favorable ratemaking treatment for the Northwest and United acquisition adjustments. Further, Petitioner asked us to reconsider this finding in its Petition for Rehearing and Reconsideration filed in that Cause which we again denied. Petitioner is not, in this proceeding, seeking a return on the United acquisition adjustment.

Petitioner's Position. John E. Eckart, President of Indiana-American, testified that in this case Petitioner has responded to our 2002 Rate Order by quantifying the amount of the savings found by the Commission in that Order that resulted solely from the Northwest acquisition. He said these savings are greater than the revenue requirement relating to the amount by which the purchase price allocated to Northwest exceeded the book value of Northwest's common equity, which equals the Northwest acquisition adjustment. Based on this analysis, Petitioner proposes that the Commission authorize a fair value increment sufficient to allow it to earn a reasonable return on the Northwest acquisition adjustment. Mr. Eckart asserted that when the Northwest acquisition is viewed separately, the standard set out in the 2002 Rate Order for recognition of the Northwest acquisition adjustment is easily satisfied.

Wayne W. Brownell, Vice President of Finance for Indiana-American, testified on the quantification of the cost savings from the Northwest acquisition accepted by the Commission in the 2002 Rate Order, identifying for each type of savings the page of the Order where findings on the cost savings are made. (Petitioner's Exhibit WWB, p. 11.) In most cases the findings related to the Northwest and United acquisitions are in the aggregate. However, Mr. Brownell explained that, by reference to testimony and exhibits of the OUCC and work papers submitted pursuant to the MSFRs, the share of the savings attributable to Northwest alone can be determined. (Id. at p. 12.) Mr. Brownell testified that the Northwest portion included operation and maintenance expense savings of $2,718,463 per year and investment savings of $312,030. (Petitioner's Exhibit WWB-5, p. 1.) Applying the cost of capital determined in the 2002 Rate Order to the net amount of the Northwest acquisition adjustment (the original acquisition adjustment of $21.472 million less the accumulated amortization as of each year through 2004), Mr. Brownell computed an excess of savings over revenue requirement as follows:

| 5p Year | Savings minus Revenue Requirement |
|---|---|
| Acquisition | ($19,529) |
| 1999 | $15,583 |
| 2000 | $85,810 |
| 2001 | $156,035 |
| 2002 | $226,260 |
| 2003 | $296,487 |
| 2004 | $366,712 |

Id.

Mr. Brownell testified that Petitioner investigated whether the savings quantified in the 2002 Rate Order continue to be achieved in the same or a greater amount. Mr. Brownell discussed each type of savings and explained how the sustainability of the savings had been confirmed. In the case of the labor cost savings, for example, the Northwest Operation employee level is actually lower now than at the time of the last rate case. Mr. Brownell said the lower employee count meant that the labor cost savings included in his analysis are underestimated by about $450,000.

Mr. Eckart testified that the acquisitions of Northwest and United are directly related to solving the problem of small and troubled water utilities because they added many new operating centers (hubs) from which extensions can be made (spokes) to reach small and troubled systems within a reasonable radius. He stated that it is feasible for larger well-run and financially-sound utilities to acquire small and troubled utilities when they are within twelve (12) to twenty-five (25) miles of a hub. He referred to this as the 'hub and spoke' approach to consolidation and regionalization. He also identified a presentation by the Chief of Staff of the USEPA's Office of Ground Water and Drinking Water recognizing that the geographic proximity to larger systems is key to resolving the infrastructure challenge faced by small water utilities. (See Petitioner's Exhibit JEE-3.) Mr. Eckart also testified that small systems become subject to more strict USEPA standards after they are acquired by Petitioner.

OUCC's Position. E. Curtis Gassert, Director of the OUCC's Sewer/Water/Rates Division, testified for the Public. In his testimony in Cause No. 42029, which he incorporated into his testimony in this Cause, Mr. Gassert explained that he considered the acquisition premium to be 'imputed' because the transaction was accounted for as a pooling of interest. Mr. Gassert asserted that under this method of accounting for acquisitions no acquisition premium is recorded. Rather, the assets and liabilities of the acquired company are simply added to the books of the acquiring company. Therefore, he asserted, there is no acquisition premium for the utility to recover. Mr. Gassert stated that the utility should not be allowed to recover something that does not exist. Mr. Gassert further testified in Cause No. 42029 as follows:

Mr. Gassert noted that the negative impacts of allowing Indiana-American to recover an acquisition premium that does not exist could be staggering. He noted the then recent announcement that RWE offered to acquire American Water Works for $4.6 billion. Also, he noted that AES completed its purchase of IPALCO. According to Mr. Gassert, if it becomes acceptable for these purchase prices to be allocated to their regulated utility subsidiaries and imputed or pushed down as indicators of fair value to the utilities, Indiana ratepayers will be required to pay millions of additional dollars just because their utility's parent company was acquired.

Mr. Gassert added that a similar request was made in Cause No. 41661 where Harbour Water requested to earn a return on an acquisition premium that was 'pushed down' from its parent company. Mr. Gassert noted that the Commission did not allow Harbour Water to earn a return on that 'pushed down' or imputed acquisition premium.

Mr. Gassert also asserted that the purchase price imputed to the Northwest acquisition was not representative of the fair value of Northwest's assets for several reasons. First, Mr. Gassert cited evidence indicating that substantial goodwill or going concern was included in the purchase price. Mr. Gassert defined goodwill as the excess of the purchase price paid to acquire a business over the market value of the assets acquired. He further noted that goodwill is different than other assets because goodwill can only be identified with the business as a going concern. For this reason, goodwill is sometimes referred to as 'going value' or 'going concern value.' Mr. Gassert cited examples of goodwill which included brand values; market share; monopoly conditions; superior earnings potential; strategic location; access to natural resources; governmentally-conferred privileges, such as franchises and grants; and other strategic benefits and competitive advantages.

Mr. Gassert stated that the Commission must exclude from fair value any amounts for goodwill and going value according to Ind. Code § 8-1-2-6. He further stated that any valuation performed on a utility's assets must include going concern because such an evaluation presupposes attached customers, a given demand for service, appropriate business organization and management, and, thus, earning power. If the properties were not actually a going concern and were not regarded as such, their market value would be much less than reproduction cost less depreciation. Practically all the plant and equipment would have very little resale value. Essentially, the utility's plant is worth very little without customers. Thus, he asserted, the going value of a business is an essential element in the proper valuation of a public utility. To support his contention, Mr. Gassert noted the following discussion by the Supreme Court of Wisconsin:

In the proper valuation of a public utility for condemnation or sale purposes certain main elements usually present in every case may legitimately be considered. These are the present value of its physical property; the present and prospective reasonable earnings of its business, the going value thereof; and the amount of money presently needed to put the plant in good condition. There may be other elements, but these are generally the essential ones .... The going value of a utility is that part of its value due to its having an existing established business.

Oshkosh Waterworks Co. v. R.R. Comm'n, 161 Wis. 122, 127, 152 N.W. 859, 861-862 (1915) (emphasis added). Mr. Gassert concluded that it is inherent that the purchase price already includes some amount of going value and cannot be relied upon to set the fair value.

Second, Mr. Gassert also noted the poor condition of the intake tunnel which required significant investment that will be more than $58 million in the first three (3) years following the acquisition. Mr. Gassert noted that when the $48.752 million purchase price is combined with the $58 million of additional investments, Indiana-American will have spent $106.752 million for a utility that had a book value of $27.280 million when acquired. Mr. Gassert asserted the premium Petitioner paid does not reflect a utility that required such substantial additional investments. Mr. Gassert concluded that such a premium for a utility requiring substantial investment indicates the purchase of something other than the tangible assets and, therefore, should be excluded from rate base.

Mr. Gassert stated that the amount of needed investment in an acquired utility should reduce the amount paid to acquire that utility. In Cause No. 40103, Mr. George Johnstone, President and CEO of American, made the following statement:

In fact, I can think of examples where you would buy a utility at lower prices than book value, and the reason that you would end up getting that price acceptable is the investment needed to bring the facilities up to the level they need to be at.'

See Ind.-Am. Co., Inc., Cause No. 40103, 169 PUR4th 252 (Indiana Utility Regulatory Commission, Date Issued May 30, 1996), Tr. p. GWJ-37, line 24.

Mr. Gassert testified that goodwill and required investment were not the only reasons to indicate that the purchase price of Northwest could not be relied on to determine the fair value of Northwest's tangible assets. Third, when the NEI purchase price was allocated between the non-regulated and regulated utilities, the Company allocated an excessive amount to the regulated utilities. Mr. Gassert asserted that this could be determined by reviewing the Merrill Lynch valuation information provided on page 8 of Mr. Hartnett's testimony in Cause No. 42029. Mr. Gassert reproduced Mr. Hartnett's data below:

| | Low | High |
|---|---|---|

| | (Millions) | (Millions) |
|---|---|---|
| Water Companies | $346.8 or 82.1% | $436.8 or 82.7% |
| Securities Held at Market | 62.7 | 78.6 |
| Other Holdings | 12.9 | 12.9 |
| Total | $422.4 | $528.3 |

From reviewing the Merrill Lynch data above, the water company values range from 82.1% to 82.7% of the total NEI holdings. But, as Mr. Gassert noted, the amount actually allocated to the regulated water companies was 87%. This amount was calculated by dividing the $415 million allocated to the water companies by the total $475 million NEI purchase price. Mr. Gassert further observed that, if the average of the low and high valuations are used, then the purchase price allocated to the regulated water utilities would be $391.4 million ($475 million X 82.4%). Mr. Gassert explained this would result in an over-allocation of $23.6 million ($415 million - $391.4 million) to the regulated water utilities.

Mr. Gassert explained that a portion of the over-allocation can be attributed to the improper allocation of income taxes that would result from the sale of nonutility assets to the regulated water utilities. As explained on page 11 of Mr. Hartnett's testimony, a 'valuation adjustment' was applied to the values of the nonutility assets to reflect the taxes that would be paid when these stocks were sold. After these adjustments were made, the net values of the nonutility assets were subtracted from the total purchase price to determine the purchase price for the water utilities.

Mr. Gassert posited that the impact of the 'valuation adjustment' is to allocate income taxes from the sale of nonutility stocks to the purchase price of the regulated water utilities which is clearly improper. He stated the income taxes that will be paid when the nonutility stocks are sold add no value whatsoever to the regulated water utilities and these income taxes should not be added to the purchase price of the utility stocks.

Mr. Gassert compared the allocated purchase prices to the Merrill Lynch valuation analysis and determined that the $475 million total price paid for NEI falls directly in the middle of the valuation range of $422.4 million to $528.3 million. However, the $415 million price allocated to the water companies falls on the high side of the valuation range of $346.8 to $436.8 million. The $391.4 million calculation Mr. Gassert performed above falls directly in the middle of the valuation range for the water companies and provides additional assurance that an unreasonable amount was allocated to the water companies.

In addition to the foregoing, Mr. Gassert expressed another concern about the amount allocated to the Northwest purchase price. Mr. Gassert noted that the NEI purchase price was allocated based on book equity and net income as of September 30, 1998. Mr. Gassert stated that allocating the purchase price in this manner does not represent the true value of the acquired utilities that an independent valuation might generate. For instance, this method of allocation does not consider the condition of the assets when acquired. As previously stated, Indiana-American will have invested $58 million in Northwest since its acquisition. The poor condition of its intake tunnel assets should have been reflected in the purchase price allocated to Northwest but was not because the NEI purchase price was allocated based on book equity and net income.

In his testimony prepared for this Cause, Mr. Gassert noted that in an effort to seek approval of Indiana-American's acquisition adjustment for the Northwest Acquisition, Mr. Eckart discussed at length the benefits of Indiana-American expanding its 'footprint' and how its acquisitions of Northwest and United created new hubs that provide the potential to help small and troubled water utilities not previously within Indiana-American's reach. Mr. Gassert disagreed that the acquisition of Northwest and United created new hubs to help small and troubled water utilities. While Mr. Gassert agreed that the acquisition of those existing hubs may have assisted Indiana-American in acquiring certain small and troubled utilities not previously in its reach, those hubs for acquiring small and troubled utilities preexisted their acquisition by Indiana-American. (See Public's Exhibit 5, pp. 29-30.) Mr. Gassert suggests that Mr. Eckart's analysis fails to acknowledge the contributions Northwest could and did make in acquiring small or troubled systems. According to Mr. Gassert, Mr. Eckart's argument rests on the false premise that only Indiana-American could have and would have acquired the small utilities it merged into the Northwest operation.

Mr. Gassert noted that well before Indiana-American acquired Northwest, which had 65,000 customers and was owned by a parent that owned four (4) water utilities, Northwest was an existing hub that possessed the technical, financial and managerial ability to acquire small and troubled utilities and exercised that ability before it was acquired by Petitioner's parent. Mr. Gassert noted that Northwest was both willing and able to acquire smaller systems to create a larger regional water utility. Mr. Gassert stated that its growing regionalism was one of the factors that caused Northwest to change its name from the Gary-Hobart Water Company to the Northwest Indiana Water Company in 1994.

By way of example of Northwest's willingness and ability to acquire smaller systems, Mr. Gassert stated that before it was acquired, Northwest acquired Shorewood Forest Utilities, Inc.; People's Water Co.; Independence Hill Third Addition Water Works, Inc.; water utility properties of Utility Services Corp.; the water distribution system of Chesterton; and the water distribution system of Burns Harbor. These six (6) acquisitions were all completed within the ten (10) years prior to Indiana-American's acquisition of Northwest and without any effort on the part of Northwest to seek acquisition adjustments. Mr. Gassert also described the willingness of many water utilities in Indiana to acquire small and troubled water utilities specifically listing such municipal utilities as Bloomington, Elkhart, Merrillville Conservancy District and the Cities of Woodburn and Whitestown.

Mr. Gassert concluded that he cannot see that Indiana-American's acquisition of

Northwest and United made possible future acquisitions of small and troubled utilities that were not previously feasible. Mr. Gassert reiterated that Northwest was very active with the acquisition of small systems and there is no reason to believe that the practice would not have continued without Petitioner's ownership. Therefore, Mr. Gassert did not believe Indiana-American's hub and spoke system justifies the recovery of the Northwest acquisition adjustment, which was denied in the last case and which it again seeks.

Further, Mr. Gassert expressed concern that Petitioner's request appears to be an effort to replace the Commission's long standing 'troubled' utility standard with a new less stringent standard. However, he added that even if the troubled utility standard were to be replaced with a standard that reviews whether the acquisition makes possible future acquisitions of small and troubled utilities that were not previously feasible, Petitioner would fail that standard since it was already feasible for Northwest to make acquisitions of small and troubled utilities before being acquired by Indiana-American. (Public's Exhibit 5, p. 27, lines 5-13.)

With respect to Petitioner's hub and spoke concept, Mr. Gassert agreed that it is better to have larger more regionalized water utilities rather than tens of thousands of smaller systems. But he disagreed with the benefit, as described by Petitioner as it relates to the Northwest acquisition, that it has created something where nothing previously existed and should get credit for its creation. Indiana-American did not create Northwest Indiana Water. Indiana-American was the successful acquirer of an existing hub. Further, Northwest did not become a hub to acquire small and troubled systems only after its acquisition by Petitioner's parent. Northwest had established a record of such transactions before being acquired. Mr. Gassert concluded that the Commission should not provide favorable ratemaking treatment for the Northwest acquisition based on Petitioner's hub and spoke argument.

Addressing Petitioner's claim of savings resulting from the Northwest acquisition, Mr. Gassert stated that Mr. Brownell's asserted annual savings of $2,789,494 overstates the annual savings and understates the annual revenue requirement. Mr. Gassert explained that Mr. Brownell failed to include the management fee expense category. Referring to page 9 of the Commission's order in Cause No. 42029, Mr. Gassert noted that Petitioner's witness calculated savings in this category of $302,224, while the OUCC's witness calculated increased costs of $639,256. Relying on the data reported on OUCC Utility Analyst Judith Gemmecke's Schedule JIG-11, page 4 of 6 submitted in Cause No. 42029, Mr. Gassert calculated Northwest's portion of the management fee to be $304,930. Mr. Gassert asserted that the annual savings corrected for the omitted management fees would be $2,413,533 ($2,718,463 - $304,930).

During his questioning at the Evidentiary Hearing, Mr. Gassert noted that Mr. Brownell, in his rebuttal testimony, disputed the management fee figure used by Mr. Gassert. Mr. Gassert testified that he performed an analysis assuming the savings Mr. Brownell said should apply. Mr. Gassert explained that Mr. Brownell suggested that the number Mr. Gassert used to calculate management fees for

**(Publication page references are not available for this document.)**

Northwest was incorrect, and so he inserted the number that Mr. Brownell indicated was the correct number to use. Mr. Gassert noted that, even using the number which Mr. Brownell provided, he still determined there were no savings.

Discussing how Mr. Brownell understated the revenue requirement related to the Northwest acquisition, Mr. Gassert noted that Mr. Brownell failed to include the annual amortization of $536,800 as a component of the revenue requirement. Both Mr. Eckart and Mr. Brownell have requested to recover the annual amortization through rates if the net acquisition adjustment is used to determine the NOI as previously discussed.

Mr. Gassert noted that the first year revenue requirement, corrected for the annual amortization, is $3,201,074 and calculated on Attachment ECG-4 of his testimony. (Public's Exhibit 5, Attach. ECG-4, pp. 1-2.) Mr. Gassert compared his results to Mr. Brownell's by summarizing his results in the same format as found on Mr. Brownell's exhibit. (See Petitioner's Exhibit WWB-5.) The OUCC's results indicate Petitioner's costs exceed the anticipated savings by a substantial amount in each of the first seven (7) years. The amount that cost exceeds savings is represented by the positive numbers. The negative numbers in Petitioner's Exhibit represent claimed savings over costs. OUCC results:

[Note: The following TABLE/FORM is too wide to be displayed on one screen. You must print it for a meaningful review of its contents. The table has been divided into multiple pieces with each piece containing information to help you assemble a printout of the table. The information for each piece includes: (1) a three line message preceding the tabular data showing by line # and character # the position of the upper left-hand corner of the piece and the position of the piece within the entire table; and (2) a numeric scale following the tabular data displaying the character positions.]

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*******************************************************************************
******** This is piece 1. -- It begins at character 1 of table line 1. ********
*******************************************************************************

| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
|---|---|---|---|---|---|
| Revenue Rqmt. | $3,201,074 | $3,143,461 | $3,085,849 | $3,028,237 | $2,970,625 |
| Cost Savings | 2,484,564 | 2,484,564 | 2,484,564 | 2,484,564 | 2,484,564 |
| Costs over (Savings) | $716,510 | $658,897 | $601,285 | $543,673 | $486,061 |

1...+...10....+...20....+...30....+...40....+...50....+...60....+...70.

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********************************************************************************
******* This is piece 2. -- It begins at character 72 of table line 1. ********
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| Year 6 | Year 7 |
|---|---|
| $2,913,012 | $2,855,400 |
| 2,484,564 | 2,484,564 |
| $428,448 | $370,836 |
| = | = |

72.....80....+...90....

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Results from Petitioner's Exhibit WWB-5:

[Note: The following TABLE/FORM is too wide to be displayed on one screen. You must print it for a meaningful review of its contents. The table has been divided into multiple pieces with each piece containing information to help you assemble a printout of the table. The information for each piece includes: (1) a three line message preceding the tabular data showing by line # and character # the position of the upper left-hand corner of the piece and the position of the piece within the entire table; and (2) a numeric scale following the tabular data displaying the character positions.]

********************************************************************************
******** This is piece 1. -- It begins at character 1 of table line 1. ********
********************************************************************************

| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
|---|---|---|---|---|---|
| Revenue Rqmt. | $2,809,023 | $2,773,911 | $2,703,684 | $2,633,459 | $2,563,234 |
| Cost Savings | 2,789,494 | 2,789,494 | 2,789,494 | 2,789,494 | 2,789,494 |
| Costs over (Savings) | $19,529 | $(15,583) | $(85,810) | $(156,035) | $(226,260) |
| | = | = | = | = | = |

1...+...10....+...20....+...30....+...40....+...50....+...60....+...70.

*******************************************************************************
******* This is piece 2. -- It begins at character 72 of table line 1. ********
*******************************************************************************

| Year 6 | Year 7 |
|---|---|
| $2,493,007 | $2,422,782 |
| 2,789,494 | 2,789,494 |
| $(296,487) | $(366,712) |
| = | = |

72.....80....+...90....

Mr. Gassert disagreed with the following testimony presented by Mr. Brownell:

Q. Are you saying that the customers will actually pay less for water service as a result of the merger of these companies even with Indiana-American's proposed ratemaking treatment?

A. Yes. The customers pay less for water service than they would have if the merger had not taken place because they get the benefit of 100% of the savings. Indiana-American will receive a return on the amount paid to make the savings possible but it is disadvantaged compared to the customers if it is only allowed a return on the acquisition adjustment net of accumulated amortization but is not allowed to recover the amortized amount as an expense.

Petitioner's Exhibit WWB, p. 17.

Mr. Gassert disagreed that the ratepayers will receive 100% of the savings under Petitioner's proposed ratemaking treatment as stated by Mr. Brownell. He explained that the only way the ratepayers could receive the benefit of 100% of the claimed savings would be for the utility to not recover any portion of the acquisition adjustment in rates. Even if actual savings were equal to costs (which Mr. Gassert asserted he has demonstrated is not the case), the ratepayers would not benefit but only break even. Mr. Gassert concluded that the entirety of the savings claimed by Petitioner is offset by the costs of the acquisition adjustment.

Mr. Gassert had other concerns regarding Petitioner's proposal to recover the Northwest acquisition adjustment in rates. He added that, as can be seen from reviewing Petitioner's Exhibit JLC-1-U, Schedule 1, all ratepayers across Petitioner's operations have been allocated a portion of the acquisition adjustment. The Northwest district itself has been allocated 28.7% of the fair value increment. Therefore, under Petitioner's proposal, ratepayers in the Southern Indiana operation will pay higher rates so that Northwest's ratepayers will pay, what Petitioner claims to be, lower operation and maintenance ('O&M ') costs. Mr. Gassert concluded that unfortunately, everyone will pay more with the inclusion of the Northwest acquisition adjustment in rates.

In addition to the difficulty with proving and verifying merger savings and uncertainty about whether the savings can even remain over a forty (40) year period of time, Mr. Gassert identified another issue that he claimed needs to be considered when reviewing merger savings. Mr. Gassert believes the Commission should consider whether the savings are achievable only because of the merger. Mr. Gassert noted that in Cause No. 40103, the Commission stated:

Additionally, we perceive that some cost savings are the natural result of a sensible consolidation of utility systems, which would appear to undermine Petitioner's claim of its responsibility for the generation of significant savings through management effort. We do not believe such natural synergies are the type of substantial savings and benefits sufficient to invoke an exception from the general propensity of the traditional standard to disallow favorable treatment of an acquisition adjustment.

In.-Amer. Water Co., Inc., Cause No. 40103, p. 7.

Mr. Gassert asserted that a significant portion of the claimed savings could have been achieved without the merger. The largest single component of the $2,789,494 claimed savings relates to labor expense. The claimed labor expense savings is $2,357,003. Mr. Gassert noted that a list of eliminated positions was provided on page 19 of Mr. Cole's testimony in Cause No. 42029. That list reveals that fifty-five (55) positions were eliminated. Of those fifty-five (55) positions, twenty (20) can easily be identified as the type of positions that could have been eliminated through centralization. Those twenty (20) positions are broken down as follows: four (4) engineering, five (5) accounting and eleven (11) customer service.

Mr. Gassert believed much of this reduction could have been completed through centralization because Northwest Indiana Water Co. was owned by Continental Water Company (which was owned by NEI). Continental owned four (4) subsidiaries that were engaged in the provision of water utility service in Indiana, Illinois, Missouri and New York. The twenty (20) positions discussed above relate to functions that could have been centralized by Continental to gain these efficiencies. In support of this notion, Mr. Gassert noted that the engineering, accounting and customer service functions have been centralized by Indiana-American.

Mr. Gassert also questioned the accuracy of the merger savings calculation. As stated in Cause No. 40103, estimates of cost savings by utilities have always been hotly disputed because the calculation of the actual savings is very nebulous, subjective and difficult to quantify. The difficulty with proving and verifying merger savings and costs lies in the difficulty of identifying and quantifying these savings and costs. Obviously, according to Mr. Gassert, utilities have an incentive to identify and quantify as much merger-related savings as possible while ignoring or minimizing costs. The OUCC asserted that testimony in this case reveals that Indiana-American is a very large, complex organization made more so by the interaction of its operations with other American subsidiaries.

Next, Mr. Gassert provided testimony of examples where he believed Indiana-American's previous merger savings calculations overstated the benefits to the ratepayers. For instance, in Cause No. 40103, Indiana-American applied a 3.75% growth rate to the O&M savings it calculated. Thus, it increased the anticipated savings every year for forty (40) years by 3.75%. However, in Cause No. 42029, Petitioner used a 3.0% growth rate. According to Mr. Gassert, the effect of using a 3.75% growth rate in Cause No. 40103 rather than a 3.0% growth rate caused Petitioner to overstate its O&M savings over forty (40) years by more than $34 million as calculated in Public's Exhibit 5, Attachment ECG-5. Mr. Gassert also asserted that in Cause Nos. 40103 and 42029 Petitioner used a tax gross-up factor that did not reflect new higher state taxes. In Cause No. 42029, Petitioner used a tax gross-up factor 1.6435. Due to changes in the tax laws, the tax gross-up

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factor in this Cause has increased to 1.7239. Petitioner, however, has continued to use the tax gross-up factor of 1.6435. Mr. Gassert testified that this has caused Mr. Brownell to understate the revenue requirement on Petitioner's Exhibit WWB-6 in every year for forty (40) years. In the first year, for example, Mr. Brownell calculated the required gross-up to be $1,099,852 ($1,709,171 X .6435). However, the actual required gross-up is $1,237,269 ($1,709,171 X .7239), and the amount should be reflected in Petitioner's rate schedules. Thus, in the first year, Mr. Brownell understated the acquisition adjustment revenue requirement by $137,417 ($1,237,269 - $1,099,852). Mr. Gassert concluded from his testimony that it is apparent that Petitioner has not been successful at estimating savings from its previous mergers over very short periods of time let alone over forty (40) years, and that Indiana-American's proposal would place the risk of overestimated savings on its ratepayers.

Intervenors' Positions. Intervenor Industrial Group's witness Michael P. Gorman, a consultant for the firm of Brubaker and Associates, Inc., disputed the recovery of the Northwest acquisition adjustment. According to Mr. Gorman, Petitioner did not reflect all of its labor and benefit costs for the Northwest district because the management fees from American Water Works Service Company ('AWWSC') have increased as a result of the Northwest acquisition. Mr. Gorman testified that Petitioner's examples of labor cost savings are entirely or largely offset by increased management fees. (Industrial Group Exhibit 1, p. 32.) In his opinion, Petitioner had not shown that the net savings of the acquisition offsets the acquisition adjustment revenue requirement.

Intervenor Schererville's witness Theodore J. Sommer, a member of the firm of London Witte Group, LLC, provided testimony that the savings did not include an allocation of the corporate costs, which should have been included in such savings calculations. Witness Sommer referred to our order in Cause No. 42029 to support his conclusions. (Intervenor Schererville Exhibit 1, p. 12, line 17 through p. 13, line 14.)

Petitioner's Rebuttal. In rebuttal, Mr. Eckart stated that he believed Mr. Gassert has taken the hub and spoke concept out of context. Mr. Eckart said he did not contend Petitioner is the only utility that can resolve small troubled utility problems, but did believe Petitioner, through its size, can accomplish this on a larger basis. For example, when the OUCC asked Petitioner to help at Farmington and Prairieton, Petitioner was able to step in because it owned adjacent operations (hubs) at Muncie and Terre Haute. Mr. Eckart also said it is not merely a question of ability, it is also a question of willingness to step forward. While Petitioner has shown this willingness, others owners have elected to exit the business in Indiana.

With respect to acquisition adjustments, Mr. Eckart stated that consistent and fair regulatory treatment is necessary to allow management to make acquisition decisions. He noted that a responsibly run business cannot invest large sums without a reasonable opportunity to achieve a return on and of its investment.

Mr. Eckart also expressed concern about the 'all or nothing' test advocated by the OUCC. While he believes the evidence supports full recognition of the acquisition adjustment, if the Commission believes the evidence supports something less, the Commission should allow recognition for the amount which the Commission finds the benefits support.

Mr. Brownell testified that he did not include the amortization as part of the revenue requirement because he followed what he understood to be the treatment for the Indiana Cities acquisition adjustment adopted by the Commission in the 2002 Rate Order. Mr. Brownell disagreed with the comments of Mr. Gassert and Mr. Gorman about management fees because the 2002 Rate Order accepted neither the Petitioner's position that there were management fee savings nor the OUCC's position that there were management fee increases. His analysis was based on the Commission's findings which were neutral on the management fees issue.

Mr. Brownell also said the OUCC's management fee analysis was flawed because it did not adjust its 'post-merger' scenario for the reclassification effective April 1, 2000, of certain employees in Petitioner's Greenwood Office from Indiana-American's payroll to AWWSC's payroll. Although this change increased management fees, it did not increase Petitioner's overall costs because of the offsetting reduction in Indiana-American's own labor costs. Mr. Brownell also showed that, if the OUCC's analysis is adjusted to an 'apples to apples' basis, there is no increase in management fees, even under the OUCC's calculation.

Mr. Brownell said the Northwest savings he quantified could not have been captured by Northwest without the acquisition. Mr. Brownell testified that Northwest already had a centralization strategy with sister companies in three other states that captured such savings as were available without further consolidation or merger. Moreover, the savings from the Northwest acquisition did not merely represent more centralization; they represented also a concerted management effort to employ the 'best practices' of the collective utility systems.

Mr. Brownell disagreed with Mr. Sommer's position that corporate costs allocated to the Northwest operation should be treated as an offset to the savings. He said the acquisition savings arose within the entire state, not a specific district within the state, and therefore a state-wide analysis was necessary. He testified the company-wide incremental increase in corporate costs had been netted against the acquisition savings. The costs allocated to a particular area within the state, however, do not reflect incremental costs and, therefore, should not be considered an offset to the acquisition savings.

Commission Discussion and Findings. In Cause No. 42029, we considered Petitioner's request to recover an acquisition adjustment related to its acquisition of Northwest. In our final order in that Cause, we found that ratepayer benefits did not exceed the costs of the acquisition premium requested. In Cause No. 42029, Petitioner also asked us to reconsider our decision on the Northwest acquisition adjustment in its Petition for Rehearing and Reconsideration, which we denied. In this case, Petitioner asks us again to consider an acquisition adjustment for Northwest based on its 'hub and spoke' concept and reiterated its position about capital and O&M savings. First, we will discuss the hub and spoke concept.

Mr. Eckart testified that the acquisitions of Northwest and United are directly related to solving the problem of small and troubled water utilities because they added many new operating centers (hubs) from which extensions can be made (spokes) to reach small and troubled systems within a reasonable radius. Petitioner suggested that due to the significance of the hub and spoke concept that the issue is not whether Northwest was a troubled utility but whether that acquisition made possible future acquisitions of small and troubled utilities that would not be feasible without the Northwest acquisition. (Petitioner's Exhibit JEE, p. 33) We are not convinced. First, there is no new evidence nor was any evidence presented in the last case to indicate Northwest was a troubled utility. Second, we do not agree that the acquisition of Northwest was the cause of the benefits claimed by Indiana-American. It is true that Indiana-American has acquired smaller utilities and integrated them into the Northwest operation. However, we disagree that this acquisition created a new 'hub.' The evidence presented by the OUCC clearly indicates that Northwest was very active in the consolidation of smaller utilities well before being acquired by Indiana-American. Not only did Northwest display a willingness to step forward, but in the six (6) most recent acquisitions, Northwest did not seek to recover an acquisition adjustment related to those acquisitions. Given the fact that Northwest was a large water utility provider that possessed the technical, financial and managerial ability to acquire small and troubled utilities and frequently utilized that ability before it was acquired by Petitioner, we cannot attribute credit to Indiana-American for creating a new hub to provide this benefit when it is clear that the benefit already existed. Therefore, the answer to the question Petitioner suggests, as to whether the Northwest acquisition made possible future acquisitions of small and troubled utilities that would not be feasible without the acquisition, is no. Thus, we are not convinced that the 'hub and spoke' concept discussed by Indiana-American warrants any favorable consideration in our determination about whether the imputed Northwest acquisition adjustment should be included in rates.

Next, we will address the savings Petitioner has reiterated in this case that relate to the Northwest acquisition. Petitioner suggests that we did not consider the Northwest acquisition separately in the last rate case because Petitioner aggregated several acquisitions into one analysis. We do not agree. Before we began our discussion about the Northwest acquisition in our final order in Cause No. 42029, we stated that:

It is the established policy of this Commission to evaluate acquisitions on a case-by-case basis. In the case of merged operational and management services, they will be separated for purposes of rate consideration insofar as possible. A case-by-case analysis will prevent the benefits, if any, from one transaction being conveyed to another transaction and ensure that each acquisition is measured on its own merits.

Ind.-Am. Water Co., Cause No. 42029, 5 (emphasis added). Therefore, it is evident that we did, insofar as possible, consider the Northwest acquisition request independently in Cause No. 42029.

Once again, there appears to be a significant amount of disagreement and controversy over the savings calculation. We note that the average of the seven (7) years of net savings calculated by Mr. Brownell is only $161,051. Even if this amount is correct, when one considers the amount of costs and savings in question, and the controversy surrounding these amounts, this is not a material amount to warrant passing such a significant cost on to the ratepayers. Also, Mr. Brownell calculated total annual savings of $2,789,494 in his calculation of net savings, which is significantly higher than the savings calculated by the OUCC in Cause No. 42029. In that Cause, Mr. Gassert calculated annual O&M savings of $1,375,762. Given the controversy and uncertainty about what level of savings have been achieved, the amount of savings calculated by Petitioner does not provide us with the level of assurance we need to pass on the costs when it is not evident that any net savings will be achieved. We note that the standard we have used to consider acquisition adjustments requires significant and demonstrable savings. Based on the evidence of record here, we cannot conclude with certainty that any savings will be generated if favorable ratemaking treatment is granted. Petitioner's reliance on at best marginal estimated savings to impose a ratepayer funded acquisition adjustment puts the risk that such savings may not occur on the ratepayers. We also note that American is in the process of consolidating its operations in ways that have increased the cost to Indiana-American. Savings projected out several decades under such circumstances are simply not assured.

We also note certain testimony presented by the OUCC in Cause No. 42029 which was included as Public's Exhibit 5, Attachment ECG-1 in this Cause. We believe some of the more important points to consider about the Northwest acquisition adjustment request from that testimony are as follows:

First, the acquisition adjustment does not exist and is not recorded on Indiana-American's books. The acquisition adjustment was created by Petitioner for ratemaking purposes.

Second, income taxes resulting from the sale of NEI's telephone companies were included in the calculated purchase price.

Third, the imputed purchase price was based on book equity and net income. This method of allocation does not consider the condition of the assets when acquired, such as the intake tunnel that cost $50 million to replace. The flaws resulted in an over-allocation of the purchase price for the Northwest acquisition.

Fourth, no consideration has been made by Petitioner to account for the fact that going concern value might properly be considered included in the allocated purchase price and therefore cannot reasonably be relied on to set the fair value.

We believe these points provide additional concerns that support our disallowance of Petitioner's request for favorable rate treatment related to Petitioner's Northwest acquisition adjustment.

Based on our previous review and findings in Cause No. 42029, our finding that Petitioner's hub and spoke concept does not warrant favorable ratemaking treatment, the questionable savings, the material impact to ratepayers, as well as the concerns raised by the OUCC in testimony filed in Cause No. 42029 that have been incorporated into this Cause, we continue to find that ratepayer benefits do not exceed the costs of the acquisition premium requested. Accordingly, and once again, we deny Petitioner's request for favorable ratemaking treatment with respect to its Northwest acquisition.

Because we have denied Petitioner's request to recover an acquisition adjustment related to Northwest Indiana Water, it is not necessary to discuss whether a return should be granted on the original unamortized balance of the imputed acquisition adjustment, the net amortized balance, or whether the annual amortization should be included in rates.

2. Indiana Cities Acquisition Adjustment

[17-22] The Commission has dealt with the treatment of the purchase price paid by Petitioner to acquire Indiana Cities Water Corporation in three (3) prior litigated rate cases. The first time was in Cause No. 40103, resulting in the 1996 Rate Order. The Commission again considered this issue in the 1997 Rate Order and in the 2002 Rate Order.

Petitioner's total investment to acquire Indiana Cities was $37,072,008. (1996 Rate Order, Cause No. 40103, p. 3.) The book value of Indiana Cities' common equity at the acquisition date was $19,659,999. (Id.) The $17,412,009 difference between the acquisition cost and the book value was recorded on Indiana-American's balance sheet as an acquisition adjustment. (Id.) For accounting purposes, Indiana-American is amortizing the Indiana Cities' acquisition adjustment over a period of forty (40) years. [FN2] (1997 Rate Order, Cause No. 40703, p. 4.) The annual expense relating to this amortization is $467,436. (Petitioner's Exhibit JEE, p. 20, line 12; Public's Exhibit 5, p. 4.)

Two issues in Cause No. 40103 were (a) whether Petitioner should be allowed to earn a return on the amount of the investment made to acquire Indiana Cities by including the acquisition adjustment in Indiana-American's rate base upon which Petitioner is allowed to earn a return and (b) whether Petitioner should be allowed to recover its investment gradually over time by including the annual amortization of the acquisition adjustment as an allowable expense for ratemaking purposes. Petitioner proposed that the acquisition adjustment be included in its original cost rate base and that the annual amortization expense be reflected 'above-the-line' for ratemaking purposes. Petitioner contended that the Indiana Cities acquisition adjustment satisfied the Commission's criteria for favorable ratemaking treatment because the purchase price was reasonable, negotiated at arms length and resulted in substantial cost savings and other benefits.

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The Commission did not accept Petitioner's proposed original cost rate base treatment. Instead, it gave 'Petitioner authority to recognize 100% of its investment in rates through its fair value rate base,' but found none of the annual amortization expense should be treated as a recoverable expense. (1996 Rate Order, Cause No. 40103, p. 15.) The Commission stated: 'Petitioner can and should be compensated for its investment in the Indiana Cities properties through informed fair value ratemaking by fully recognizing their fair value in [the Commission's] fair value rate base determination.' (Id. at p. 49.) The Commission explained that it was not allowing above-the-line recognition for the amortization expense because it analogized fair value treatment to an investment in stocks or bonds wherein the investor earns a return on the investment in the form of dividends or interest but does not recover the principal until the end of the investor's holding period. (Id. at p. 10.)

In the 1996 Rate Order, the Commission approved a fair value NOI increment of $1,112,482, i.e., the amount the authorized return exceeded the product of the Commission-determined cost of capital and the original cost rate base that did not include the Indiana Cities' acquisition adjustment. (Petitioner's Exhibit JEE, p. 14.) The Commission also used an interest synchronization method to determine the interest expense deducted in the income tax calculation by multiplying the weighted cost of debt by the original cost rate base (from which the Indiana Cities' acquisition adjustment was excluded). (Id. at pp. 14-15.) The effect of this methodology essentially is to allocate to the shareholder the benefit of the tax deduction for the interest on the debt used to finance the acquisition adjustment. (Id.)

In the 1997 Rate Order, the Commission confirmed its position that Petitioner should be compensated for its investment in Indiana Cities through fair value ratemaking. The Commission stated:

> In [Cause No. 40103], Indiana-American submitted extensive evidence regarding the cost savings from the combination of Indiana-American and Indiana Cities, showing that the savings were greatly in excess of the cost of the capital invested in order to make those savings possible. Under informed fair value ratemaking, Indiana-American will be compensated for that investment by recognition of the full amount of the purchase price in the fair value rate base. Indiana-American continues to incur the capital costs associated with the debt and equity funds used to acquire Indiana Cities. We must also continue to grant a fair value return increment which provides that compensation, an issue we shall discuss in more detail later.

Ind.-Am. Water Co., Cause No. 40703, p. 30. The Commission also found that, due to the savings generated by the acquisition adjustment, recognition of the Indiana Cities' acquisition adjustment should be treated as a 'reasonable cost of bringing the property to its then state of efficiency ' includible in Petitioner's fair value rate base pursuant to Ind. Code § 8- 1-2-6(a). The Commission also stated that 'Petitioner would be allowed for ratemaking purposes a return on the acquisition adjustment but not a return of the acquisition adjustment.' (Id. at p.

40.)

In the 1997 Rate Order, the Commission found a fair value NOI increment of $1,340,279 above what would result from multiplying the cost of capital determination by the original cost rate base excluding the Indiana Cities acquisition adjustment. (Id. at p. 46; Petitioner's Exhibit JEE, p. 17.) The Commission also reaffirmed use of the interest synchronization method used in the 1996 Rate Order. (1997 Rate Order, Cause No. 40703, p. 64.)

The 2002 Rate Order included a fair value increment of $1,282,693 and used the same interest synchronization method as in the prior two (2) orders. (Petitioner's Exhibit JEE, p. 19.) In Cause No. 40703, Petitioner and the OUCC disagreed about whether the fair value should be based on the full amount of the Indiana Cities' acquisition adjustment ('gross amount') or the amount net of the accumulated amortization as of the rate base valuation date ('net amount '). Petitioner contended that the findings in the 1996 Rate Order and 1997 Rate Order supported use of the gross amount. Petitioner also asserted that only the gross amount was consistent with the stock and bond analogy adopted by the Commission and its finding about the non-recoverability of the amortization. The OUCC argued that the net amount should be used because it reflects diminishing value over time. In the 2002 Rate Order, the Commission stated that it 'agree[d] with the OUCC analysis of this issue.' (2002 Rate Order, Cause No. 42029, p. 13.)

Petitioner's Position. Petitioner computed a proposed fair value increment for the Indiana Cities' acquisition adjustment by applying its proposed cost of capital to the net amount. (Petitioner's Exhibit JLC, p. 10; Petitioner's Exhibit JLC-1, Sched. 4.) Petitioner's witness Eckart testified that Petitioner followed the treatment adopted by the Commission in the 2002 Rate Order. Mr. Eckart stated, however, that if the net amount were used, the Commission should allow Petitioner to recover the annual amortization amount as an above-the-line expense. (Petitioner's Exhibit JEE, p. 20.) Mr. Eckart also testified that if the fair value increment were calculated on the gross amount, it would be about $280,000 greater. (Id.)

OUCC's Position. Mr. Gassert noted that the amortization of the Indiana Cities acquisition adjustment had been discussed and denied by the Commission in Cause No. 40103. Mr. Gassert also noted that despite the denial in Cause No. 40103, Indiana-American was allowed to receive compensation for a portion of the annual amortization in Cause No. 40703. Mr. Eckart acknowledged this on page 18 of his testimony in response to the following quote from our 1997 Rate Order:

We have not allowed Petitioner to amortize the acquisition adjustment as an above-the-line expense. Moreover, the 1993 acquisition adjustment is included in the fair value rate base but not the original cost rate base to which interest synchronization applies. Therefore, the acquisition adjustment should not be included in the interest synchronization calculation.

Ind-Am. Water Co., Cause No. 40703, at p. 120. In response to this quote, Mr.

Eckert stated that '[t]his methodology served to offset some of the effect of disallowing any recovery of the annual amortization expense.' (Petitioner's Exhibit JEE, p. 18, lines 19-20; Public's Exhibit 5, p. 39, lines 10-14.) Mr. Gassert concluded, therefore, that in addition to receiving a return on the Indiana Cities' acquisition adjustment, Petitioner has been receiving a good portion of the annual amortization.

Intervenor's Position. Intervenor Industrial Group's witness Michael Gorman, disagreed with Mr. Eckert that the Commission's 2002 Rate Order on the treatment of acquisition expense was inconsistent with the Commission's 1996 and 1997 Orders. Mr. Gorman stated that fair value of an acquisition adjustment will decline over time just as the fair value of the assets that were originally acquired. Consequently, according to Mr. Gorman, reflecting the acquisition adjustment net of accumulated amortization is not inconsistent. Rather, according to Mr. Gorman, it is necessary in order to state the acquisition adjustment at its test year fair value. (Industrial Group Exhibit 1, pp. 33-34.) According to Mr. Gorman, the fair value of an asset declines over time as its remaining life is shortened. He noted that the on-going value of the acquisition is maintained by reinvesting in the utility, but the reinvestment is not tied to the original acquisition premium that Petitioner paid to acquire the companies. (Id. at p.35.) Mr. Gorman opined that the fair value of an acquisition adjustment would be overstated if the adjustment is not reduced over time. (Id.) Mr. Gorman also testified that the Commission's interest synchronization methodology provides additional revenues to Petitioner by allowing it to earn a full return on the acquisition adjustment grossed up by the tax factor. (Id. at pp. 35-36.) In Mr. Gorman's opinion, if the Commission allows Petitioner to amortize above-the-line, then the interest synchronization methodology should be modified to include the debt component relating to the acquisition adjustment. (Id. at p. 36.)

Petitioner's Rebuttal In rebuttal, Petitioner's witness Eckart testified that although Petitioner's filing in this Cause followed its interpretation of the 2002 Rate Order, Petitioner believed the use of an amortized approach was inconsistent with prior Commission Orders. (Petitioner's Exhibit JEE-R, p. 20- 21.) He described the statement in the 2002 Rate Order that the Commission agreed with the OUCC's analysis of this issue as a change from the prior two (2) rate orders. (Id. at p. 26.) Mr. Eckart further said that '[c]larification and consistency is needed in order for the Company to make good business decisions and have those decisions result in quality service for the citizens in Indiana.' (Id. at p. 27.)

Commission Discussion and Findings. In testifying for the OUCC in Cause No. 42029, witness Gassert effectively responded to Petitioner's continued request to earn a return on the unamortized balance of the Indiana-Cities acquisition adjustment. (See Public's Exhibit 5, Attach. ECG-1.) Mr. Gassert stated, 'In Cause No. 40103, Petitioner requested to collect $72,475,271 over a forty-year period. Without the two changes I discuss, Petitioner would collect $109,593,692 for that same time period. Thus, Petitioner will collect an additional $37,118,421 or 51% more in revenues than it originally requested. ' (Id. at p.28, lines 5-9.) Also during that testimony, Mr. Gassert discussed the Commission's findings in Cause

No. 40103. He declared that:

Clearly, the $1,112,482 fair value increment provided by the Commission is less than the $1,485,244 calculated using Petitioner's interpretation of Cause No. 40103. Therefore, it is clear that the Commission was providing a return on something less than the unamortized $17,412,009 acquisition premium and was possibly using the amortized amount.

Id. at p. 29, lines 17-22.

We conclude that our previous Orders are not inconsistent. Petitioner has never been given a return on its unamortized acquisition adjustment. Further, our position to disallow Petitioner the annual amortization is consistent with our previous Orders where the annual amortization was not included in rates. In fact, our position with respect to granting a return on an acquisition adjustment but no return of an acquisition adjustment is consistent with past practice of this Commission. As can be seen from reviewing Petitioner's Exhibit JLC-2, Schedule 3, 'Summary of Acquisition Adjustments,' Indiana-American's two (2) acquisition adjustments prior to the Indiana Cities' acquisition are included in rate base but the annual amortization is treated as a below-the-line item. Thus, we conclude that our position to allow a return on the amortized balance of the Indiana-Cities' acquisition adjustment is consistent with our prior orders and is fair and reasonable because we have provided Petitioner with additional compensation by not applying interest synchronization to the Indiana-Cities' acquisition premium.

3. Turkey Creek and Westwood Acquisition Adjustments

The Company did not contest the OUCC's proposed elimination of acquisition adjustments for the Turkey Creek and Westwood acquisitions and, therefore, we will not consider favorable ratemaking treatment with respect to these two (2) acquisitions.

C. Quantification of Original Cost Rate Base

[23, 24] Based on the evidence and the findings made above, the Commission finds that the original cost of Petitioner's water and sewer utility properties used and useful for the convenience of the public is as follows:

ORIGINAL COST RATE BASE

| 5p<br>UTILITY PLANT IN SERVICE | COMMISSION FINDING |
|---|---|
| 5p | |
| UTILITY PLANT IN SERVICE | $743,339,339 |
| MISCELLANEOUS REMOVALS FROM RATE BASE | (946,378)* |
| E-CIS SOFTWARE (See Sect. XI. B. 5.) | 659,378** |
| CAPITALIZED TANK PAINTING | 618,576 |

**(Publication page references are not available for this document.)**

| | |
|---|---|
| DEFERRED DEPRECIATION | 2,394,136 |
| POST IN SERVICE AFUDC | 4,280,607 |
| TOTAL PLANT IN SERVICE | $750,345,658 |
| 5p | |
| ACCUMULATED DEPRECIATION | |
| 5p | |
| UTILITY PLANT IN SERVICE | $169,763,405 |
| MISCELLANEOUS REMOVALS FROM RATE BASE | (304,020)*** |
| CAPITALIZED TANK PAINTING | 423,626 |
| DEFERRED DEPRECIATION | 619,527 |
| POST IN SERVICE AFUDC | 1,018,365 |
| TOTAL ACCUMULATED DEPRECATION | $171,520,903 |
| 5p | |
| NET UTILITY PLANT IN SERVICE | $578,824,755 |
| 5p | |
| DEDUCTIONS: | |
| 5p | |
| CIAC | $68,021,992 |
| ACCUMULATED AMORTIZATION OF CIAC | - |
| CUSTOMER ADVANCES FOR CONSTRUCTION | 43,277,659 |
| CAPACITY ADJUSTMENT | 175,990 |
| TOTAL DEDUCTIONS | $111,475,641 |
| 5p | |
| ADDITIONS | |
| 5p | |
| ACQUISITION ADJUSTMENT (NET) | $1,086,259 |
| LESS: TURKEY CREEK (NORTHWEST) & WESTWOOD (W.LAFAYETTE) | (139,064) |
| MATERIALS AND SUPPLIES | 1,571,215 |
| TOTAL ADDITIONS | $2,518,410 |
| TOTAL ORIGINAL COST RATE BASE | $469,867,524 |

Note: The totals marked with *, ** and *** are calculated in the tables below.

| UTILITY PLANT IN SERVICE WATER GROUPS -- Public's Exhibit 3, Sch. 1. | COMMISSION FINDING |
|---|---|
| 5p | |

| | |
|---|---|
| Excessive Capacity- Seymour Wells | - |
| Excessive Capacity- S. Indiana Pumps | $753,378 |
| Muncie Meters | 193,000 |
| Repl 2 1/2 ton truck- partial support | - |
| INS Coating System @ I-65- partial support | - |
| INS Lab Equipment- partial support | - |
| TOTAL UTILITY PLANT IN SERVICE ADJ. | $946,378* |
| E-CIS CALCULATION (See, Sect. XI. B. 5.) | |
| ORIGINAL COST OF ECIS SOFTWARE | $7,326,422 |
| INDIANA ALLOCATION OF SOFTWARE COST % | 9% |
| INDIANA ALLOCATION OF SOFTWARE COST | $659,378** |
| ACCUMULATED DEPRECIATION | |
| WATER GROUPS -- Public's Exhibit 3, Sch. 1. 5p | |
| Excessive Capacity- Seymour Wells | - |
| Excessive Capacity- S. Indiana Pumps | $232,248 |
| Muncie Meters | 71,772 |
| Repl 2 1/2 ton truck- partial support | - |
| INS Coating System @ I-65- partial support | - |
| INS Lab Equipment- partial support | - |
| Total | $304,020*** |

D. Update of Prior Fair Value Finding

[25, 26] Petitioner's witness James Cutshaw evaluated Petitioner's proposed fair value increment by recomputing Petitioner's proposed cost of capital after deducting inflation from the cost of its outstanding debt, and multiplying that rate times a fair value rate base determined by updating the fair value finding from Petitioner's last rate order for new additions and inflation. To implement this methodology, Mr. Cutshaw updated the fair value finding in the 2002 Rate Order ($639,949,626) for inflation since the valuation date in the 2002 Rate Order using inflation rate data from the Valuation Edition of the Ibbotson Associates' publication, Stocks Bonds Bills and Inflation 2003 Yearbook ('SBBI 2003 Yearbook'). (Petitioner's Exhibit JLC, p. 12.) This publication is commonly used as a source of data for cost of capital studies. Mr. Cutshaw pointed out that this methodology is consistent with our Order in PSI Energy, Inc., Cause No. 40003, 18; 173 PUR4th 393, 410 (Indiana Utility Regulatory Commission, Date Issued Sept. 27, 1996) and Indiana-American's 1997 and 2002 Rate Orders. To this total, Mr. Cutshaw added net investor-supplied plant additions since the last rate base valuation date to arrive at a total updated fair value estimate of $663,437,626. (Petitioner's Exhibit JLC, pp. 12- 13; Petitioner's Exhibit JLC-1, Sched. 4, line 24.) Although OUCC witness Gassert disagreed with Mr. Cutshaw's inflation

adjustment procedure, he did not disagree with the updated fair value amount and, in fact, used it in his own analysis. (Public's Exhibit 5, p. 21, line 19 through p. 22, line 3.) We shall discuss the issue of how to compute the rate of return applicable to the fair value rate base later.

E. Reproduction Cost New Less Depreciation

[27] Petitioner's Position. A valuation of the reproduction cost new less depreciation ('RCNLD') of Petitioner's utility property as of December 31, 2003, was sponsored by Alan J. DeBoy. (Petitioner's Exhibit AJD-1 and AJD- 2.) As part of his job responsibilities, Mr. DeBoy has visited and inspected each of Petitioner's operations and their associated facilities. (Id. at p. 8, lines 4-7.) Mr. DeBoy expressed the opinion that Petitioner's plant and systems are in a good state of operating condition, well maintained and used to provide utility service to the public. (Id. at p. 8, lines 9-12.)

RCNLD represents the cost of reproducing the existing system at present day costs, reduced for the loss in value experienced by the existing system due to wear and tear, obsolescence and lack of utility. (Id. at p. 9, lines 2- 4.) Mr. DeBoy determined the reproduction cost new ('RCN') of Petitioner's utility property by applying cost trend factors to the original cost by vintage year of the various components of Petitioner's property (excluding land). (Id. at p. 9, line 16 through p. 10, line 8.) Mr. DeBoy said Petitioner's accounting records provide the necessary detail for a trended original cost study. (Id. at p. 10, lines 8-10.) The primary source for the trend factors used in Mr. DeBoy's study was the Handy-Whitman Index of Public Utility Construction Costs for Water Utilities, particularly utilities located in the North Central United States. (Id. at p. 11, lines 1-6.) Mr. DeBoy stated that he believed the Handy-Whitman Indexes are reasonable to use for estimating RCN because they were developed specifically for that purpose. (Id. at p. 12, lines 1-4.) Mr. DeBoy also testified that the Handy-Whitman Indexes have been published continuously since 1924 and are well-recognized around the country as suitable for determining the RCN of utility property. (Id. at p. 12, lines 20-22.)

Mr. DeBoy determined the RCNLD by deducting from the RCN depreciation necessary to reflect the current condition of the property. (Id. at p. 18, lines 12-17.) Mr. DeBoy calculated the percent condition of Indiana-American's property to be 77.12%. (Id. at line 18.) This ratio reflects the inverse of the relationship of the depreciation reserve to the cost of the plant. Mr. DeBoy asserted that this method is well accepted and recognized by the Commission and the Courts.

Mr. DeBoy's study quantified the RCNLD of Petitioner's used and useful utility plant in service as of December 31, 2003, to be not less than $1,242,525,436 after adjustment for 77.12% condition (depreciation) as follows:

| | |
|---|---|
| Indiana-American, excluding Northwest | $841,421,166 |
| Northwest | 401,104,265 |

| | |
|---|---|
| Total | $1,242,525,436 [sic] |

Petitioner's Exhibit AJD, p. 18, line 19 through p. 19, line 2 (correct total is $1,242,525,431).

OUCC's Position. The OUCC presented the testimony of Scott A. Bell, Assistant Director of the Public's Sewer/Water/Rates Division, in response to Mr. DeBoy's testimony regarding Petitioner's RCNLD study and to Dr. John A. Boquist's testimony regarding 'replacement cost rate base.' Petitioner's witness, Dr. Boquist, is the Edward E. Edwards Professor of Finance at the Indiana University Graduate School of Business in Bloomington, Indiana.

Mr. Bell testified that Petitioner has presented a RCNLD study to support a fair value rate base figure in each of its last eight (8) rate cases. (Public's Exhibit 8, p. 6, lines 10-12.) He noted that in Indiana-American's last four (4) rate cases (Cause Nos. 42029, 41320, 40703 and 40103), Dr. Boquist provided testimony on fair value rate base and replacement cost rate base values. (Id. at p. 6, lines 12-14.) In addition, Mr. Bell acknowledged the Commission has accepted Indiana-American's RCNLD studies into the record as evidence in each of these cases.

However, Mr. Bell pointed out that this Commission has consistently determined that the fair value rate base is not equal to Indiana-American's proposed RCNLD value or its Replacement Cost Rate Base value. (Id. at p. 6, lines 15-21.) He created the following table of Petitioner's past eight rate cases to illustrate his point:

| Cause No. | Final Order Date | Commission's Determination of Original Cost Rate Base | Petitioner's Proposed RCNLD or 'Replacement Cost Rate Base' Value | Commission's Fair Value Rate Base Determination |
|---|---|---|---|---|
| 42029 | 11/06/02 | 403,085,800 | * 756,281,105 | 562,680,669 |
| 41320 | 07/01/99 | 293,003,938 | * 492,108,096 | No Determination |
| 40703 | 12/11/97 | 221,628,031 | * 398,701,046 | 311,804,823 |
| 40103 | 05/30/96 | 186,279,406 | * 303,571,716 | 261,571,000 |
| 39595 | 02/02/94 | 114,762,256 | 299,336,080 | 166,500,000 |
| 39215 | 05/27/92 | 107,435,891 | 289,367,162 | 155,800,000 |
| 38880 | 09/26/90 | 90,964,050 | 273,239,652 | 127,000,000 |
| 38347 | 07/06/88 | 80,721,738 | 209,196,578 | 107,415,200 |

*RCNLD value adjusted downward for technological change by Dr. Boquist to determine 'Replacement Cost Rate Base.'

Id. at p. 6, line 24, though p. 7.

In addition, Mr. Bell testified this Commission has considered RCNLD studies in other utilities' rate cases. However, Mr. Bell testified that this Commission has not equated fair value and RCNLD results in other utility cases. He stated the Commission has 'consistently found utilities' fair value rate bases to be significantly less than the RCNLD values.' (Id. at p. 7, lines 15-16.)

Mr. Bell went on to note that the Commission echoed the OUCC's concerns regarding use of RCNLD studies in prior Indiana-American rate cases. Specifically, Mr. Bell provided the following quote from the Commission's 2002 Rate Order:

> The Commission is equally dubious of the Petitioner's proposed valuation. In reviewing past Commission determinations of fair value for this utility, the Petitioner's proposed valuation represents a considerable leap in value, with no compelling justification given to support such an increase.

Ind.-Am. Water Co., Cause No. 42029, p. 28, lines 1-10; cited by Public's Exhibit 8, p. 8, lines 1-10.

He also quoted from the Commission's Order in Northwest Indiana Water Company, Cause No. 40467:

> We are faced with a concern that plagues all reproduction cost new studies, which is the very real probability that Petitioner's system would not in fact be reproduced in the same fashion today. Efficient planning, efficient construction, advances in technology, shifting demands and location for water and numerous other factors must first accurately be reflected otherwise a reproduction cost new study cannot be said to reflect fair value. Accordingly, while we will take Petitioner's proposed RCNLD into consideration in making our judgment as to what is an appropriate 'fair value' for Petitioner's utility plant, we will be fully mindful of the inherent limitations of Mr. Smith's methodology and the theory of reproduction cost new.

Northwest Ind. Water Co., Cause No. 40467, 21-22 (Indiana Utility Regulatory Commission, Date Issued March 26, 1997) (cited by Public's Exhibit 8, p. 8, line 11 through p. 9, line 12).

Mr. Bell contended that the Company's plant would not remain the same if it were to be rebuilt today. He cited several Commission cases in which the Commission has expressed concern about using RCNLD studies to determine fair value rate base. Based on these prior Commission rate cases, Mr. Bell concluded that RCNLD studies have not been useful indicators of fair value. Mr. Bell therefore recommended this Commission not grant more weight to Petitioner's RCNLD study than we have in previous rate cases. (Id. at p. 9, line 13 through p. 10, line 7.)

Petitioner's Rebuttal. In rebuttal, Mr. DeBoy testified that, even if Petitioner's system would not remain exactly the same if rebuilt today, the RCNLD would not be less than the results presented in his study. (Petitioner's Exhibit AJD-R, p. 3, lines 5-15.) In fact, Mr. DeBoy noted that his study was conservative

**(Publication page references are not available for this document.)**

because it did not include the additional cost of working around or dealing with roadways, driveways and other surface improvements as well as underground utilities that would be required today. (Id. at p. 2, lines 2- 18.) Furthermore, Mr. DeBoy noted that it would have been inefficient if the initial system had been designed and built to accommodate Petitioner's current customer demands. (Id. at p. 3, lines 10-12.) He further stated that differences in management practices and management personnel are not relevant because Petitioner's system is designed based on engineering standards and practices. (Id.) Finally, Mr. DeBoy responded to Mr. Bell's criticism of reliance on RCNLD studies by noting that Mr. Bell himself relied upon such studies in Cause Nos. 39838, 39839, 39840 and 39841 to determine the RCNLD of four (4) systems now owned by Petitioner. (Id. at p. 2, line 20 through p. 3, line 3.)

Commission Discussion and Findings. The Commission has long taken RCNLD studies into consideration in setting rates. We recently noted that '[t]his Commission has routinely accepted RCNLD studies into the record and considered them as evidence in support of Petitioners' fair value. ' (south haven sewer works, inc., cause No. 41903, 2 (iNdiana utility Regulatory Commission, Date Issued June 5, 2002).) In Northwest Indiana Water Co., Cause No. 40467, we responded to arguments of the OUCC similar to those made here by Mr. Bell as follows:

The OUCC's arguments regarding RCNLD are familiar to us. We recognize that no RCNLD study will achieve absolute perfection. Yet, as we have said many times previously, '[r]atemaking is, at best, an imprecise art.'Indiana Gas Co., Cause No. 36816, 49 PUR4th 594, 609 (PSCI 10/27/82). This Commission routinely must rely on estimates which, we recognize, 'can only be reasonable approximations.'Boone County Rural Elec. Membership Corp. v. Public Serv. Comm'n, 239 Ind. 525, 535; 159 N.E.2d 121, 125 (1959). Accordingly, despite the minor shortcomings identified by the OUCC, we have found the use of the Handy-Whitman Index to be reliable in conducting RCNLD studies. Ind. Cities Water Corp., Cause No. 39166 (Indiana Utility Regulatory Commission, Date Issued July 8, 1992); Ind.-Am. Water Co., Cause No. 39215 (Indiana Utility Regulatory Commission, Date Issued May 27, 1992). We have also found that evidence of RCNLD is helpful in the task of determining fair value. See Id.; S. Ind. Gas & Elec. Co. ('SIGECO'), Cause No. 39871, 18 (Indiana Utility Regulatory Commission, Date Issued June 21, 1995).

Northwest Ind. Water Co., Cause No. 40467, p. 21.

Mr. Bell's prior reliance on this methodology also demonstrates its usefulness. Indeed, as a matter of law, 'reproduction cost new cannot be disregarded in fixing a valuation for rate making purposes.' (Pub. Serv. Comm'n v. City of Indianapolis, 235 Ind. 70, 108, 131 N.E.2d 308, 325 (1956).) Reproduction costs take into consideration inflation which the Commission may not ignore. (Indianapolis Water Co. v. Public Serv. Comm'n, 484 N.E.2d 635, 640 (Ind. Ct. App. 1985).) We therefore find that a reasonable estimate of the RCNLD of Petitioner's utility plant in service is $1,242,525,436.

F. Replacement Cost Less Depreciation

**(Publication page references are not available for this document.)**

[28] Petitioner's witness, Dr. John A. Boquist, testified that in economic theory the fair value of property should represent the depreciated replacement cost of the property, i.e., the cost today of similar assets with the same function and service potential. This definition captures the opportunity costs associated with allowing a firm to control its assets for the production of goods and services according to its business strategy. Any strategy which results in a value less than the assets' replacement cost should be abandoned, and the assets dedicated to other opportunities. This valuation concept is consistent with the work of James Tobin, developer of the 'Tobin's q ratio,' a widely accepted and recognized method of investment analysis which compares the market value of assets to their replacement cost.

Dr. Boquist said that the replacement cost of assets can be affected by technological change. Dr. Boquist testified that, while Mr. DeBoy's RCNLD value already reflects the impact of present day construction practices, to make sure the impact of technological change was not understated in the replacement cost estimate, he asked the Company to make a downward adjustment to Mr. DeBoy's RCNLD computation of 1.347% per year. This is the long-run average annual rate of change in multifactor productivity in the U.S. manufacturing sector during the period of 1948 through 2001 as reported by the U.S. Bureau of Labor Statistics. This adjustment results in an estimate of replacement cost less depreciation as follows:

| | |
|---|---|
| Indiana-American, excluding Northwest | $605,575,457 |
| Northwest | 270,079,469 |
| Total | $875,654,926 |

Petitioner's Exhibit AJD, p. 19, lines 4-9.

This amount when combined with other components of Petitioner's rate base results in a replacement cost less depreciation value of $882,408,588. (Petitioner's Exhibit JAB, p. 61; Petitioner's Exhibit JAB-6.) Dr. Boquist testified that this was a conservative estimate of fair value because land has been included at original cost (instead of its current value) and the 1.347% rate for technological change probably exceeds the rate experienced by the water industry. Accordingly, we find the replacement cost less depreciation value to be $882,408,588.

G. Fair Value

[29, 30] Indiana Code § 8-1-2-6 establishes that this Commission shall value a public utility's property at its 'fair value.' In Indianapolis Water Co. v. Public Service Commission (Ind. Ct. App. 1985), the Indiana Court of Appeals confirmed that a utility should be entitled to earn a fair rate of return on the fair value of its rate base. Furthermore, in its determination of 'fair value' the Commission may not ignore the commonly known and recognized fact of inflation. (Indianapolis Water Co., p. 640.) In Indianapolis Water, the Court of Appeals reaffirmed its

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holding in Public Service Commission v. City of Indianapolis, stating that 'reproduction cost new cannot be disregarded in fixing a valuation for rate making purposes.' (Public Serv. Comm'n, 235 Ind. 108, 131 N.E.2d 325 (1956).) The Court of Appeals expressly stated that this observation is as pertinent today as in 1956. The Court of Appeals has more recently confirmed that the Commission must authorize rates that provide the utility with the opportunity to earn a fair rate of return on the fair value of its property. (Gary-Hobart Water Corp. v. Office of Util. Consumer Counselor, 591 N.E.2d 649, 653-654 (Ind. Ct. App. 1992), reh'g denied July 1992; Office of Util. Consumer Counselor v. Gary-Hobart Water Corp., 650 N.E.2d 1201 (Ind. Ct. App. 1995).)

As previously discussed, we will compensate Petitioner for the investment that made the Indiana Cities acquisition possible in the fair value return authorized herein. Such a result is well within the scope of the evidence, which includes quantification of the difference between the purchase prices and book values, the reproduction cost new less depreciation of Petitioner's utility properties, the replacement cost less depreciation of Petitioner's utility properties and an updating of our last fair value finding for inflation and new additions.

Based on the evidence of record, we find that the fair value of Indiana-American's utility property used and useful in the provision of utility service is not less than $663,400,000.

X. FAIR RATE OF RETURN

[31-33] Having determined the fair value of Petitioner's property, the Commission must determine what level of net operating income represents a reasonable rate of return. This determination requires a balancing of the interests of the investors and the consumers. In Bethlehem Steel Corp. v. Northern Indiana Public Service Co., the Indiana Supreme Court instructs that '[w]hat annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts.' (397 N.E.2d 623, 630 (Ind. App. 1979)(quoting Bluefield Water Works and Improvement Co. v. Public Serv. Comm'n, 262 U.S. 679, 692 (1923)).) One consideration in evaluating the reasonableness of a utility's return is the utility's overall weighted cost of capital.

A. Cost of Common Equity

[34] Petitioner's Position. Petitioner presented the testimony of Dr. John Boquist on Petitioner's cost of common equity. In his direct testimony Dr. Boquist expressed the opinion that an 11.00% cost of common equity would be reasonable for Petitioner. (Petitioner's Exhibit JAB, p. 33, lines 6-14; See Petitioner's Exhibit JAB-5.)

In examining the cost of common equity, Dr. Boquist first employed the discounted cash flow ('DCF') model. Dr. Boquist testified that the DCF model stems from the assumption that investors are interested in the expected dividend yield and the future long-ran growth in dividends. He said the annual form of the DCF model is simple but has two (2) inherent problems. First, it assumes annual dividends, while virtually all firms pay more frequent quarterly dividends, and quarterly dividends have greater value because they can be put to other profitable uses. Second, the DCF model assumes a single constant growth rate in perpetuity, which is an unrealistic assumption because dividend growth rates change over time and the ability to forecast what will happen to a single company in perpetuity from currently available company-specific data is problematic.

Dr. Boquist stated that he addressed these problems by reformulating the model in two respects. First, he incorporated quarterly dividend payments. Second, he used a two-stage model that reflected company-specific growth rates for the first ten (10) years (the first stage) and a growth rate reflective of the overall economy thereafter (the second stage). Since Petitioner's common stock is not publicly-traded, Dr. Boquist applied his DCF model to the three (3) publicly-traded water companies followed by Value Line Investment Survey ('Value Line') as a sample group.

Current dividends and stock prices for the sample companies were used to determine the current dividend yield. Dr. Boquist converted the current dividend yield to a forward-looking basis by applying his estimate of one (1) year of dividend growth. He used a growth rate in the first stage equal to Value Line's projection of each company's growth in cash flow. Dr. Boquist stated that for the water industry today, particularly given the recent lowering of the tax rate on dividends which encourages dividend increases, estimated cash flow growth best reflects investor expectations for these stocks. For the second stage, Dr. Boquist used a growth rate of 6.32%, the average growth rate of the gross domestic product ('GDP') since 1980. Dr. Boquist pointed out that this rate is virtually identical to the 6.3% estimate of nominal long-term GDP growth used in the SBBI 2003 Yearbook. This DCF approach arrived at an unadjusted result of 10.00%. (Petitioner's Exhibit JAB, p. 21, lines 1-3.)

Dr. Boquist made an upward adjustment of 1.00% or 100 basis points to the unadjusted DCF result to reflect Petitioner's greater inherent level of risk relative to the proxy group. Dr. Boquist stated that this greater level of risk stemmed from Petitioner's relatively small size, its investment quality, the relatively limited marketability of its securities and its limited service area. In making the adjustment Dr. Boquist considered the current yield spreads between various ratings of utility bonds and between utility bonds and treasury bonds. (Petitioner's Exhibit JAB-4.) Dr. Boquist said that investors are currently demanding extra returns to induce them to buy lower quality issues, a situation referred to as a 'flight to quality.' Dr. Boquist's adjusted DCF result was 11.00%. (Petitioner's Exhibit JAB-5.)

Dr. Boquist also used the capital asset pricing model ('CAPM'), which holds that the cost of equity is equivalent to the return on a riskless security plus a risk premium appropriate for the company being analyzed. The risk premium represents the equity risk premium for the entire market (the 'market risk premium') multiplied by the beta coefficient ('beta') of the company. The beta measures the responsiveness of a common stock's rate of return to that of the overall market. In applying the CAPM, Dr. Boquist used a beta of 0.633, the average beta of the sample group as reported by Value Line. The market risk premium was represented by the difference between the long-run (post-1926) arithmetic average rate of return on the Standard & Poor's 500 ('S&P 500') and the average long-term government bond income return (interest) for the same period as reported in SBBI 2003 Yearbook. Dr. Boquist used as the riskless rate the greater-than-ten (10) year maturity treasury bond yield computed by Merrill Lynch and reported in the Wall Street Journal (the 'Merrill Lynch 10+ year treasury index'). Dr. Boquist stated that this index has a par value weighted average maturity of approximately twenty (20) years which matches the maturity used by Ibbotson Associates in calculating the historical treasury bond returns. Dr. Boquist's unadjusted CAPM result for the proxy group was 9.59%. (Petitioner's Exhibit JAB, p. 25, lines 20-22; Petitioner's Exhibit JAB-2, line 7.)

Dr. Boquist increased this result by 2.06% (206 basis points) to 11.65% to adjust for the small stock risk premium specified in the SBBI 2003 Yearbook for companies with an equity market capitalization between $314.2 million and $521.3 million. (Petitioner's Exhibit JAB, p. 27, lines 20-21; Petitioner's Exhibit JAB-2, lines 8-9.) Dr. Boquist said this adjustment was necessary because Ibbotson Associates uses the large company stocks in the S&P 500 as a proxy for the market. Dr. Boquist cited the SBBI 2003 Yearbook which explains that a size adjustment is necessary because 'even after adjusting for the systematic (beta) risk of small stocks, they outperform large stocks. ' (Petitioner's Exhibit JAB, p. 30.) Dr. Boquist testified that Ibbotson Associates gives substantial attention to the manner in which this adjustment can be made with their data, and he followed their procedure.

Dr. Boquist testified that it was necessary to use the treasury bond income return (interest) rather than the total return (interest and changes in value) in determining the market risk premium because only the income return is truly riskless to investors. (Id. at p. 28.) Dr. Boquist said the arithmetic averages must be used because the purpose is to estimate uncertain future returns, not measure historical performance. He cited a number of authorities supporting this view.

Dr. Boquist testified that a higher recommendation than 11.00% could easily be supported by giving more weight to the CAPM result because the CAPM accounts explicitly for risk relative to the overall market and the DCF model tends to understate the cost of common equity. He noted that the Commission has recognized the understatement inherent in the DCF a number of times, including its Order in PSI Energy, Inc., Cause No. 40003 (Sept. 1996).

Dr. Boquist also discussed the understatement in the required return that will result if the market-derived cost of capital is applied to an original cost (book value) rate base when the market value of stock exceeds book value as is generally the case today. He noted that the average market-to-book ratio of the three (3) sample companies is 2.18, i.e. the average market value of their stock exceeds the book value of their stock by 2.18 times. He suggested some ways of responding to this issue would be to (1) make a market-to-book adjustment to the market-derived common equity models; (2) use the book value of stock, rather than the market value of stock, to determine the dividend yield in the DCF model; (3) use a market value capital structure, rather than a book value capital structure, which would increase the equity ratio and thus the overall weighted cost of capital; and/or (4) use a fair value rate base. Dr. Boquist said he would use the last alternative. This subject will be discussed hereafter.

OUCC's Position. The Public's witness, Mr. Edward Kaufman, Lead Financial Analyst in the OUCC's Rates/Water/Sewer division, used two (2) proxy groups to estimate cost of equity in this Cause. The first ('primary') proxy group was the same proxy group of water companies that Dr. Boquist used. The second ('secondary') proxy group included three (3) additional water companies not used by Dr. Boquist. Mr. Kaufman indicated that both of his proxy groups produced similar results.

Mr. Kaufman used both a DCF model and a CAPM analysis to reach his estimated cost of common equity for Petitioner of 8.75%. Mr. Kaufman's DCF analysis produced a range of 8.52% to 8.57%, while his CAPM analysis produced a range of 7.52% to 9.08%. Mr. Kaufman concluded that Petitioner was similar in size to two (2) of the three (3) companies in Dr. Boquist's proxy group and larger than the three (3) companies that Mr. Kaufman added to make up his secondary proxy group. Based on Petitioner's size compared to the companies in both proxy groups, Mr. Kaufman concluded that a small company risk adjustment was not merited for a company as large as **Indiana-American Water Company**. In addition, Mr. Kaufman quoted from Mr. John Eckart's testimony in Cause No. 42250, where Mr. Eckart asserted that American Water Works' acquisition by RWE would increase Indiana-American's access to capital markets. Mr. Kaufman also pointed out that in Cause No. 42488 Petitioner's witness Pauline Ahern had recommended a small company risk premium of only 25 basis points for Twin Lakes Utilities (A utility with only 5,000 customers). Mr. Kaufman's cost of equity estimates ranged from 7.52% to 9.08%. Mr. Kaufman then recommended a cost of equity of 8.75%.

Mr. Kaufman relied on the more traditional single stage DCF model. He based his estimate of growth (g) on historical and forecasted growth in earnings per share ('EPS'), dividends per share ('DPS'), and book value per share ('BVPS '). Mr. Kaufman also completed a CAPM analysis. His CAPM analysis relied on both an arithmetic and geometric mean risk premium. Mr. Kaufman also relied on total bond returns instead of income bond returns to estimate the market risk premium.

Although Mr. Kaufman relied on Value Line to estimate beta for his cost of equity analysis, his testimony indicates that he reviewed several sources of beta including Merrill Lynch, SmartMoney.com and Yahoo.com. Mr. Kaufman's testimony also indicated that Value Line produced the highest source of beta of all the sources he reviewed.

Mr. Kaufman asserted that an 8.75% cost of equity was reasonable in today's

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markets. Mr. Kaufman pointed out the forecasted inflation over the next few years was expected to remain low and asserted that lower inflation rates translate directly into lower capital costs. Mr. Kaufman cited to an article by Fama & French (the same analysts Dr. Boquist relied on for his return on replacement cost analysis), supporting a long term expected market return of 8.0% to 8.5%. Next, Mr. Kaufman cited to an article by John Bogle, founder of Vanguard Group, which forecasted a stock market return of 6.0% to 9.0% per year over the next decade. Mr. Kaufman also cited a book by Dr. Jeremy Siegel, Stocks for the Long Run, that forecasted a real (before inflation) return for the market of 6.6% to 7.2%. Mr. Kaufman then noted that when current forecasted inflation rates of 2.2% to 2.5% are combined with Dr. Siegel's forecasted market returns, it produces a market return of 8.9% to 9.9%.

Mr. Kaufman commented that since Petitioner was less risky than the overall market, and should have a lower expected return than the overall market, his proposed cost of equity was reasonable and consistent with the market forecasts made by John Bogle, Dr. Siegel and the Fama-French analysis. Finally, Mr. Kaufman cited to an order issued in West Virginia-American's recent rate case where the West Virginia Commission authorized a 7.0% cost of equity.

Mr. Kaufman criticized Dr. Boquist's two-stage DCF analysis. While accepting the theory behind the two-stage DCF model, Mr. Kaufman did not agree with Dr. Boquist's applications. Dr. Boquist's analysis assumes that for the next ten (10) years the dividends for each of the water companies in his proxy will grow at their three (3) to five (5) year forecasted growth rate in cash flow per share. His analysis then assumes that dividends will grow at the average historical growth rate of the United States Gross Domestic Product from 1980- 2002, or 6.32%, in perpetuity after that. Mr. Kaufman criticized Dr. Boquist's analysis because he provides no basis to assume that each company in his proxy group will grow at the same rate in its mature stage. There was also no basis to assume that each company in Dr. Boquist's proxy group will reach its mature or a steady stage of growth at the same time. Some if not all of the companies in Dr. Boquist's proxy may have already reached their mature or steady rate of growth. Mr. Kaufman concluded that if one uses reasonable assumptions and tailors a two-stage DCF analysis to the specific conditions for each of the companies in a proxy, a two-stage DCF analysis could have merit. However, according to Mr. Kaufman, Dr. Boquist did not tailor his DCF analysis to be specific for each company and, therefore, Mr. Kaufman does not believe his assumptions are reasonable.

As an example, Mr. Kaufman cited to Dr. Boquist's analysis of one of the water companies used in his proxy group, American States Water. Mr. Kaufman testified that Dr. Boquist's analysis assumes that American States Water's dividends will grow at an average rate of 5.5% for the next ten (10) years and then will somehow increase to an average growth rate of 6.32% for the years 2014 and beyond. Without a company-specific analysis to explain why Dr. Boquist would expect American States Water's dividends to grow in that manner, Mr. Kaufman was unable to accept Dr. Boquist's assumption.

Mr. Kaufman also asserted that water company dividends will grow more slowly than the overall growth rate of the U.S. economy. Water utilities traditionally have relatively high dividend payout ratios, and therefore, low retention ratios. To illustrate, in 2003 California Water (CWT), another proxy company, had a payout ratio of almost 109% (CWT paid dividends of $1.12 per share on earnings of $1.01 per share) and a retention ratio of -9.0%. Mr. Kaufman stated that companies with high payout ratios are by definition retaining or reinvesting a smaller percentage of their earnings back into the company which causes slower earnings growth. Slower earnings growth in turn leads to slower dividend growth. Furthermore, dividend growth cannot indefinitely exceed earnings growth. Therefore, according to Mr. Kaufman, due to their higher payout ratios and lower retention ratios, it is unreasonable to assume that water utility dividends will grow as quickly as the U.S. economy.

Next, Mr. Kaufman stated that Dr. Boquist had overstated his estimate of growth in the U.S. economy. Mr. Kaufman asserted that, even if one accepts the premise that water utility dividends will grow as quickly as the U.S. economy, he believed that Dr. Boquist's analysis overstates the future growth rate of nominal GDP and subsequently overstates forecasted dividend growth for the second stage in his two-stage DCF model. To estimate the future growth rate of the U.S. economy, Dr. Boquist averages the growth rate of nominal GDP over the last twenty-three years (1980-2002). Mr. Kaufman asserted it would be more reasonable to use a forecasted growth rate of GDP than it is to rely on historical data, because the growth rate of nominal GDP and inflation have slowed significantly when compared to the growth rate of nominal GDP and inflation from the early 1980s. Furthermore, both the growth rate of the U.S. economy and the rate of inflation are forecasted to remain low. Thus, in his opinion, Dr. Boquist's reliance on historical nominal GDP overstates forecasted growth in nominal GDP and subsequently overstates his own estimate of dividend growth.

Furthermore, notwithstanding Dr. Boquist's premise that water company dividends will grow as quickly as the U.S. economy and his opinion that it is more appropriate to rely on historical data than it is to rely on forecasted data, Mr. Kaufman still believed Dr. Boquist's analysis overstated the expected growth rate in the U.S. economy and the subsequent forecast of dividend growth. Mr. Kaufman asserted that Dr. Boquist's reliance on historical growth in nominal GDP is based on data for the twenty-three (23) year period from 1980- 2002 and seems somewhat subjective. Mr. Kaufman stated it would seem more appropriate to use a ten (10) year average of growth in nominal GDP to match Dr. Boquist's use of a ten (10) year period for the first stage of his DCF analysis. The ten (10) year average growth rate of nominal GDP of the U.S. economy was 5.16% (1993-2002). If Dr. Boquist used a 5.16% growth rate in the second stage of his DCF analysis, it would have reduced his unadjusted DCF estimate of Petitioner's cost of equity by 84 basis points from 10.00% to 9.16%.

Next, Mr. Kaufman emphasized that Dr. Boquist's analysis assumed a dividend stream that does not exist because it assumes dividends will grow each and every quarter. Mr. Kaufman stated that he was not aware of any publicly traded company that raises its dividends on a quarterly basis. By assuming that dividends increase every quarter, Dr. Boquist's analysis inflates the stream of dividend payments that the shareholder will receive. The higher dividend stream will lead to a higher estimated cost of equity. As such, the quarterly version of Dr. Boquist's two-stage DCF model inflates his estimate of Petitioner's cost of equity. Dr. Boquist cites the works of Dr. Ibbotson and Dr. Morin to support his DCF analysis. However, Mr. Kaufman testified that neither Dr. Ibbotson nor Dr. Morin employ a quarterly DCF model in the same manner that Dr. Boquist does in this Cause and that Dr. Boquist's DCF model is his own interpretation and is not directly supported by Dr. Morin or Dr. Ibbotson.

On page 41 of his testimony Mr. Kaufman also quoted from the Commission's Final Order in Petitioner's previous rate case, Cause No. 42029, as follows:

As we noted in Cause No. 40103 the Commission expects the parties to exercise sound judgment when deciding which inputs to include as part of their analysis. This Commission has concerns regarding Dr. Boquist's implementation of the two-stage DCF model. Dr. Boquist has used a high estimate of dividend growth (g) for the second stage of his DCF model. Additionally, Dr. Boquist's quarterly DCF analysis assumes dividends will grow each and every quarter.

Ind.-Am. Water Co., Cause No. 42029, p. 83. Mr. Kaufman claimed that the two-stage DCF model that Dr. Boquist uses in this case suffers from the same flaws that the Commission criticized in Petitioner's last rate case.

Mr. Kaufman also criticized Dr. Boquist's use of forecasted cash flow per share of 7.17% for the first stage in his DCF analysis. Mr. Kaufman pointed out that this was the first time in five Indiana-American rate cases that Dr. Boquist had relied on forecasted cash flow per share in a DCF analysis. Mr. Kaufman then pointed out the change in Dr. Boquist's methodology from ten (10) year historical dividend growth to three (3) to five (5) year forecasted cash flow growth increased Dr. Boquist's estimate of growth (g) by 450 basis points. Next, Mr. Kaufman asserted that, since both Value Line and CA Turner are both forecasting relatively slower growth in dividends over the next five (5) years, he did not believe that using forecasted growth in cash flow was justified. Finally, Mr. Kaufman asserted that it was inappropriate to rely on any single estimator of growth because it ignored relevant information.

Mr. Kaufman also criticized Dr. Boquist's CAPM analysis. Mr. Kaufman stated in the development of his CAPM analysis, Dr. Boquist considered only an arithmetic mean risk premium. Also, Dr. Boquist relied solely upon long-term interest rates. Mr. Kaufman asserted that depending on the period of analysis, either the arithmetic mean risk premium or the geometric mean risk premium can provide reliable cost of equity estimates if combined with the appropriate risk-free rate. An arithmetic mean risk premium is based on short-term (annual) returns, and an arithmetic mean risk premium can be combined with a short term interest rate. The geometric risk premium is a long term measure of returns, and it is appropriate to combine the geometric mean risk premium with longer term interest rates. Mr.

Kaufman explained that both methodologies have merit and should be given substantial weight.

Mr. Kaufman also criticized Dr. Boquist's use of bond income returns instead of total returns. On page 26 of his testimony, Dr. Boquist asserted that it is more appropriate to rely on income returns rather than total returns in estimating the market risk premium in his CAPM analysis. Although Mr. Kaufman acknowledged that Dr. Boquist's argument had some merit, he disagreed with his application.

Mr. Kaufman also challenged Dr. Boquist's 206 basis point adjustment to his CAPM analysis and his 100 basis point company-specific risk adjustment to his DCF model. In criticizing Dr. Boquist's 206 basis point adjustment to his CAPM analysis and his use of Dr. Ibbotson's small company adjustment, Mr. Kaufman asserted that these adjustments substantially overstate Petitioner's company-specific risk. As Ibbotson's equity size premium adjustment is based on the theory that smaller companies have earned returns above what would otherwise be predicted by a CAPM analysis, Mr. Kaufman stated he did not believe it is appropriate to directly apply Ibbotson's equity size premium adjustment to a regulated utility like Petitioner. He asserted that regulation decreases the risks faced by Petitioner. For example, Petitioner does not face the same bankruptcy risks that other small companies may face. Mr. Kaufman testified that the Commission supported the view that Ibbotson's micro cap adjustment cannot be blindly applied to utilities:

We are familiar with the Ibbotson derived 400 basis point small company premium used by Mr. Beatty. The rationale behind this approach is that, all other things being equal the smaller the company, the greater the risk. However, to blindly apply this risk premium to Petitioner is to ignore the fact that Petitioner is a regulated utility. The risks from small size for a regulated utility are not as great as those small companies facing competition in the open market.

South Haven Sewer, Cause No. 40398, p. 30.

Mr. Kaufman also asserted that Ibbotson seems to recognize that its small company adjustment cannot be blindly applied to regulated water companies. The Valuation Edition of Ibbotson's SBBI Yearbook 2001 provides estimates of industry-specific risk premiums. For the water supply industry, Ibbotson estimates a negative risk premium of 611 basis points. Thus, according to Mr. Kaufman, despite the smaller size of the companies included in the water supply industry, the water industry and the companies included in the water industry are significantly less risky than the overall market.

Mr. Kaufman then criticized Dr. Boquist's 100 basis point adjustment to his DCF model and stated it also overstated Petitioner's company-specific risk. In making his adjustment Dr. Boquist relied on or averaged the spread between A bonds vs. BBB bonds (47 basis points), and the spread between U.S. Treasury Securities and BBB bonds (184 basis points). Mr. Kaufman did not believe it is appropriate to use U.S. Treasury securities to estimate Petitioner's company-specific risk relative

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to the proxy group. In this analysis Petitioner is being compared to the proxy group. Mr. Kaufman further testified that the companies in Dr. Boquist's proxy have bond ratings ranging from AA- to A+. None of these companies in Dr. Boquist's proxy have a bond rating equal to the full faith and credit of the U.S. Government and, as such, it did not make sense to compare the spreads between BBB bonds and U.S. Treasury securities when comparing Petitioner's company-specific risk relative to the proxy group. Mr. Kaufman testified that Dr. Boquist's analysis assumes that if Petitioner were rated it would have a bond rating of BBB, while the companies in the proxy group have bond ratings from AA- to A+. Thus, Mr. Kaufman claimed that it makes sense to calculate the spreads between BBB versus both AA and A bonds to make a company-specific risk adjustment. While Mr. Kaufman was not in complete agreement that Petitioner would be rated as low as BBB, he agreed that a comparison to AA and A bond yields would have logic, but a comparison to U.S. Treasury securities would not.

Mr. Kaufman pointed out that if Dr. Boquist's use of United States Treasury securities to estimate a company-specific risk adjustment for Petitioner is disregarded, Dr. Boquist's own evidence does not support a 100 basis point adjustment to account for Petitioner's company-specific risk. The average spread between BBB bonds and A bonds is 47 basis points. Thus, according to Mr. Kaufman, even if one assumed Petitioner was rated as low as BBB, Dr. Boquist's analysis would not support a 100 basis point adjustment.

Mr. Kaufman asserted that Dr, Boquist has not provided evidence to support his assumption that Indiana-American would be rated as low as BBB, if it were rated. In fact a review of Indiana-American's most recent debt offerings does not seem to support the contention that Indiana-American's debt would be rated as low as BBB. Finally, the company-specific risk adjustments proposed by Dr. Boquist in this Cause are larger than the company adjustments he proposed in Petitioner's prior rate cases.

Mr. Kaufman's testimony also included a schedule which illustrated the changes in Dr. Boquist's testimonies over the last four Indiana-American rate cases.

Intervenors' Positions. The Industrial Group presented the testimony of Mr. Gorman on rate of return, who recommended that the Commission find Petitioner's cost of common equity to be 9.75%. Mr. Gorman first assessed Petitioner's risk because the allowed rate of return should reflect the investment risk. (Industrial Group Exhibit 1, p. 4.) In Mr. Gorman's opinion, the fact that water utilities typically finance their plant with a higher percentage of debt than unregulated companies indicates low operating risk. (Id. at p. 5-6.) He noted that Petitioner primarily relies on a subsidiary when issuing its debt. (Id.) He also noted that while Petitioner receives the economies of scale by participating in a corporate wide debt issuance program, it also incurs substantial costs. He concluded that both the value and risk reduction of Petitioner's affiliation with its parent company should be recognized in developing the appropriate rate of return. (Id. at p. 7.)

Mr. Gorman generally agreed with Petitioner's capital structure, but noted that the retained earnings reflected in its capital structure should be modified to reflect the Commission's approved return on common equity. (Id. at pp. 8-9.)

Mr. Gorman used both the DCF and CAPM analyses to derive his recommended return on equity. Mr. Gorman used a single stage annual DCF model using Dr. Boquist's sample group. He determined the dividend yield by dividing the current annualized dividend, adjusted for next year's growth, by a thirteen (13) week average stock price. He determined the growth rate by averaging various analyst forecasts of earnings growth for the sample companies. A common equity cost rate of 8.6% resulted from this procedure. (Id. at pp. 10-13.)

Mr. Gorman opined that his DCF result was reasonable because the yield component was reasonable in light of the utility group's earnings retention and reduction of federal tax on dividend income and in comparison to the projected yield on five-year treasury bonds. He also noted that his growth rate was sustainable because it did not exceed the growth rate of the overall U.S. economy. (Id. at pp 13-14.) According to Mr. Gorman, the 'U.S. economy growth projection represents a ceiling for a sustainable growth rate for a utility over an indefinite period of time.' (Id. at p. 14.)

Mr. Gorman also applied the CAPM, using a beta of 0.68, the average of the Value Line betas for the three companies. He developed two market risk premiums, a forward looking estimate and a long term historic average. The forward looking estimate was based on his opinion of the expected return on the S&P 500, less the risk free rate of 6.1%, which was a projection of future long-term treasury bond yields appearing in the February 2004 edition of Blue Chip Financial Forecasts. The expected return was based on the arithmetic average of the real S&P 500 return (the return in excess of the inflation rate) from 1926 to 2002 as reported in SBBI 2003 Yearbook plus a consensus analyst inflation projection in the January 1, 2004 edition of the Blue Chip Financial Forecasts. (Id. at p. 16-17.) The second market risk premium was based on the arithmetic average of the S&P 500 total return for the same period as reported in the same volume, less the total return during that period on long-term treasury bonds. (Id.) Mr. Gorman's CAPM results were 9.8%, based on the historic risk premium estimate, and 10.5%, based on the prospective market risk premium. (Id.)

Based on his analysis, Mr. Gorman recommended that an appropriate return on equity for Petitioner would be 9.75%. (Id. at p. 18.) Mr. Gorman noted that the 9.75% would allow Petitioner to maintain the bond rating of its affiliate, American Water Capital Corporation ('AWCC'). (Id. at p. 19.)

Mr. Gorman also criticized Dr. Boquist's application of the DCF model, maintaining that an average stock price (rather than a spot price) should be used to calculate the dividend yield; cash flow growth does not necessarily indicate dividend growth; and analyst forecasts, rather than historical averages, should be used to estimate GDP growth in the second stage. Because of these factors, Mr. Gorman believed Dr. Boquist's two-stage DCF result was inflated. (Id. at p. 21.)

Mr. Gorman also disagreed with Dr. Boquist's use of a 1% premium as a small company risk premium. Mr. Gorman noted that Petitioner is not a small, stand alone company but rather a subsidiary of one of the world's largest water and wastewater companies. (Id. at p. 22.) Removing the 1% risk premium and high growth rate estimates from Dr. Boquist's DCF model would result in 8.6%. (Id.)

Mr. Gorman disagreed with Dr, Boquist's market risk premium estimate in the CAPM analysis. Mr. Gorman supported the use of treasury bond total returns, rather than income returns as the risk free rate in the CAPM because the income return does not measure the actual return investors earn on treasury bonds. Rather, he stated that total annual returns are based on both dividend yields and price changes to bonds. (Id. at p. 23.) He noted that since investors cannot invest only in bond income returns, his own method is more accurate than Dr. Boquist's. (Id. at 24.) He also opined that a size adjustment for Petitioner should not be made because of the size of its parent company. He also contended that since Petitioner is a water utility, it is less risky than the companies in Ibbotson's eighth decile size category that Dr. Boquist relied upon. (Id. at pp. 24-25.)

Mr. Gorman also disagreed with Dr. Boquist's method of estimating a rate of return on the Petitioner's fair value rate base. He stated that method does not measure what investors require to assume the risk of the underlying investment. (Id. at p. 26.)

Intervenor Schererville's witness Sommer expressed the opinion that Petitioner's return on equity should be no greater than 10%. (Intervenor Schererville's Exhibit 1, p. 17.) Mr. Sommer reasoned that since Dr. Boquist's recommendation of 11.0% was 50 basis points less than his recommendation in Petitioner's last rate case, the Commission's 10.5% finding in the 2002 Rate Order should now be reduced by 50 basis points. Mr. Sommer asserted that in determining the cost of common equity, the Commission should treat Petitioner as less risky and, therefore, as having a lower cost of capital because of its affiliation with RWE AG, its ultimate parent company, which owns the stock of the largest U.S. regulated water utility holding company. (Id. at pp. 14- 15.)

Petitioner's Rebuttal. In rebuttal, Dr. Boquist criticized Mr. Kaufman's DCF approach, including his failure to adjust for a full year of forward growth in determining the dividend yield. Dr. Boquist said Mr. Kaufman's half-year forward yield procedure was inconsistent with the mathematical derivation of the model, was theoretically unjustified and would result in the investor perpetually being short one half of the expected dividend growth.

Dr. Boquist disputed Mr. Kaufman's failure to give consideration to the quarterly payment of dividends. He said the ability to receive dividends quarterly has value, which increases the stock price and, thus, decreases the dividend yield calculated by Mr. Kaufman. Dr. Boquist pointed out that in PSI Energy, Inc., Cause No. 40003, the Commission found it to be 'inconsistent to use a stock price which reflects quarterly dividends in a model which assumes annual dividend payments unless the model is adjusted to reflect the quarterly dividends which lend to the

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investor expectations which give rise to the stock price.' (Cause No. 40003, p. 29 (Sept. 1996).)

Dr. Boquist also criticized Mr. Kaufman's DCF growth rates. Dr. Boquist said the BVPS was a particularly poor indicator of dividend paying ability. Dr. Boquist opined that a more reasonable approach in this case is to use a two-stage quarterly dividend model and employ forecasted cash flow growth as the first stage. He noted that recent changes in the tax treatment of dividends render the historical data suspect.

Dr. Boquist disagreed with Mr. Kaufman's contention that a forecasted GDP growth rate would be more appropriate in the second stage of the two-stage DCF model. Dr. Boquist stated typical GDP forecasts do not encompass a long-term time frame as required for the second stage.

With respect to the CAPM, Dr. Boquist criticized Mr. Kaufman's use of geometric averages to estimate uncertain forward-looking expected returns. Dr. Boquist stated that Mr. Kaufman misinterpreted the 1982 Ibbotson volume, which did not discuss CAPM; in fact, the book never even mentions the CAPM. Dr. Boquist said the quote relied on by Mr. Kaufman is not inconsistent with specifying the use of the arithmetic average in the CAPM.

Dr. Boquist also said Mr. Kaufman failed to match the bond terms used for the risk-free rate with the twenty-year maturity period represented by the Ibbotson data. Dr. Boquist testified that it was incorrect for Mr. Kaufman to use treasury bond total returns as the risk free rate in the market risk premium calculation because they are affected by changes in value. Only the income return is truly riskless. He disputed Mr. Kaufman's position that the fact that the total return is higher than the income return is inconsistent with the theory for using the income return. Total returns reflect price risk from changes in interest rates. Dr. Boquist said it is only logical that the riskless rate as evidenced by the income return would be lower than the risky rate represented by the total return because investors expect compensation for risk.

Dr. Boquist also challenged Mr. Kaufman's view that the CAPM is more controversial and less reliable than the DCF model. He cited sources concerning reliability problems with the DCF model, including Charles F. Phillips, Jr., The Regulation of Public Utilities 395-396 (3rd ed. 1993), which describes a number of 'theoretical and practical difficulties' with the DCF model, suggesting a degree of precision that does not exist and leaving wide room for controversy and argument. Dr. Boquist also said that Mr. Kaufman's own recommendation implicitly gives more weight to his CAPM results.

Dr. Boquist said Mr. Kaufman is in error in contending that a small stock premium is inappropriate for a regulated utility. A size adjustment is necessary for all small stocks because a small company will have a cost of common equity greater than that of a larger company with an equivalent beta. He pointed out that the SBBI 2003 Yearbook, on page 54, provides an example of the application of the CAPM to a small electric utility company which includes the addition of a size premium.

Dr. Boquist made some of the same comments about Mr. Gorman's testimony, particularly concerning unrealistically low DCF growth rates; a single-stage DCF that does not recognize the quarterly payment of dividends; use in the CAPM of treasury bond total returns instead of the truly riskless income returns; and failure to adjust for size in the CAPM. He also disputed Mr. Gorman's contention that analysts' forecasts should be used to estimate GDP growth in the second stage of his DCF model. Dr. Boquist stated that the second stage does not begin for ten years and then extends into perpetuity. The short term GDP forecasts to which Mr. Gorman refers have no relationship to the second stage time period.

[35-41] Commission Discussion and Findings. There was considerable disagreement among the parties over the mechanics of the DCF model. First, regarding the calculation of the forward dividend yield in the DCF model, Dr. Boquist chose the full-year method, while Mr. Kaufman and Mr. Gorman utilized the half-year method. Second, regarding the estimation of the perpetual growth rate (g), Dr. Boquist chose the three (3) to five (5) year forecasted growth in cash flow per share for the first stage of his DCF model and the nominal growth rate of GNP for the second stage of his DCF model. Mr. Kaufman relied upon ten (10) year, five (5) year and forecasted growth rates of dividends, earnings and book value per share. Mr. Gorman relied on five (5) year forecasted growth in EPS. We note that while Mr. Kaufman and Mr. Gorman relied on different estimators of growth for their respective DCF analyses, both estimates of growth had very similar results.

The Commission again reaffirms the positions it took in Petitioner's previous rate case, Cause No. 42029, regarding the growth rate and forward dividend yield, where, on page 31, we quoted from our Order in Cause No. 40103:

This Commission believes that the DCF remains a viable model to aid in our determinations of Petitioner's cost of equity. As stated in our Final Order in Cause No. 40103 pages 40-41:

The Commission has considerable experience with the DCF model for estimating the cost of equity. We are well aware of the advantages and limitations of the various approaches used by each of the witnesses. For example, the half-year method used by the OUCC for calculating the forward yield is the most frequently used approach in this jurisdiction and is rarely a point of contention in DCF analysis. We believe it fairly represents the dividend payments expected and received by investors, while the full-year method employed by Petitioner overstates dividend yield. A recalculation of Petitioner's DCF using the half-year method by the OUCC resulted in a 20 basis point reduction (Sudhoff direct, p. 29). On the issue of deriving growth rates this Commission has sanctioned the use of per share data for earnings, dividends and book value. Northern Indiana Fuel and Light, Cause No. 39145, 25 (IURC, Date Issued January 29, 1992). In all cases however, the Commission expects the parties to exercise sound judgment when deciding which inputs to include as part of their analysis.

Ind.-Am. Water Co., Cause No. 42029, 31 (quoting 1996 Rate Order, Cause No. 40103, 40-41).

As we stated in Cause No. 40103, the Commission expects the parties to exercise sound judgment when deciding which inputs to include as part of their analysis. This Commission has concerns regarding Dr. Boquist's implementation of the two-stage DCF model. Dr. Boquist has used a high estimate of dividend growth (g) for the second stage of his DCF model. Additionally, Dr. Boquist's quarterly DCF analysis assumes that dividends will grow each and every quarter.

As we have stated before, this Commission continues to believe that both historical and forecasted earnings, dividends and book value per share data are useful when employing the DCF model. We will be skeptical of any DCF analysis that relies solely on one estimator of growth. This is particularly true when the change in growth estimator significantly increases the estimate of growth during a period of declining capital costs. In this case, Dr. Boquist's change from historical growth in dividends per share to forecasted growth in cash flow per share increases his estimate of growth from 2.83% to 7.17% (an increase of over 400 basis points). This 'increase' in growth takes place despite the fact capital costs are lower than they were during Petitioner's previous rate case. Again, we disagree with relying on any single estimator to predict growth. We do not believe that investors will focus on any one estimator of growth and ignore other relevant information. We disagree with relying solely on either forecasted or historical data in a DCF analysis.

Moreover, we are also specifically concerned about Dr. Boquist's use of cash flow per share to estimate growth in a DCF analysis. Depending on the utility's construction budget, changes in cash flow may not lead to changes in dividend growth. In his direct testimony Mr. Eckart stressed most water utilities will need to increase their construction budgets. When construction needs are high, an increase in cash flow may have little impact on dividend growth.

On a more technical basis, there is a mismatch in time periods. Dr. Boquist uses a three (3) to five (5) year forecast for the next ten (10) years. Dr. Boquist could perform a two-stage DCF analysis with the first stage being five (5) years. In addition, Dr. Boquist argues that investors look for cash flow to pay dividends. (Petitioner's Exhibit JAB-R, page 5, line 13.) However, retirement of debt and capital spending are also paid out of cash flow. A review of the Value Line Survey from Dr. Boquist's direct testimony reveals that for all three (3) utilities in his proxy group, capital spending per share exceeded cash flow per share. It follows that an increase in cash flow may not lead to an increase in dividends. Finally, a 7.17% near term forecasted growth rate in dividends per share fails any reality test. Analysts are not forecasting that type of growth in dividends for the water industry. The dividend forecasts presented by the other witnesses in this case forecast lower near-term growth in dividends for the water industry.

When determining a common equity cost rate, the Commission has observed the tendency of some cost of capital models to understate the required return, particularly when used in conjunction with an original cost rate base. As the Commission stated in Indiana Michigan Power Co., 'the unadjusted DCF result is almost always well below what any informed financial analyst would regard as defensible, and therefore requires an upward adjustment based largely on the expert witness's judgment.' (Cause No. 38728, 116 PUR4th 1, 17-18 (Indiana Utility Regulatory Commission, Date Issued Aug. 24, 1990). See, PSI Energy. Inc., Cause No. 40003, 27 (Indiana Utility Regulatory Commission, Date Issued Sept. 27, 1996) ('We have indicated our own concerns with heavy reliance on the DCF model.'). See also, S. Ind. Gas and Elec. Co., Cause No. 40078, 24 (Indiana Utility Regulatory Commission, Date Issued June 21, 1995) (' ...the DCF model, heavily relied on by the Public understates the cost of common equity,'). These conclusions are borne out once again in this case and must be recognized.

Even though Mr. Kaufman continues to argue that the DCF model is a more reliable model, it would appear that he recognized the understatement inherent in his DCF model because his ultimate recommendation of 8.75% is more consistent with his CAPM results. Mr. Kaufman's DCF analysis results ranged from 8.52% to 8.57%, while his CAPM results ranged from 7.52% to 9.08%.

We also find some of Mr. Kaufman's criticisms of Dr. Boquist to be overstated. For example, Mr. Kaufman criticizes Dr. Boquist for using forecasted cash flow to establish the growth rate in the first stage in his DCF model on the ground that it is inconsistent with prior cases where Dr. Boquist used historical dividend growth. (Public's Exhibit 6, p. 55.) But he fails to acknowledge that Dr. Boquist has used cash flow growth in other cases in the past. (Petitioner's Exhibit JAB-R, p. 9.) Similarly, Mr. Kaufman seeks to persuade us that Dr. Boquist's use of a company-specific risk adjustment that is different in amount than in some past cases is inconsistent. (Public's Exhibit 6, pp. 56-57.) Yet, Mr. Kaufman himself switched from making a company-specific risk adjustment in Petitioner's last rate case to making none here. (Compare, 2002 Rate Order, Cause No. 42029, p. 33 to Public's Exhibit 6, pp. 23, 56. See also the description of the OUCC's testimony in 1996 Rate Order, Cause No., 40103, p. 39 and 1997 Rate Order, Cause No. 40703, p. 34.)

There was also considerable disagreement regarding the CAPM analysis. The OUCC has relied on both the arithmetic and geometric mean to estimate the market risk premium, while Petitioner relied exclusively on the arithmetic mean premium. Petitioner's reliance on the arithmetic risk premium increases his risk premium by more than 150 basis points over the blended risk premium used by Mr. Kaufman.

In past rate cases this Commission has given weight to both the arithmetic and the geometric mean risk premiums. This position was reaffirmed in our 1996 Rate Order, when we stated '[t]he debate over the proper use of the arithmetic and geometric means is one we consider resolved. As we stated in Indianapolis Water Company, Cause No. 39713-39843, each method has its strengths and weaknesses, and neither is so clearly appropriate as to exclude consideration of the other.' (1996 Rate Order, Cause No. 40103, p. 41.) Also, in the 2002 Rate Order, we stated '

...that, while the debate over the proposed use of the arithmetic and geometric means continues, however, each method has its strengths and weaknesses, neither is so clearly appropriate as to exclude consideration of the other.' (2002 Rate Order, Cause No. 42029, p. 32.)

Statements from Dr. Ibbotson's 1982 edition of Stocks, Bonds, Bills, and Inflation: the Past and the Future support our findings that both methodologies should be given weight. On page 59, Dr. Ibbotson stated as follows:

The arithmetic mean historical return component is used in making one-year forecasts, since the arithmetic mean represents the average performance over a one-year period. Over a long forecast period, however, the geometric mean historical return represents average performance over the whole period (stated on a compound annual basis). Therefore, we input the arithmetic mean for the one-year forecast, the geometric mean for the twenty-year forecast, and intermediate values for two, three, four, five and ten-year forecasts.

We will continue to give both the geometric and arithmetic mean risk premiums substantial weight. Neither the arithmetic nor geometric mean risk premiums should be excluded in favor of the other.

Another area of disagreement in the CAPM analysis is whether the model should use total returns or income returns. We find Mr. Gorman's analysis in this area to be the most persuasive. The income return on Treasury bonds is simply the average of Treasury bond yield quotes over the historical period, and this yield quote does not measure the actual return investors earn by making investments in Treasury bonds. Investors simply cannot invest only in Treasury bond income returns. Rather, investors must take the risk of variations in bond prices before they invest in treasury bonds. Therefore the actual return experienced by investors in Treasury securities is measured by total return, not simply the income return.

We are also mindful, as was the OUCC in this Cause, of the assertions made by Thames Water and Indiana-American during our investigation in Cause No. 42250 of the effect that American's recent acquisition by Thames Water, a subsidiary of RWE AG, would have on Indiana-American ratepayers. In our Order in Cause No. 42250, we recalled the testimony of James McGivern, Managing Director-Americas of Thames Water, that Indiana-American's rates would not be increased as a result of the acquisition; that, to the contrary, Indiana-American's access to capital at reasonable rates should be enhanced by its affiliation with Thames Water and RWE AG, thereby providing long-term benefits to ratepayers in what is an extremely capital intensive industry.

In its testimony in this Cause, the OUCC quoted Indiana-American's President, Mr. Eckart, as testifying in Cause No. 42250 that American's acquisition by Thames Water would increase Indiana-American's access to capital markets. Our Order in Cause No. 42250 also recognized Mr. Eckart's assertion that Thames Water and RWE AG have strong credit quality and large financial resources that are devoted to their subsidiary utility businesses in general and water and wastewater utility businesses in particular. Our Order in Cause No. 42250, therefore, recognized Mr. Eckart's assertion that Indiana-American's affiliation with Thames Water and RWE AG would enhance Indiana-American's ability to meet its financial requirements.

The OUCC and Intervenors have put forth a number of reasons to disallow risk premiums in the calculations used to determine a cost of equity in this Cause. In particular, we agree with the testimony of the OUCC that Petitioner should not be subjected to a downward adjustment because of its subsidiary or otherwise affiliated relationship with American, Thames Water and RWE AG. Likewise, it would not be appropriate to determine Petitioner's cost of equity by delving into American's, Thames Water's or RWE AG's financial requirements or resources. But it is a reasonable conclusion that the benefits of being associated with such large and obviously credit-worthy companies should offset the company-specific risk adjustments that Petitioner has maintained should be applicable in this Cause. The standard financial models that all parties have relied upon to some extent in this Cause, that are useful in determining Petitioner's cost of equity, are based upon calculation of a number of components, including the inclusion or exclusion of a company-specific risk adjustment. The fact of Petitioner's relationship with a large international water company is a reasonable factor to consider in analyzing the applicability of the company-specific risk adjustment component. To be blind to the fact of Petitioner's relationship with a large international water company, when determining the appropriateness of applying a company-specific risk adjustment component to the standard models used to determine a reasonable cost of equity, would be to ignore reality. In addition, it is disconcerting to this Commission that Petitioner gives no recognition in its models for a rate adjustment in this Cause to the financial benefits that it claimed, in Cause No. 42250, its ratepayers would enjoy as a result of the relationship with a large international water company.

The Petitioner recommended a return of 11.00% on equity capital. However, the foregoing discussion of the evidence indicates that Petitioner's recommendation is too high given current levels of capital costs, prevailing economic conditions and because of adjustments made to Mr. Boquist's raw results to reflect Petitioner's increased level of risk relative to that of the proxy group. Petitioner's unadjusted DCF and CAPM results were 10.0% and 9.59%, respectively. These were then adjusted upward to reflect the alleged special circumstances of the Company and resulted in values of 11% for the DCF and 11.65% for the CAPM. The Public recommended a return on equity capital of 8.75% based on DCF results of approximately 8.5% and CAPM results ranging from 7.52% to 9.08% with no special adjustments. Mr. Gorman recommended a return of 9.75% based on the results of his DCF and CAPM analysis, while Mr. Sommer recommended a return of no more than 10%.

Our review of the evidence indicates that Petitioner's circumstances, as well as economic conditions, have changed significantly since Indiana-American's last rate case. Petitioner's size has significantly increased; its ability to attract capital has improved as a result of being associated with a large international water company; and the cost of capital is substantially below that which prevailed at the time of the Company's last rate case. Taken together, Petitioner is no more risky than the proxy group companies and is less risky than in the past. Ignoring Petitioner's adjustments to its cost of equity estimates establishes a range of 9.59% to 10.0%.

Overall, the evidence does not support a cost of equity as low as the Public recommended. We recognize that capital costs have declined and that the cost of equity should follow suit. However, we have already opined that unadjusted DCF results can understate the cost of equity, and we are mindful of improved economic conditions which will continue to increase the cost of capital over time.

Based on our discussions above, we find the Petitioner's cost of common equity to be 9.25%. This figure is slightly below Petitioner's unadjusted range of results, but compares favorably to the recommended range of results of both the OUCC and the Intervenors of 8.75% to 10.0%. It affords Petitioner an opportunity to earn a pre-tax interest coverage ratio that will preserve an 'A' bond rating, is high enough to compensate Petitioner for any marginal risks it faces and anticipates small but continuous increases in the cost of capital in the future.

B. Cost of Capital and Capital Structure

Having determined the cost of equity, we can now determine Petitioner's cost of capital. When a 9.25% cost of equity is incorporated into Petitioner's capital structure as shown below it produces a weighted cost of capital of 7.17%.

| Description | Amount | Percent of Total | Cost Rate | Weighted Cost |
|---|---|---|---|---|
| Long Term Debt | $254,659,452 | 50.47% | 6.86% | 3.46% |
| Common Equity | 199,979,016 | 39.64% | 9.25% | 3.67% |
| Preferred Stock | 420,000 | 0.08% | 6.00% | 0.00% |
| Post-Retirement Benefits, net | 2,815,896 | 0.56% | 0.00% | 0.00% |
| Deferred Income Taxes | 43,642,668 | 8.65% | 0.00% | 0.00% |
| Job Development ITC-Post 1970 | 2,833,994 | 0.56% | 7.91% | 0.04% |
| Deferred ITC-Pre 1971 | 136,821 | 0.03% | 0.00% | 0.00% |
| Customer Deposits | 0 | 0.00% | 6.00% | 0.00% |
| Accumulated Depreciation: Muncie Sewer | 43,208 | 0.01% | 0.00% | 0.00% |
| Total | $504,531,055 | 100.00% | | 7.17% |

C. Fair Rate of Return and Net Operating Income

[42-54] Petitioner's Position. In its case-in-chief, Petitioner proposed to determine its NOI by multiplying its cost of capital by its original cost rate base plus its proposed acquisition adjustments. It is not until page 68 of Petitioner's proposed order that it proposes a single fair rate of return of 6.04%

that can be applied to a single fair value rate base of $663,400,000. However, the fair rate of return figure does not appear in Petitioner's direct or rebuttal testimony, thus the origin of this figure is unclear. When a 6.04% fair rate of return is multiplied by the fair value rate base of $663,400,000, it produces a NOI of $40,069,360. The Commission notes that this is virtually the same figure which would be produced by multiplying Petitioner's weighted cost of capital by its original cost rate base plus its proposed acquisition adjustments.

Mr. Cutshaw performed a fair value test that he suggested supported Petitioner's proposed NOI. To derive a fair rate of return, Mr. Cutshaw removed the inflation component that he determined was embedded in Indiana-American's long term bonds. So, Mr. Cutshaw derived a rate of return by reducing the interest rate for each issue by the rate of inflation from the year of issuance to the end of 2002. In his direct testimony, Mr. Cutshaw argued that his methodology is appropriate because it will more accurately determine how much of Indiana-American's debt cost represents compensation for inflation. (Tr. p. G-77-78.) Mr. Cutshaw also cites to various Commission Orders to support his contention that inflation should be removed only from the debt portion of the capital structure. After removing the historical inflation from each debt issuance, Mr. Cutshaw derives an inflation adjusted cost of debt of 4.52%. Mr. Cutshaw then uses the adjusted cost of debt to derive an overall fair rate of return of 6.7%. Finally, Mr. Cutshaw concludes that since the NOI that would be produced from multiplying his fair rate of return by Petitioner's fair value rate base is greater than Petitioner's proposed NOI, Petitioner's proposed NOI is reasonable.

In an additional attempt to support the reasonableness of Petitioner's proposed return, Dr. Boquist presented a comparable return on replacement cost study. Dr. Boquist testified that the return of a utility should correspond to the return investors could earn on investments of comparable risk in the unregulated sector. If investors can earn a larger return and bear identical risks or, conversely, earn identical returns with less risk by investing in other industries, they will do so. Failure to recognize this fact would make it difficult for utilities to raise capital on a competitive basis. Dr. Boquist expressed the opinion that Petitioner should be allowed to earn a fair rate of return on the fair value of its property similar to the rate of return which unregulated companies of comparable risk earn on the fair value of their assets. Dr. Boquist performed a detailed study to determine that rate of return.

Dr. Boquist first identified a large group of comparable-risk, unregulated companies by using the approach advocated by Fama and French in a 1992 study published in the Journal of Finance and in subsequent papers. Fama and French concluded that the size of a firm measured by the market value of its equity ('market equity,' 'ME') and the ratio of a firm's book value of equity to a firm's market value of equity ('book-to-market equity,' 'BE/ME') are the two risk factors influencing common stock returns because they have strong ties to economic fundamentals, such as profitability and the growth of earnings and assets that have long been associated with investment performance. Fama and French contend these factors explain stock returns better than beta.

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Dr. Boquist replicated the Fama and French study approach by performing a computer analysis of non-regulated firms in the New York Stock Exchange, American Stock Exchange and NASDAQ return files from the Center for Research in Security Prices and the merged COMPUSTAT annual industrial files of income statement and balance sheet data. The time period covered by this study extended from 1976 through 2002. The companies were then partitioned into matrixes for each year based upon the two (2) key Fama and French risk factors. Dr. Boquist then developed a portfolio of comparable companies reflecting the range of ME and BE/ME values for his three (3) proxy companies for each year.

Dr. Boquist then determined the pre-tax rate of return earned by the comparable companies on the depreciated replacement cost of their assets. To determine replacement cost, Dr. Boquist used the techniques described in the work of Lindenberg and Ross, published in the Journal of Business in 1981, which prescribes a methodology for estimating replacement cost of a firm's assets from its accounting statements. This method considers price level changes, technological change, real economic depreciation and investment in new plant and equipment. The same 1.347% technological change adjustment used by Dr. Boquist in his determination of Petitioner's depreciated replacement cost was used for the comparable companies. Dr. Boquist testified that he measured before income tax operating profit to eliminate the effects of leverage (the interest of which affects income taxes), the tax strategies some firms employ and tax loss carryforwards and carrybacks available to some companies. From this study, Dr. Boquist determined that the average, annual, pre-tax rate of return on replacement cost for the comparable companies from 1976 through 2002 was 10.6%. (Petitioner's Exhibit JAB, p. 57.) He concluded that a rate of return of 10.6% before income taxes on the depreciated replacement cost of Petitioner's property, would be fair and reasonable.

OUCC's Position. The Public used a process similar to that of the Petitioner to estimate an appropriate level of NOI for Indiana-American. The key difference is that the Public did not believe it was appropriate for Petitioner to earn a return on its proposed acquisition adjustment from its merger with Northwest. We considered this matter in a prior section of this Order and concluded that the return on the proposed acquisition adjustment for the merger with Northwest should be denied.

OUCC witness Mr. Gassert disputed Mr. Cutshaw's fair value test. Mr. Gassert showed that the methodology Petitioner used in this Cause to determine the fair rate of return was different than the methods Petitioner had employed in its previous cases. Mr. Gassert criticized Mr. Cutshaw's newest method that reduced the interest rate for each debt issue by the rate of inflation from the year of issuance to the end of 2002. Mr. Gassert noted that not only was this method inconsistent with Commission Orders in Petitioner's previous Causes but it was also inconsistent with the method Petitioner used since it began performing this calculation. Mr. Gassert stated that the purpose of removing inflation from the rate of return is not to remove inflation that is embedded in the cost of debt based on the life of the debt, but to remove the inflation for the time period that is embedded in the fair value rate base. Mr. Gassert then stated that it was necessary to try and match the inflation included in the fair value rate base when removing inflation from the cost of capital to determine a fair rate of return. Since all rate base items contain inflation, it is necessary to remove inflation from the entire capital structure and not just the debt component of the capital structure. Mr. Gassert further opined that, if Indiana-American continues to insist that inflation should be removed from only the debt component, the Petitioner should only inflate assets in its fair value rate base funded by debt to eliminate the mismatch created by Indiana-American.

Mr. Gassert noted that the Commission has consistently recognized that inflation is embedded in the overall weighted cost of capital. Mr. Gassert supported his comment with quotes from previous Indiana-American Orders in Cause Nos. 39595, 40103 and 40703. Mr. Gassert noted that in Cause Nos. 40103 and 40703, when inflation was removed from the debt component, the Commission explained that unfortunately it was forced to take a more conservative approach than it may have taken under different evidentiary circumstances because the evidence on inflation was 'meager' in those cases. Next, Mr. Gassert applied the Commission's methodology outlined in Petitioner's rate order from Cause No. 39595 to Petitioner's fair value test. Using the Commission's method, Mr. Gassert estimated that the average inflation in Petitioner's rate base ranged from 3.0% to 4.6%. When Mr. Gassert applied the fair rate of return to Petitioner's fair value rate base, Mr. Gassert concluded that if Petitioner had followed a methodology similar to that outlined by the Commission, its fair value test would have resulted in a NOI substantially lower than the Company's requested NOI level. Mr. Gassert explained that in the OUCC's calculation of Petitioner's NOI, the OUCC did not remove inflation from the overall weighted cost of capital. Mr. Gassert further stated that the OUCC's calculation is consistent with the methodology used by the Commission in Cause No. 39595 and concluded that the OUCC's 5.07% fair rate of return when applied to a fair value rate base of $663,437,626 provided Petitioner's shareholders with a fair and reasonable return.

Through its witness Mr. Kaufman, the Public challenged Dr. Boquist's return on replacement cost analysis. Mr. Kaufman had several concerns regarding Dr. Boquist's Fama-French analysis. In sum, the key concerns expressed by Mr. Kaufman were that Dr. Boquist's return on replacement cost analysis does not react to changes in capital markets, Dr. Boquist's analysis is based on operating returns while the Fama-French analysis is based on market returns and, lastly, the results of Dr. Boquist's analysis are contrary to the model.

Specifically, Mr. Kaufman asserted that Dr. Boquist's return on replacement cost analysis does not react to changes in market conditions. In models such as the DCF or CAPM, changes in investor expectations are quickly incorporated into expected returns. That is not the case in Dr. Boquist's return on replacement cost analysis. For example, a change in interest rates will impact investor expectations, and the results of both a CAPM and DCF analysis will, in turn, quickly react to reflect the change in investor expectations. Mr. Kaufman stated on page 61 of his testimony that ' ...during 2003 the yield on 'A' Utility bonds decreased by approximately 81 basis points and Dr. Boquist's return on replacement cost analysis fails to either react or incorporate the change in interest rates over the last year into his return on replacement cost analysis.'

Next, Mr. Kaufman criticized Dr. Boquist's use of operating returns. The Fama-French analysis assumes that firms in the same grid location will earn similar market returns. Market returns refer to price appreciation plus dividends. Dr. Boquist's analysis is based on net operating profit. Dr. Boquist uses operating income before taxes as his measure of return in estimating his return on replacement cost. While Dr. Boquist's analysis assumes that firms in the same grid location will earn similar operating returns, Mr. Kaufman contended that he presents no evidence to support his opinion that the Fama-French analysis can be extended to include his assumption. Mr. Kaufman agreed that there will be some relationship between market returns and operating returns, but he stated that many other factors will influence market returns that may have little or no impact on operating returns. For example, a change in interest rates will typically have an immediate impact on the market return of a company, but that change in interest rates may not have the same impact on current operating returns. According to Mr. Kaufman, a firm's financial leverage will impact its markets returns, yet Dr. Boquist's analysis specifically intends to remove the impact of financial leverage, as the Petitioner's witness stated on page 54 of his direct testimony, 'I sought to obtain a measure of operating earnings of the comparable company group unaffected by leverage (the interest from which affects income taxes).'

Mr. Kaufman asserted that operating returns and market returns are distinct. Companies may have similar market returns, yet have very different operating returns. According to the OUCC, if Dr. Boquist chooses to assert that firms in the same Fama-French grid location will also have similar operating returns in addition to similar market returns, then it is his responsibility to demonstrate that this is the case. Given the lack of support that Dr. Boquist provides in his testimony which demonstrates that the Fama-French analysis can also be applied to operating returns, Mr. Kaufman claimed that such an assumption is not reasonable. Mr. Kaufman asserted, as an example, that in 1999 HJ Heinz Co. had a market return of -27.3%, yet Dr. Boquist estimated an operating return on replacement cost of 21.1%. (Public's Exhibit 6, pp. 62- 63.)

Mr. Kaufman stated that the results of Dr. Boquist's return on replacement cost analysis produced results that were contrary to the model's predicted results. The Fama-French model predicts that 1) smaller companies will earn a higher rate of return than larger companies and 2) companies with a higher book-to-market ratio will earn a higher rate of return than companies with a lower book-to-market ratio. [FN3] In his work papers, Dr. Boquist provides a calculation of returns by grid location for each of the 25 grid locations on his 5 by 5 grid. He does this on a year-by-year basis for each year from 1976- 2002 and on a composite basis for all years. Mr. Kaufman provided a schedule that replicates the composite or average results of Dr. Boquist's analysis for all years. (Public's Exhibit 6, Sched. 4, p. 3.) Mr. Kaufman also included a copy of Petitioner's work paper that contains the data provided in Schedule 4, page 3. (Id. at p. 4.) In his analysis

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Dr. Boquist separates the companies into quintiles, as measured by market equity, which get larger going left to right (grid locations 1 to 5). Companies are also separated into quintiles as measured by book-to-market ratio with an increasing book-to-market ratio going from top to bottom (grid locations 1 to 5). Thus, companies in grid location (1,1), located in the upper left hand corner, have the smallest market equity and the lowest book-to-market ratio. Conversely, companies in grid location (5,5), located in the lower right hand corner, have the largest market equity and have the highest book-to-market ratio. Under the Fama-French model smaller companies should earn higher rates of return than larger companies, therefore rates of return should increase as one moves horizontally from grid 5 to 1 (right to left). Likewise, under the Fama-French model, where firms with a lower book-to-market ratio should earn lower rates of returns, rates of return should increase as one moves vertically from grid 1 to grid 5 (top to bottom).

Mr. Kaufman then asserted that the figures in Dr. Boquist's analysis did not follow the theory put forth by the Fama-French model. Mr. Kaufman stated that grid location (5,1) located in the upper right hand corner, which contains the largest companies with the smallest book-to-market ratio, shows the highest rate of return (18.04%) when, in fact, the theory dictates it should have the lowest rate of return. According to Mr. Kaufman, under the Fama-French model, the highest rate of return should appear in grid location (1,5) which contains the smallest companies with the highest book-to-market ratio. But, under Dr. Boquist's analysis, grid location (1,5) has one of the lowest rates of return (2.24%).

Additionally, Mr. Kaufman compared the final results of Dr. Boquist's analysis in Cause No. 42029 to the results in a previous Indiana-American rate case, Cause No. 41320. This comparison caused Mr. Kaufman to question the validity of the study's results. According to Mr. Kaufman, although both he and Dr. Boquist disagreed on Indiana-American's cost of equity in Cause No. 42029, both of them estimated a cost of equity in that case that was similar to what each witness estimated in Cause No. 41320. Mr. Kaufman asserted that, despite this fact, Dr. Boquist's estimated return on replacement cost had increased from 7.58% in Petitioner's Cause No. 41320 to 11.88% in Cause No. 42029. According to Mr. Kaufman, between Petitioner's Orders in Cause Nos. 42029 and 41320, Dr. Boquist had increased his estimate of Petitioner's cost of equity by 25 basis points [FN4] and increased his estimated fair rate of return by 430 basis points. Mr. Kaufman stated that Dr. Boquist did not explain this dramatic increase in his estimated return on replacement cost during a period where capital costs have remained relatively stable.

Finally, Mr. Kaufman testified that Dr. Boquist performed no review or analysis of his results to test the validity of his study. For example, in his analysis there are approximately 26,375 return on replacement cost estimates from 1990-2002. This sample has an average return of 5.13% and a standard deviation of 28.69%. According to Mr. Kaufman, such a high standard deviation raised concerns, in addition to the concerns he stated previously, and should not be ignored. In his opinion, Dr. Boquist had not demonstrated the validity of his analysis.

Petitioner's Rebuttal. OUCC witness Gassert proposed deducting the average annual inflation rates since 1926 or 1963 from Petitioner's entire cost of capital. Mr. Cutshaw testified in rebuttal that his method is more accurate than Mr. Gassert's because it accounts for the fact that the inflation of concern to the debt investor is the inflation that will occur during the time the debt is outstanding. Mr. Gassert's inflation deduction lacks this correlation because Petitioner's debt has been outstanding for periods much shorter than those used by Mr. Gassert and during a period when inflation was lower than the long-term averages used by Mr. Gassert. Mr. Cutshaw testified that Mr. Gassert's method of deducting inflation from all components of the capital structure is inconsistent with the 1996, 1997 and 2002 Rate Orders. For example, in the 2002 Rate Order the Commission stated that, '[T]his Commission has asserted in previous rate cases that, since the fair value rate base contains inflation that ...is historic and not prospective inflation, it should be removed from the debt component of the cost of capital to estimate a fair rate of return.' (2002 Rate Order, Cause No. 42029, p. 39.) Mr. Cutshaw said that Mr. Gassert's proposal created negative cost rates for some capital structure components and resulted in an unreasonable and illogical net operating income when applied to the OUCC's proposed cost of capital.

Mr. Cutshaw argued that Mr. Gassert's proposed methodology produced NOIs that were too low to be credible because it produced a NOI that was below the NOI that would be derived based on original cost rate making. By adjusting for historic inflation in the embedded cost of debt, Mr. Cutshaw also claimed that his own methodology of deducting from each debt issuance the average inflation rate during the period that the issue has been outstanding is better than Mr. Gassert's method. Finally, Mr. Cutshaw maintained that Mr. Gassert's position that inflation should be deducted from all components of the cost of capital is not consistent with prior Commission orders.

In his rebuttal testimony, Dr. Boquist testified that his study was consistent with the Fama-French model. He said Fama-French have employed a 5 by 5 grid in their analysis. Dr. Boquist testified operating returns are a necessary component of fair value ratemaking and are correlated to market returns. Dr. Boquist also argued that the results of his analysis were consistent with the theory of the Fama-French model and that it would be expected for small companies to show relatively lower contemporaneous returns on fair value since the denominator is larger even though small companies generate higher average stock market returns (i.e., dividend and stock price increases) than do large companies. He said his study is company-specific, pointing out that there is no difference in the level of specificity in the study and in Mr. Kaufman's CAPM results. He also said higher rates of return on replacement costs are to be expected during periods of strong economic growth.

Commission Discussion and Findings. The cost of capital is a percentage which can be converted into an earnings requirement only by applying that percentage to a rate base. In Duquesne Light Co. v. Barasch, the United States Supreme Court held that the U.S. Constitution does not require 'the adoption of a single theory of valuation .... The Constitution within broad limits leaves the States free to

**(Publication page references are not available for this document.)**

decide what rate setting methodology best meets their needs in balancing the interests of the utility and the public.' (488 U.S. 299, 316 (1989).) Indiana has selected the fair value rate base methodology. The Supreme Court described the fair value approach as follows:

Under the fair value approach, a 'company is entitled to ask ...a fair return upon the value of that which it employs for the public convenience,' while on the other hand, 'the public is entitled to demand ...that no more be exacted from it for the use of [utility property] than the services rendered by it are reasonably worth. [ Smyth v. Ames,] 169 U.S. 466, 547 [(1898)]. In theory the Smyth v. Ames fair value standard mimics the operation of the competitive market. To the extent utilities' investments in plants are good ones (because their benefits exceed their costs) they are rewarded with an opportunity to earn an 'above-cost' return, that is, a fair return on the current 'market value' of the plant. To the extent utilities' investments turn out to be bad ones (such as plants that are canceled and so never used and useful to the public), the utilities suffer because the investments have no fair value and so justify no return.

Duquesne Light Co., pp. 308-309. As previously discussed, the Indiana fair value rule is a significant factor in treating the acquisition adjustments at issue in this case. In light of the findings made above, including how the purchase prices served to bring the property to its present state of efficiency and the cost savings that investment made possible, Petitioner should be allowed a return on the net amount of the Indiana Cities acquisition adjustment through fair value ratemaking.

As we did in our 2002 Rate Order, we will use the following standards and criteria to determine a fair rate of return on Petitioner's investment in its utility plant:

1) Return comparable to return on investments in other enterprises having corresponding risks;

2) Return sufficient to ensure confidence in the financial integrity of the Petitioner;

3) Return sufficient to maintain and support the Petitioner's credit [rating];

4) Return sufficient to attract capital as reasonably required by the Petitioner in its utility business.

2002 Rate Order, Cause No. 42029, p. 38. One recognized method for evaluating the reasonableness of a utility's allowed return involves investigation of the utility's capital structure. From such investigation, we can develop the overall weighted cost of capital. This cost of capital may then be considered in determining a fair return. Having previously determined that the fair value of Petitioner's rate base is $663,400,000, it is now our duty to determine a fair rate of return that can be used to calculate a fair dollar return for Petitioner's net operating income.

It is clear that because the cost of capital and the fair value rate base are derived in different manners the two may not be directly applied to each other. If the fair value rate base is found to be other than the original cost rate base, determining return by multiplying the cost of capital including a consideration for inflation by a fair value rate base, which also includes inflation, would overstate the required return. This overstatement would reflect a redundant consideration of the anticipated impact of inflation on the value of Petitioner's property.

As the Supreme Court of Indiana determined in Public Service Commission v. City of Indianapolis,

The ratemaking process involves a balancing of all these factors and probably others. It involves a balancing of the owner's or investor's interest with the consumer's interest. On the one hand, the rates may not be so low as to confiscate the investor's interest or property. On the other hand, the rates may not be so high as to injure the consumer by charging an exorbitant price for service and at the same time giving the utility owner an unreasonable or excessive profit.

235 Ind. at p. 96, 131 N.E.2d at p. 318. Therefore, the results of any return computation may be tempered by the Commission's duty to balance the respective interests involved in ratemaking. Finally, the end result of this Commission's Orders must be measured as much by the success with which they protect the broad public interest entrusted to our protection as by the effectiveness with which they maintain credit and attract capital.

This Commission has asserted in previous rate cases, insofar as the fair value rate base contains historic inflation, that it is historic inflation and not prospective inflation that should be removed from the cost of capital to estimate a fair rate of return. For example, in the 1996 Rate Order, we explained that '[i]n order to avoid over-compensating Petitioner for the effects of historical inflation, it is necessary to remove the historical inflation component from the costs of capital to derive a fair return.' (1996 Rate Order, Cause No. 40103, p. 48.) In addition, this Commission determined in Indiana Michigan Power Company that

It is inappropriate to apply to the fair value of Petitioner's used and useful property its weighted cost of capital because the weighted cost of capital contains both historic and prospective inflationary factors. We have accounted for the historic inflationary factors in determining the fair value of Petitioner's property. Therefore, to arrive at a fair return to be applied to the fair value of Petitioner's property the historic inflationary considerations must be removed, lest they be double counted. (emphasis added).

Ind. Mich. Power Co., Cause No. 38728 (1990), p. 28.

**(Publication page references are not available for this document.)**

On page 21 of his testimony, Mr. Gassert recommended rates of inflation from 3.0% to 4.6% and a fair value range of 3.27% to 4.87%, using the methodology in Cause No. 39595. Mr. Gassert ultimately recommends a fair return of 5.07%. However, Mr. Gassert removed his inflation values from Petitioner's proposed cost of capital of 7.87%. Applying the methodology from Cause No. 39595 to the OUCC's proposed cost of capital of 6.97% and our finding of 7.17% results in ranges of 2.37% to 3.97% and 2.57% to 4.17%, respectively. The use of the Cause No. 39595 methodology in this case yields results that are too low when compared to the OUCC's ultimate recommendation. Petitioner's recommended fair value return appears to be 6.04%. Based on the results of the parties' analyses and their recommendations, we find a range for fair value return to be 5.0% to 6.0%. Based on the evidence, we find 5.38% to be a fair rate of return, and should be approved. When applied to the $663,400,00 fair value rate base, a required NOI level of approximately $35,669,628 is produced. This should adequately compensate Petitioner for the purchase price paid to acquire Indiana Cities.

XI. OPERATING RESULTS UNDER PRESENT RATES A. Revenues

Petitioner's proposed pro forma annual revenues at present rates originally totaled $135,646,024, and were increased to $137,740,829 on rebuttal. The OUCC's proposed pro forma revenues at present rates equaled $139,532,714. The differences are described and reconciled hereinafter. The resolution of these issues will also have a corresponding impact on certain expenses which vary with the quantity of water delivered and revenues received.

1. Residential Usage Normalization

[55, 56] Petitioner's Position. Petitioner proposed to adjust test year revenues to reflect the normalization of residential customer usage. A usage normalization adjustment would account for potential unusual or unseasonable conditions during the test year which might impact the demand for water. It is derived by comparing the test year usage to some other benchmark over an historical period.

In direct testimony, Bruce I. Tapp, Jr., a Financial Analyst for Indiana-American, conducted a regression analysis in which he examined the trend in consumption over time. He used time as the independent variable and average residential water usage per month as the dependent variable. In conducting this analysis, Mr. Tapp used data from the last nine and one half (9 1/2) years (114 months). (Petitioner's Exhibit BIT, pp. 7-10.)

In performing his analysis, Mr. Tapp compared actual test year average residential usage to the model's predicted usage during the test year. As part of his analysis Mr. Tapp used a method he called the Classical Decomposition Multiplicative Model ('CDMM'). The CDMM adjusted residential usage data for seasonality so that it could be used in a regression analysis. (Id.)

Based on his analysis, Mr. Tapp concluded that average residential usage was declining. He concluded that actual usage during the test year exceeded his expected/projected usage. Therefore, Mr. Tapp reduced test-year revenues by $1,734,221 to correct the discrepancy between the actual test-year data and his projected data for the same time period. (Id.)

Mr. Tapp testified the Commission had used simple, historical averages in the past, rather than a regression analysis. In explaining his departure from previously employed methodologies, he stated that his methodology using a regression analysis was superior to either a three (3) year average or a five (5) year average because his regression analysis had a mean absolute deviation ('MAD') of .196, while a five-year average and a three-year average had MADs of .221 and .256, respectively. In other words, the average monthly difference or 'error' between the actual, historical data and the projected (or averaged) data was lowest (best) for Mr. Tapp's regression analysis and highest (worst) for a three-year average. The MAD for a five-year historical average was in between the MAD for the three-year average and the regression analysis. (Id.)

OUCC's Position. The OUCC recommended this Commission make no adjustment to test-year data for usage normalization. The OUCC's witness Edward Kaufman presented testimony disputing the reliability of Mr. Tapp's analysis. (Public's Exhibit 6, pp. 70-76.)

Specifically, Mr. Kaufman criticized Mr. Tapp's analysis because Mr. Tapp did not calculate the $R^2$ value for his regression analysis. Mr. Kaufman explained, '$R^2$ is the proportion of the total variation in Y explained by the regression of Y on X. Or in layman's terms the $R^2$ explains the percentage change in the dependent variable (in Mr. Tapp's analysis, water usage) that is explained by the change in the independent variable (in Mr. Tapp's analysis, time [monthly basis]).' (Id. at p. 71- 72.)

Mr. Kaufman explained that calculating the $R^2$ is an easy way to test the reliability of a regression analysis. Specifically, he noted in his testimony that Mr. Tapp's analysis was performed as a Microsoft Excel document, and Excel gives users the option of having the $R^2$ of an analysis automatically calculated. (Id.)

Mr. Kaufman testified that Mr. Tapp's regression analysis had an $R^2$ of only .0511 before correcting for autocorrelation (discussed below). Mr. Kaufman explained that this $R^2$ showed that only 5.11% of the change in average customer usage was explained by the passage time. Mr. Kaufman concluded that an $R$

2 of only 0.0511 was too low to make a reliable conclusion between time and its impact on water usage. (Id.)

In addition, Mr. Kaufman criticized Mr. Tapp's analysis because Mr. Tapp did not correct his results for a statistical bias called 'autocorrelation.' Mr. Kaufman explained that autocorrelation exists where there is a relationship or correlation between the values of a time series and previous values in the same series. The result is the appearance of a stronger relationship between the dependent and independent variables than actually exists. Mr. Kaufman pointed out that correcting for autocorrelation showed the 5.11% relationship between time and usage shown by Mr. Tapp's analysis was actually overstated. (Id. at p. 72, line 7 though p. 73, line 6.)

Mr. Kaufman further disputed Mr. Tapp's analysis by noting Mr. Tapp failed to account for changes in Indiana-American's customer base. Specifically, Mr. Kaufman divided Mr. Tapp's data into two (2) samples: one prior to the merger with Northwest and United (January 1994 -- December 1999) and a second after the merger with Northwest and United (January 2000 -- June 2003), and then recalculated Mr. Tapp's regression analysis for the post-merger data. Mr. Kaufman testified that this analysis, using only the post-merger data, shows that average residential monthly usage is increasing and not decreasing. (Id. at p. 74, line 13 through p. 75, line 3.)

Mr. Kaufman's testimony included a series of eight (8) graphs that illustrated the low R

2 in Mr. Tapp's analysis and the impact of dividing Mr. Tapp's data into two (2) samples. (Public's Exhibit 6, Sched. 6.) Finally, Mr. Kaufman asserted that a MAD, or average error, of 196 gallons per month was so high that it rendered Mr. Tapp's analysis and his subsequent conclusions meaningless. Mr. Kaufman observed that this average monthly error (196 gal.) was nearly as high as Mr. Tapp's entire projected decrease over 9 1/2 years (203 gallons per month). (Public's Exhibit 6, p. 75, line 9 through p. 76, line 15.)

Based on Mr. Kaufman's analysis and his criticism of Mr. Tapp's analysis, the OUCC recommended that no adjustment be made based on residential usage.

Petitioner's Rebuttal. In rebuttal, Petitioner's witness, Mr. Cutshaw stated Petitioner would no longer rely on Mr. Tapp's regression analysis, due to 'the complexity of the issues that have been raised by Mr. Kaufman[.]' (Petitioner's Exhibit JLC-R, p. 5, lines 14-16.) Instead, Mr. Cutshaw offered a new usage normalization adjustment, calculated by comparing a three-year historical average to actual test year data. This change in methodology reduced Petitioner's proposed revenue adjustment from $1.73 million to $1.2 million.

OUCC's Response to Three-Year Average. The Presiding Officers permitted the OUCC to present live testimony at the end of the hearing to respond to Petitioner's new usage normalization adjustment and corresponding new revenue adjustment. The OUCC

(Publication page references are not available for this document.)

continued to recommend that the Commission make no revenue adjustment, due to the unreliability of both of Petitioner's proposed methodologies.

The OUCC presented the live testimonies of Edward Kaufman and Utility Analyst Judith I. Gemmecke. Mr. Kaufman reminded the Commission that Petitioner's justification for using a three-year average instead of a five-year average in Cause No. 42029 was that average residential monthly usage was declining at that time. However, Mr. Kaufman reiterated the point from his direct testimony that according to Petitioner's data, average monthly residential usage over the last three and one half (3 1/2) years is in fact increasing, not decreasing. Consequently, the OUCC testified that using an adjustment based on a three-year average was inappropriate. (Tr. pp. H-73-74.)

Mr. Kaufman stated that using a five-year historical average was more appropriate than using Petitioner's three-year average. Mr. Kaufman noted that using Petitioner's proposed three-year average resulted in a downward adjustment to test-year revenues of $1,193,000, while using a five-year average resulted in an upward adjustment to test-year revenues of $214,000. (Tr. p. H-74.)

Mr. Kaufman stated that a five-year average had a lower MAD than the three-year average advocated by Mr. Cutshaw. (Tr. p. H-75.) Mr. Kaufman observed that the three-year average's higher error rate indicated less reliability. (Id.) However, Mr. Kaufman stated that the spread of results from all three (3) methodologies (three-year average, five-year average, and regression analysis) demonstrated that estimating average customer usage is imprecise at best. (Tr. pp. H-76-77.) Therefore, Mr. Kaufman concluded that all three (3) methods were unreliable and that none of them should be used. (Id.)

Public's witness Ms. Gemmecke also provided live and filed testimony. (Tr. p. H-79-85; Public's Exhibit 1-A, 1-B, 1-C, and 1-D.) In her testimony submitted at the hearing, she claimed that Petitioner has not been consistent in a methodology to determine usage normalization. (Public's Exhibit 1-D.) For example, in Cause No. 42029, the Commission allowed Petitioner to use a three-year historical usage average because, in that case, the three-year precipitation average more closely approximated the precipitation average for the previous thirty (30) years. (Id.; Tr. p. H-84.)

Ms. Gemmecke testified that in this case, however, the five-year precipitation average more closely approximated the thirty-year precipitation average than did Petitioner's proposed three-year average. Consequently, there was no justification for Petitioner's use of a three-year average. Ms. Gemmecke provided a chart and data to support her position that the five-year average is in fact closer to the thirty-year average than is the three-year average. (Id.)

Next, Ms. Gemmecke explained the difference between 'weather normalization' and 'usage normalization.' She explained there are many factors that influence usage other than weather. In response to Petitioner's claim that water conservation has reduced customer usage Ms. Gemmecke explained that there are several other factors that could increase usage. (Id.)

Finally, Ms. Gemmecke reiterated the OUCC's position that no usage normalization adjustment was appropriate in this case. However, she stated that, if the Commission felt a usage adjustment was absolutely necessary, the five-year average was superior to the three-year method recommended by Petitioner. (Id.)

Petitioner's Rebuttal to Live Testimony. Petitioner's witness Duane Cole provided live rebuttal testimony in response to the Public's live testimony. Mr. Cole claimed that Ms. Gemmecke's analysis of rainfall was irrelevant because her analysis was based upon the entire State of Indiana rather than particular locations where Petitioner serves. He asserted that it is not uncommon in any given month for rainfall amounts within the State of Indiana to vary by as much as ten (10) inches. (Tr. p. H-87.)

Mr. Cole also submitted an analysis of consumption during winter months. (See Petitioner's Exhibit DDCole-R; Tr. pp. H-90-93.) He asserted that by analyzing consumption during winter months, many variables of water consumption are removed. (Tr. pp. H-89-90.) Mr. Cole testified that his schedule is consistent with his opinion that the effect of increased conservation efforts is driving base consumption per customer down. (Tr. pp. H-93-94.) Mr. Cole asserted that with declining base consumption per customer, the use of a longer average would drive consumption up to artificially high levels. (Id.)

Commission Discussion and Findings. Petitioner, in this case, advocates use of a three-year average for adjusting revenues for residential usage, while the OUCC recommends no usage normalization adjustment. However, during the course of this proceeding, the Commission has been presented with three (3) possible methodologies for adjusting test year revenues based on customer usage. First, Petitioner proposed a $1.73 million decrease to test-year revenues based on a regression analysis. Second, Petitioner proposed a $1.2 million decrease to test-year revenues based on a three-year average of historical usage. Finally, in the event this Commission felt an adjustment was necessary, the OUCC calculated a $214,567 increase to test-year revenues based on a five-year average of historical usage. We will address each of these methodologies in turn.

At the close of evidence, Petitioner was no longer relying on Mr. Tapp's regression analysis, nor was Petitioner advocating use of the resulting $1.73 million revenue adjustment. Consequently, we see no reason to accept Mr. Tapp's conclusions, including his proposed revenue adjustment. Furthermore, we find the R

2 of .0511, indicating only a 5.11% relationship between the dependent variable (average monthly usage) and the independent variable (time), insufficient to satisfy Petitioner's burden of proving an adjustment is warranted. In addition, we are troubled by the error rate (MAD) of 196 gallons per month. This seems excessive, given Mr. Tapp's conclusion that residential usage has decreased by only 203 gallons per month over nearly a ten-year period.

However, while we do not accept Mr. Tapp's methodology or proposed revenue adjustment, we cannot ignore portions of Mr. Tapp's testimony which were uncontested and upon which other witnesses relied. Specifically, both the OUCC and Petitioner ultimately repudiated Mr. Tapp's regression analysis, but both the OUCC and Petitioner continued to rely on Mr. Tapp's underlying data. In addition, the MADs Mr. Tapp calculated for each of the three (3) methodologies at issue in this Cause were not part of Mr. Tapp's regression analysis itself and were based on uncontested data.

This brings us to the adjustments based on three-year and five-year averages performed by Mr. Cutshaw and the OUCC, respectively. The error rates expressed as MADs for both the three-year and the five-year averages exceed the error rate for Mr. Tapp's regression analysis. Further, the average error (MAD) for Mr. Cutshaw's three-year average exceeds the average error (MAD) for the five-year average calculated by the OUCC. Consequently, we find the five-year average the more compelling of the two (2) methodologies. However, because both methodologies have higher MADs than Mr. Tapp's regression analysis, which all parties to this Cause have rejected as unreliable, we cannot accept a usage normalization adjustment based on any of these methodologies.

In addition to the above deficiencies in all three proposed methodologies, we have particular concerns about Petitioner's reliance on a three-year historical average. Specifically, we find that Petitioner's justification for reliance on a three-year average inconsistent with this Commission's reasoning in Cause No. 42029. In addition, we find Mr. Cole's testimony and exhibits in support of Petitioner's three-year average troubling in a number of respects.

First, as to our findings in Cause No. 42029, we stated that using a three-year average for a residential usage normalization adjustment was appropriate in that case for the following reason:

Because weather during the three-year period approximates the thirty-year average, the use of the three-year period appropriately captures this most significant variable for which the usage normalization is an attempt to adjust. We therefore find that Petitioner's proposed three-year average for purposes of usage normalization is appropriate.

2002 Rate Order, Cause No. 42029, p. 41.

However, in this case, only OUCC's witness Gemmecke testified and presented evidence for the record comparing a three-year or five-year average to the thirty-year weather average. She presented data showing that the five-year average more closely matched the thirty-year precipitation average for Indiana than did Petitioner's proposed three-year average. Petitioner provided no historical weather data.

Further, in Cause No. 42029, Mr. Cole testified on behalf of Petitioner in support of using a three-year average. He justified this approach by stating that consumption was declining over time in Indiana-American's service territory. As a result, Mr. Cole argued that limiting historical data to a three-year period was appropriate. We summarized his reasoning as follows:

[Mr. Cole] explained that usage normalization based upon longer historical averages will overstate revenues since the recent trend in base consumption reflects a more severe decline. If an adjustment is to be made at all, Mr. Cole explained that the period over which the average is to be computed should be shorter rather than longer to avoid including years where the base consumption per customer is higher than it is anticipated to be again, thus overstating normal usage.

Id. at p. 40.

However, in this case usage is not decreasing, according to Mr. Kaufman's testimony. As Mr. Kaufman's testimony and attached schedules show, customer usage in Indiana-American's service territory did decrease from 1994 to 1999, but consumption has actually been increasing since Indiana-American's merger with Northwest and United in January of 2000. (Public's Exhibit 6, Sched. No. 6, pp. 4-8.) Indeed, if consumption is decreasing over time, as Petitioner contends, it is unclear why the test year, which is the third and final year of Mr. Cutshaw's three-year historical period, is higher than the three-year average.

Second, as to Mr. Cole's testimony, we are troubled both by Mr. Cole's general arguments as well as by discrepancies between Mr. Cole's Exhibit DDCole and data submitted in Petitioner's direct testimony.

In live testimony, Mr. Cole attempted to show that residential usage was decreasing over time. In support of this position, Mr. Cole offered Petitioner's Exhibit DDCole, which was a chart showing consumption during 'winter' months (November through March) from 1994 to 2003. However, in presenting data demonstrating a downward trend in consumption, Mr. Cole eliminated all summer months from his review. As he acknowledged on cross-examination, in doing so he did not take into account any trends in consumption that may have taken place during summer months. (Tr. p. H-96.)

We cannot accept an analysis that ignores seven (7) months of the year, rather than attempting to explain inconsistent data. This is especially true in this case, where the OUCC's evidence shows contrary data regarding both consumption and historical weather data.

Even more perplexing, however, are discrepancies between data contained in Mr. Cole's Exhibit DDCole and data on which Mr. Cutshaw relied in generating his three-year average. Below is a chart that reproduces the format, but not the values, of Exhibit DDCole as admitted into evidence during Mr. Cole's live testimony. (See Tr. p. H-90.) The values contained in this chart are values we obtained from Petitioner's Exhibit BIT-4, attached to the Direct Testimony of Bruce I. Tapp, and upon which Messrs. Tapp, Kaufman and Cutshaw all relied in performing their analyses. If Mr. Cole had utilized the values used by Messrs. Tapp, Kaufman and Cutshaw in performing their analyses, Exhibit DDCole would appear as follows:

Winter Residential Analysis

Using Data from Petitioner's Exhibit BIT-4, Sched. 1

| | JAN | FEB | MAR | APR-OCT | NOV | DEC | Winter Total |
|---|---|---|---|---|---|---|---|
| 1994 8p | | | | | 5.456 | 5.358 | |
| 1995 8p | 5.719 | 5.374 | 5.077 | | 5.456 | 5.416 | 26.984 |
| 1996 8p | 5.487 | 5.529 | 5.330 | | 5.259 | 5.217 | 27.218 |
| 1997 8p | 5.577 | 5.541 | 5.053 | | 5.592 | 5.126 | 26.647 |
| 1998 8p | 5.450 | 5.200 | 4.928 | | 5.385 | 5.052 | 26.296 |
| 1999 8p | 5.521 | 5.218 | 4.976 | | 5.201 | 5.078 | 26.143 |
| 2000 8p | 5.401 | 5.327 | 4.871 | | 5.015 | 5.101 | 25.878 |
| 2001 8p | 5.393 | 5.253 | 4.814 | | 4.535 | 5.091 | 25.576 |
| 2002 8p | 4.793 | 4.978 | 4.539 | | 4.916 | 5.068 | 23.936 |
| 2003 | 5.767 | 6.169 | 5.335 | | | | 27.255 |

This chart contains the data which Mr. Cutshaw used to calculate his three-year average. However, only the numbers highlighted in bold match the data contained in Mr. Cole's Exhibit DDCole, which Mr. Cole used in live testimony to justify using Mr. Cutshaw's three-year average. It appears, therefore, that Mr. Cutshaw relied on different data to calculate his three-year average than Mr. Cole used to support the three-year average.

Both Mr. Cutshaw's analysis and Mr. Tapp's analysis are based on the same data contained on Document No. 000029 from Book 2 of Petitioner's Minimum Standard Filing Requirements, which was admitted as Public's Exhibit CX-1 in this proceeding. Further, Mr. Cutshaw agreed (to within $100) to the OUCC's calculation of a five-year average based on this same data. (Tr. p. G-88-89.) However, Mr. Cole's Exhibit DDCole is based on almost entirely different data, the origins of which are unknown to this Commission.

We are concerned about this discrepancy. At no time in his live, oral testimony did Mr. Cole indicate the data in Exhibit DDCole was any different from that on which the other witnesses relied. Similarly, Mr. Cole offered no analysis or explanation as to the source of this data or what impact this data would have if used in either a three-year or five-year average.

Furthermore, we are concerned about the impact of this inconsistent data on the evidence before us. We note that initially Mr. Cole relied on a 'visual review' of the trend in the column of Exhibit DDCole titled 'Winter Total'' to show that usage was decreasing over time. (Tr. p. H-92-93.) However, a 'visualreview' of the chart above, using Mr. Cutshaw's and Mr. Tapp's data, shows a less clear and less substantial trend, if any. Conversely, if Mr. Cutshaw had used Mr. Cole's data, which was substantially lower during the winter months of the test year than Mr. Cutshaw's and Mr. Tapp's, Mr. Cutshaw's calculations would have yielded a smaller revenue adjustment in favor of Petitioner, assuming all other data remained unchanged.

In conclusion, we find that no usage normalization adjustment is appropriate in this case. Petitioner proposed a $1.2 million adjustment to revenues based on Mr. Cutshaw's three-year historical average of residential consumption. However, we believe this methodology is not appropriate under the facts of this case. Specifically, Petitioner offered no evidence to establish that weather patterns over the three-year period are in any way comparable to thirty-year averages. In addition, the OUCC, through the testimony of Mr. Kaufman, demonstrated that residential consumption is increasing rather than decreasing. Petitioner attempted to contradict this conclusion through the live testimony of Mr. Cole, but the data on which Mr. Cole relied in attempting to show a decreasing trend in consumption was inconsistent with the data Mr. Cutshaw used to calculate Petitioner's revenue adjustment. No explanation was offered for this discrepancy.

2. Customer Growth

[57-60] Petitioner's Position. Petitioner's witness Tapp proposed an increase in test year revenues to reflect an increase in Petitioner's residential and commercial customers. (Petitioner's Exhibit BIT-2, Sched. 1.) Mr. Tapp calculated his adjustment by determining the change in the number of residential and commercial customers for each of the months from July 2002 through December 2003 and multiplying that change by Petitioner's meter charge. Mr. Tapp also accounted for six (6) months of service charges to the test year for residential and commercial irrigation meters. (Petitioner's Exhibit BIT, p. 6, lines 12-18.) Mr. Tapp determined the change in customers for each month and then annualized for the number of months for which the service charge was not accounted for in the test year bill analysis. (Id. at lines 18-20.) Mr. Tapp testified his methodology was consistent with the methodology accepted by this Commission in Cause Nos. 39595, 40103, 40703 and 42029. Finally, Mr. Tapp determined the impact of the increased number of residential customers from the Turkey Creek and Westwood acquisitions. This adjustment was determined using the difference between the projected normalized or forecasted usage and actual usage of the customers acquired. Mr. Tapp calculated a projected test year usage for these customers by calculating an average forecasted use from the residential customers in the district that the acquired customers would be served. Mr. Tapp then multiplied the projected usage

through Petitioner's rate blocks.

Mr. Tapp testified that his customer accounting expense adjustment calculated the average cost per bill and multiplied that cost by the number of additional bills related to his customer growth adjustments and his adjustments associated with the additional customers added from the Turkey Creek and Westwood acquisitions. (Id. at p. 22, lines 15-20.)

Mr. Tapp also made corresponding adjustments to purchased power, purchased water, and chemical expenses. (Id. at pp. 15-21.)

OUCC's Position. OUCC witness Dana Lynn accepted the Petitioner's adjustments to annualize service charges for commercial customer growth that occurred during the test year. However, Ms. Lynn did not accept such an adjustment for residential customer growth.

Instead, the OUCC proposed that Petitioner's residential customer growth adjustment should be calculated for each district by taking the average test year bill by district and multiplying that average by the annualized increase in the number of test year bills. Ms. Lynn calculated the additional revenue expected by district from residential customers added to the system during the test year. She computed an average sales volume for residential customers by district based on test year data. (Public's Exhibit 3, Attach. DML-7.) Ms. Lynn testified that her adjustment normalized the growth of Petitioner's residential customer base on a per-bill basis. (Public's Exhibit 3, p. 26, lines 22-24.)

The OUCC also adjusted certain operational costs associated with its proposed adjustment. Ms. Lynn stated that a customer accounting adjustment was not needed because Petitioner had already performed the adjustment that would account for the increased bills. (Id. at 27, lines 9-10.)

Petitioner's Rebuttal. Petitioner's witness James Cutshaw testified that Ms. Lynn's methodology for calculating the residential customer growth adjustment was unreliable. Mr. Cutshaw noted that Ms. Lynn's use of annualized sales volumes was a methodology the Commission had rejected as not fixed, known and measurable. (Petitioner's Exhibit JLC-R, p. 7, lines 15-17.) Mr. Cutshaw claimed Ms. Lynn offered no explanation for why her use of annualized sales volumes was fixed, known and measurable. (Id. at p. 8, lines 11-12.) Mr. Cutshaw contrasted Ms. Lynn's proposed methodology with the proposed methodology used by Mr. Tapp to adjust for customer growth. (Id. at p. 7, lines 15-17.)

Mr. Cutshaw also identified three (3) other problems with the customer growth adjustment proposed by Ms. Lynn. First, Mr. Cutshaw testified that Ms. Lynn's adjustment only accounted for changes in customers through the end of the test year (June 2003), whereas Mr. Tapp adjusted for changes through the rate base cutoff. Second, Mr. Cutshaw testified that Mr. Tapp's methodology more accurately accounted for additional revenues from the customers added by the Turkey Creek and Westwood acquisitions because the Company prepared a specific calculation for each

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individual customer based upon their actual usage history since acquisition. (Id. at p. 9, lines 19-20.) Ms. Lynn, on the other hand, used average bills for the entire Northwest and West Lafayette operations, respectively. Finally, Mr. Cutshaw explained that Ms. Lynn included a full year's worth of bills for customers with separate irrigation meter services. (Id. at p. 9, lines 21-23.) Mr. Cutshaw testified that such customers typically only activate their irrigation service during six (6) months of the year and that Ms. Lynn's assumptions, therefore, resulted in an inflated allocation of sales revenue to irrigation customers.

Mr. Cutshaw presented a reconciliation of the differences between Ms. Lynn's adjustment and the Company's for residential customer growth:

| | Petitioner | OUCC | Difference between Petitioner and OUCC |
|---|---|---|---|
| Customer Growth | $393,836 | $610,832 | |
| Turkey Creek/Westwood | 196,629 | (included in above) | |
| Sales-for-Resale | | 18,725 | |
| | $590,465 | $629,557 | $39,092 |
| | = | = | = |

Petitioner's Exhibit JLC-R2.

Mr. Custshaw also criticized the OUCC's methodology used to calculate the adjustments to purchased water, purchased power and chemical expense stating that the proper criteria to use is the change in water sales rather than the change in customers. Lastly, Mr. Cutshaw noted an error in the OUCC's calculation due to incorrect customer numbers. (Petitioner's Exhibit JLC-R, pp. 20-24.)

Commission Discussion and Findings. Petitioner complained that a usage adjustment based on an average monthly bill of a customer is not a fixed, known and measurable indication that total usage would increase. However, the Public cited Cause No. 38868 where Petitioner applied the same methodology the Public used in this Cause.

Further, that Petitioner experienced residential customer growth during the test year is undisputed, and this Commission can reasonably expect that this growth will place additional demands on Petitioner's system, resulting in an increase of total water usage. In fact, Petitioner has used the same method the Public used when Petitioner made its revenue adjustments for the customers added as a result of the Turkey Creek and Westwood acquisitions.

Mr. Cutshaw claimed Mr. Tapp's methodology accounted for additional revenues from customers added by the Turkey Creek and Westwood acquisitions based upon each customer's actual usage history since acquisition. However, after a review of Mr. Tapp's testimony, we find that Mr. Cutshaw's representations about Mr. Tapp's calculation are incorrect.

**(Publication page references are not available for this document.)**

In fact Mr. Tapp used projected data for test year usage of residential customers in each of the entire districts that now serve the Westwood and Turkey Creek acquisitions. Mr. Tapp relied on his CDMM to forecast test year data for the entire districts that serve Westwood and Turkey Creek and used the results of the district forecast (i.e. Northwest and West Lafayette) for test year usage instead of the actual historical usage from the time Westwood and Turkey Creek were acquired by Indiana-American. Thus, Mr. Cutshaw's claim, that Petitioner's method to account for additional revenues from the customers added from Westwood and Turkey Creek are based on actual usage history since the acquisition, is erroneous.

When discussing the Turkey Creek acquisition in his prefiled testimony, Mr. Tapp explained that projected usage was determined using normalized usage for the Northwest operation. (Petitioner's Exhibit BIT, p. 13, lines 13-14 (emphasis added).) With the exception of the forecasted step in Mr. Tapp's calculation, Mr. Tapp's and Ms. Lynn's methods are essentially the same. The only difference is that Petitioner used projected usage, while the Public used projected sales. We see no substantive difference. Further, the Public has consistently applied this method in other cases. For example, in Cause No. 42481, the Public applied this methodology and we found that the Public's adjustments for customer growth were fixed, known, and measurable. (Morgan Cty. Rural Water Corp., Cause No. 42481, 9 (Indiana Utility Regulatory Commission, Date Issued March 31, 2004).) We make the same finding here.

Petitioner raised two (2) additional concerns. First, the Petitioner asserted that the Public did not update its customer growth adjustment through the rate base cutoff. While this is a practice that we have accepted in some past cases, it is not a requirement. Second, the Petitioner claimed that the Public has included a full year's worth of bills for customers with separate sprinkler (irrigation) meter services. However, it appears that if the Public has done this, then so has Petitioner. Ms. Lynn testified that Petitioner had already increased test year expenses for the increased bills based on test year customer growth, thus making no adjustment. If the number of bills the Public projected was different than the number of bills Petitioner projected, then the Public and Petitioner would not have been in agreement on the appropriate customer accounting adjustment, because Petitioner's customer accounting adjustment is also based on projected number of bills. (See Petitioner's Exhibit BIT, p. 22, lines 15-20.) However, the OUCC and Petitioner did agree on the customer accounting adjustment, which demonstrates they both relied on the same number of projected bills. (Public's Exhibit 3, p. 27, lines 6-10.)

We accept Public's adjustment for changes resulting from residential customer growth and so reject the Petitioner's proposal to exclude Public's customer growth adjustment. We find the Public has adequately demonstrated that customer growth existed during the test year and that total usage will increase; accordingly, the pro forma revenue increase of $610,832 is approved. Regarding corresponding adjustments to operating expenses, we agree with Petitioner's criticism of the OUCC's calculation of the adjustment to purchased water, purchased power, and chemical expense. After taking Petitioner's criticisms into account, the pro forma customer growth increase is $2,290 for purchased water expense; $21,253 for purchased power expense; and $3,375 for chemical expense.

3. Changes in Large Customer Consumption

Petitioner's Position. Petitioner's witness Tapp identified several large customers who, for a variety of reasons, have changed their consumption patterns either during or subsequent to the test year. The total of all such customers resulted in a proposed adjustment to reduce test year revenues by $183,665. (Petitioner's Exhibit BIT-2, Sched. 1., line 22) Mr. Tapp also proposed corresponding adjustments to purchased power, purchased water and chemical expense.

OUCC's Position. OUCC witness Lynn accepted Petitioner's adjustment except for $18,572 associated with Seymour Tubing. She believed that Petitioner's data does not indicate this customer's consumption has materially decreased during the test year, and that Petitioner's support does not warrant a permanent reduction in consumption from Seymour Tubing. (Public's Exhibit 3, p. 28, lines 2-10.) OUCC Utility Analyst Margaret A. Stull also proposed corresponding adjustments to purchased power and chemical expense. However, Ms. Stull objected to Petitioner's proposed purchased water adjustment associated with Seelyville and the new penitentiary, on the grounds these customers would not impact purchased water. (Public's Exhibit 2, p. 12, lines 5 - 13.)

Petitioner's Rebuttal. Petitioner agreed that Seelyville and the penitentiary would not impact purchased water. With respect to Seymour Tubing, Mr. Tapp testified in Petitioner's case-in-chief that the adjustment is derived from the customer's implementation of water conservation measures and reduced production from levels to which the customer does not anticipate returning. In rebuttal, Petitioner's witness Cutshaw disagreed with Ms. Lynn's comments that Seymour Tubing's consumption is not decreasing. Mr. Cutshaw testified that he reviewed Seymour Tubing's usage for the most recent twelve (12) month period (69,605 CCF), and noted that this is less than Mr. Tapp's projected consumption rate (70,415 CCF). (Petitioner's Exhibit JLC-R, p. 5, lines 5-8.) He testified that the Company's adjustment of $18,572 is amply supported and should be utilized in the determination of pro forma revenues.

Commission Discussion and Findings. We accept Petitioner's adjustment for changes in large customer consumption and so reject the OUCC's proposal to exclude the adjustment for Seymour Tubing. We find that Petitioner has adequately demonstrated that Seymour Tubing has decreased its consumption below the test year level; accordingly, the pro forma revenues should reflect the adjustment as proposed by Petitioner. Accordingly, we also find that Petitioner's pro forma adjustments to purchased power and chemical expense should be accepted, though the pro forma adjustment to purchased water should be rejected.

B. Operating Expenses

1. Pro Forma Labor Positions

**(Publication page references are not available for this document.)**

Petitioner proposed a pro forma adjustment to labor expense in excess of test year labor expenses. Petitioner's witness Cutshaw characterized these extra labor costs as the inclusion of anticipated salary and incentives and anticipated hours of current employees as well as current vacancies and new positions. Most of this upward adjustment in costs was effected through increases to 'management fees' Petitioner pays to its affiliates. However, to the extent these management fee adjustments are truly adjustments to Labor Expenses, we address them here. We will discuss each area of labor expense below.

a) Vacant Positions

[61] Petitioner's Position. Petitioner's proposed pro forma adjustment to labor expense included funding for twelve (12) positions which were vacant at the end of the test year (June 30, 2003).

OUCC's Position. OUCC witness Gemmecke testified that Petitioner was seeking an increase of $2,082,496 (13.82% increase) over test year salaries. She testified Petitioner was seeking 'full-employment,' or inclusion of expense for a full year of salary for employees who only worked part of the year, just as it did in its last rate case (Cause No. 42029). She stated Petitioner was also requesting positions held open during the last four (4) years be funded by its customers. She claimed Petitioner has twelve (12) positions which were not filled as of June 30, 2003, and were still vacant as of January 6, 2004. In addition, five (5) of those twelve (12) positions had been unfilled since before June 30, 2002.

Ms. Gemmecke proposed to reduce Petitioner's pro forma labor expense by excluding the costs of the twelve (12) positions that were vacant during the test year. She stated that each of the positions was vacant or became vacant during the period of August 2000 through June 2003 and remained vacant as of January 6, 2004. (Public's Exhibit 1, p. 18.) Further, according to Petitioner's responses to Town of Schererville's data request Q 1.14 (attached as Attachment JIG-2 to Ms. Gemmecke's testimony), each of these positions had been vacant anywhere from six (6) months to three (3) years, as of January 6, 2004. (Public's Exhibit 1, Attach. JIG-2.)

Petitioner's Rebuttal. Petitioner, through the testimony of Mr. Cutshaw, agreed to the OUCC's proposed elimination of two (2) of the twelve (12) vacant positions, which are two (2) corporate level employees whose leave dates were May 2003 and June 2003. (Petitioner's Exhibit JLC-R, p. 14, lines 1-3.) However, Petitioner's witnesses Duane Cole and James Cutshaw both testified on rebuttal that ten (10) of the positions should remain in labor expense. They argued that three (3) of these ten (10) positions had been filled, and that the Company was actively recruiting for the seven (7) remaining positions. (Id. at p. 13, lines 19-23; Petitioner's Exhibit DDC-R, pp. 8-10.)

Commission Discussion and Findings. Petitioner has agreed to the OUCC's reduction for two (2) of the twelve (12) vacant positions. Consequently, we remove the costs of 'Operations Engineer' and 'Financial Analyst' positions, shown at the bottom of Petitioner's Exhibit JIG, Attachment JIG-2, p. 3, from Petitioner's pro forma labor expense. Petitioner has filled three (3) of the remaining ten (10) 'vacant' positions with persons hired from outside the company. (Petitioner's Exhibit DDC-R2, pp. 1, 17, 20.) Consequently, we allow Petitioner's pro forma adjustment as to these three (3) positions. However, we reject Petitioner's pro forma adjustment for the remaining seven (7) vacant positions. Each of these seven (7) positions is either still vacant or was filled by simply shifting employees from other positions within the company.

Of the seven (7) positions we exclude from Petitioner's pro forma labor expense, two (2) were filled with in-house transfers, thereby leaving two (2) other positions newly vacant. If we were to find these in-house transfers alone were sufficient evidence to support Petitioner's adjustment to test-year expenses, it would open the door to potential double-counting of Petitioner's employees.

As to the remaining five (5) positions at issue, we cannot accept that these positions are necessary for providing utility service, given the length of time they were vacant. The most recently vacated of these positions was March 1, 2003, and it remains vacant. Of these five (5) positions, the position that has remained vacant the longest was vacated on October 26, 2001, and it remains vacant. While Petitioner's officers have authorized the filling of these positions, the timing and circumstances of these authorizations are suspect.

Specifically, we are troubled by the circumstances under which the ten (10) contested, vacant positions were authorized to be filled. The Commission was made aware through cross-examination of Mr. Cole regarding Exhibit DDC-R2, that the vast majority (eight (8) of ten (10)) of these vacancies were requested to be filled on January 12, 2004, which was the day before Petitioner's Evidentiary Hearing. (Tr. p. E-97-99.) Further, seven (7) of the ten (10) vacancy requests were approved by Mr. Cole and Mr. Eckart on January 13, 2004, the day of the Evidentiary Hearing. Four (4) of the five (5) currently unfilled positions were approved by Mr. Cole on the morning of his testimony. The fifth became vacant on August 31, 2002, but was never requested to be filled until April 5, 2004.

In addition, a review of Petitioner's Exhibit DDC-R2, which is composed of the Job Posting Requests for these vacant position's, shows that nearly all of the 'Requested by' and 'Manager' signatures were electronic signatures or approvals obtained by telephone. This fact, taken with the fact Mr. Cole approved the requests hours before he was to give sworn testimony in this case, gives an impression that Petitioner rushed to approve hiring for these positions expressly for the purposes of this rate case. The fact that these positions were vacant for such long periods of time (most of them for more than a year) supports this conclusion.

Based on the foregoing, we will allow in rates full annual salaries for the following positions:

| | Request to | Agreed | Vacancy |
|---|---|---|---|

**(Publication page references are not available for this document.)**

| District | Vacant Name | Title | Last Held | Fill | to Fill | Filled |
|---|---|---|---|---|---|---|
| John. Co. | Meter Reader | Meter Reader | 6/23/20-03 | 1/12/2004 | 1/13/2004 | 2/9/2004 |
| Kokomo | Rinker | Utility Sp-ecialist | 5/31/20-03 | 1/12/2004 | 1/13/2004 | 3/22/2004 |
| Mooresville | Jackson, DE | Utility Tech | 8/11/20-00 | 1/12/2004 | 1/20/2004 | 3/23/2004 |

Based on the foregoing, we will not allow in rates salaries for the following positions:

| District | Vacant Name | Title | Last Held | Request to Fill | Agreed to fill | Vacancy Filled |
|---|---|---|---|---|---|---|
| Warsaw | Dorell AP | F.S. | 8/31/2002 | 4/5/2004 | 4/5/2004 | No |
| N.W. | Furlow | Field Service | 10/4/2002 | 1/12/2004 | 1/13/2004 | No |
| N.W. | Townsend R | FSR | 3/1/2003 | 1/12/2004 | 1/13/2004 | No |
| Corporate | Nitza | Engineer | 5/23/2003 | | | |
| Corporate | Norris, K | unknown | 6/6/2003 | | | |
| Corporate | Maintenance | Maintenance | 10/26/2001 | 1/12/2004 | 1/13/2004 | No |
| So. Ind. | Satterwhite | Operator | 7/6/2001 | | | transfer |
| John. Co. | Fitter | Fitter | 2/28/2002 | 1/12/2004 | 1/13/2004 | transfer |
| N.W. | Hamilton | Field Service | 3/14/2002 | 1/12/2004 | 1/13/2004 | No |

b) New Positions

[62] Petitioner's Position. Petitioner's case-in-chief appeared to involve no increase to Labor Expense for new positions. In fact, Petitioner appeared to be proposing a $1,096,516 decrease to Labor Expense as a result of the elimination of the Customer Service Center in Richmond, Indiana. (Petitioner's Exhibit WJW, p. 7.) However, as Petitioner's witness Wolf explained, these expenses were added to the cost Petitioner is billed from its affiliated management company, AWWSC. (Id.)

OUCC's Position. OUCC witness Gemmecke testified that Petitioner was seeking an increase of $2,082,496 (13.82% increase) over test year salaries. However, this increase did not appear as an increase to 'Labor Expense' because Petitioner was seeking to shift some of these labor costs from Indiana-American to AWWSC, which would then bill Indiana-American 'management fees' for those labor expenses. Ms. Gemmecke discussed these pro forma increases as 'Labor Expenses,' rather than under the heading of 'Management Fees.' (Public's Exhibit 1, p. 4, lines 5-11.)

Ms. Gemmecke testified Petitioner's adjustment to test-year labor expense included the addition of fifteen (15) new positions, including four (4) additional customer service representatives, three (3) dispatchers, six (6) closers, a team

**(Publication page references are not available for this document.)**

leader and a supervisor. (Id. at p. 19, lines 4-13.) However, she observed that none of Petitioner's witnesses in Direct Testimony offers an explanation why these positions, above test year expense, were necessary. (Id. at lines 20-22.) Consequently, Ms. Gemmecke reduced Petitioner's increase to labor expense by $388,949 for the fifteen (15) additional positions.

Ms. Gemmecke explained that Petitioner had proposed that all of these positions should be paid through management fees in the future. However, she further testified that she had asked Mr. Cutshaw during an on-site visit why AWWSC needed to hire fifteen (15) additional personnel. Mr. Cutshaw informed her that, with the move of Customer Service Center personnel to Alton, Illinois, AWWSC would need to hire local people to handle those functions. (Id. at lines 14-18.)

Ms. Gemmecke noted that the Richmond, Indiana Customer Service Center was already performing these functions prior to the move to the Illinois center. (Id. at line 19.) Consequently, Ms. Gemmecke concluded that the need to add fifteen (15) positions, in addition to moving customer service operations to Illinois, appeared to contradict Mr. Cole's testimony that centralizing customer service functions would allow Petitioner to take advantage of economies of scale. (Id. at p. 19, line 23 through p. 20, line 2.)

Petitioner's Rebuttal. Mr. Cole presented rebuttal testimony opposing Ms. Gemmecke's proposed exclusion of eleven (11) of the new customer service employees. Specifically, he explained the functions of the three (3) dispatchers, six (6) closers, one (1) team leader and one (1) supervisor. He testified that these are positions that are currently being filled. The dispatchers dispatch time critical orders that come from the Alton Customer Satisfaction Center plus perform other duties. Closers have been hired so that all work orders can be closed by the next morning after the work is completed. The team leader and supervisor are already in place. Mr. Cole testified that these positions are not being eliminated as a part of the move to the Alton Customer Satisfaction Center. Mr. Cole also stated that Petitioner did not increase its number of customer service representatives in Richmond by four (4). (Petitioner's Exhibit DDC-R, pp. 6-7.)

Commission Discussion and Findings. With respect to the three (3) dispatchers, six (6) closers, a team leader and a supervisor, none of Petitioner's witnesses, including Mr. Cole, rebutted Ms. Gemmecke's assertion that the functions of these eleven (11) positions had been performed during the test year and costs associated with the performance of this work was already included in the test year expenses. Petitioner bears the burden of proof when advocating expenses in excess of test year, and Petitioner has not met that burden of proof for these eleven (11) positions. The duties carried out by these 'new' position titles were the same duties carried out by other personnel during the test year. Consequently, the costs of performing these functions are already included in test year expenses. Permitting Petitioner to adjust test-year expenses for these new positions would result in double-recovery.

Costs related to the four (4) customer service representatives are also denied and are considered within our discussion and findings below regarding the Customer Satisfaction Center. Consequently, we reduce Petitioner's pro forma labor expense by $388,949 for the elimination of these fifteen (15) positions.

c) Wabash District Position

[63] OUCC's Position. The OUCC proposed to eliminate one position in the Wabash District which was double-counted.

Petitioner's Rebuttal. Petitioner agreed that one position had been double counted. Consequently, Petitioner agreed with the removal of $48,262 from Labor Expense.

Commission Discussion and Findings. We find the elimination of $48,262 appropriate.

Commission Discussion and Findings Regarding Labor Expense. For the above reasons, the Commission finds pro forma labor expense, before 'shifting' a portion of those costs to management fees, is $16,424,456 or $1,353,835 over the test year. After shifting the labor expenses for customer service and a portion of corporate to management fees, the pro forma direct labor expense is $14,329,245.

2. Incentive Pay Program

[64] Petitioner's Position. Petitioner did not propose a separate adjustment for incentive pay. Instead, Petitioner calculated labor expense to include incentive pay at the percentage of each eligible employee's expensed labor.

OUCC's Position. Ms. Gemmecke proposed to remove all of Petitioner's Annual Incentive Plan ('AIP') from Petitioner's operations and management expense. She summarized her reasons for disallowing this expense as follows:

. The entire variable pay plan can be withheld by the Board if minimum financial goals are not met.

. A large portion of the AIP compensation is based upon financial goals.

. The Merit Pay Plan already encompasses incentives for excellence in performance for the same employees eligible for the AIP.

. A generous pay and benefits plan already exists without the AIP compensation to attract and retain qualified employees.

Public's Exhibit 1, p. 5, line 14 through p. 6, line 2.

Ms. Gemmecke further testified that the requested level of net operating income of $40,071,000 in this case would be short of the required financial goal of $44,982,000 for 2003. (Id. at p. 8, lines 6-14; Public's Exhibit 1, Attach.

JIG-15, p. 2, resp. to Q-283.) Consequently, Petitioner would not need the funds to pay for the incentive payment. Further, she testified that while Petitioner was authorized incentive pay in the last rate case of $411,000, Petitioner had only paid $133,369 in incentive pay as of the date the OUCC prefiled its case-in-chief.

She criticized the calculation of Petitioner's proposed incentive pay for 1) being calculated after the April 2004 Merit Pay increase and 2) being calculated on positions rather than actual eligible employees. Ms. Gemmecke broke down the incentive pay as the portion related to financial goals (56% of total AIP), operational goals (27% of total AIP) and individual goals (17% of total AIP).

Ms. Gemmecke also stated that Petitioner's benefit package is generous. Petitioner has a merit pay incentive which covers the same employees as the AIP covers, and the OUCC has not opposed the merit pay increase. Ms. Gemmecke points out that Petitioner does not keep records on employee turnover which is necessary to determine the extent the incentive compensation has had on retaining employees. She stated the OUCC's position that each element of the incentive compensation (financial, operational, and individual) be paid by the shareholders and not the ratepayers.

Petitioner's Rebuttal. Mr. Eckart responded to many of Ms. Gemmecke's criticisms. (Petitioner's Exhibit JEE-R, pp. 2-16.) He explained the basic aspects of the Company's incentive pay program and employee eligibility for the program.

All full-time management, professional and technical employees who are employed as of December 31 or who retire during the plan year may be eligible to receive incentive pay, subject to three 'performance' components of the program: financial, operational and individual. The financial component is based upon achieving targeted operating results and net debt. The operational component is based upon achieving targeted results in the areas of customer satisfaction, environmental compliance and health and safety. Lastly, the individual component is based upon the individual employee's performance. Mr. Eckart admitted that the Board does have the discretion to withhold the financial component based upon failure to reach minimum financial performance; however, he testified that failure to achieve financial goals could not result in the withholding of the other components. (Id. at pp. 2-5.)

Mr. Eckart further argued that Petitioner could potentially earn sufficient revenue to meet the requisite financial goals to satisfy the 'financial' component of the incentive pay program, noting that the required 'operating result' is not synonymous with the 'net operating income' granted by this Commission. He explained how the company could yield a higher operating result than the net operating income requested in this case. (Id. at pp. 8-9.)

Mr. Eckart responded to Ms. Gemmecke's testimony concerning the portion of incentive pay which is funded by shareholders. He stated that 87% of the annual incentive pay is allocated to operation and maintenance expense. The balance is not capitalized. Thus, Mr. Eckert argued Petitioner's proposal would result in responsibility for financing incentive pay to be split between shareholders and customers. (Id. at pp. 15-16.)

Mr. Eckart also disputed Ms. Gemmecke's description of Petitioner's AIP benefits as 'very generous.' (Id. at p. 13.) He disputed Ms. Gemmecke's position that the AIP only benefits Petitioner's stockholders, stating why he believes a financially strong company is to the benefit of both the stockholder and the customer. (Id. at pp. 14-15.) In addition, Mr. Eckart testified that an incentive plan payment was made for the plan year 2003 in excess of $500,000. (Id. at p. 16.)

Mr. Cutshaw argued that incentive pay should be calculated based on positions in pro forma labor expense rather than persons actually employed during the test year. He opined that all expenses, including incentive pay and other labor-related expenses associated with positions included in pro forma labor expense, should be recovered. (Petitioner's Exhibit JLC-R, p. 12-13.)

Commission Discussion and Findings. In the 2002 Rate Order, we approved Petitioner's recovery of a portion of its annual incentive pay. We found significant two (2) criteria by which the recovery of incentive pay is to be judged: (1) a pure profit-sharing plan, which only incents employees to become more profitable is more appropriate for funding solely by the shareholders than a plan which also ties compensation levels to better service to the customers; and (2) a plan which causes compensation to exceed levels which are reasonably necessary for the utility to attract its workforce should be disallowed as an unnecessary expense. In addition, we found it significant that Petitioner's plan was funded only in part through rates.

As we review Petitioner's incentive plan, we find these criteria are still satisfied. Petitioner's plan is not a pure profit-sharing plan. Rather, significant components of annual incentive pay are derived solely from operational goals, which relate to customer service, environmental compliance, and health and safety, and from individual goals which are based upon the individual employee's performance. Furthermore, Mr. Eckart demonstrated that Petitioner's incentive program does not cause total compensation to exceed levels which are reasonably necessary to attract the workforce. To the contrary, the at-risk component of pay is necessary for Petitioner's employees to receive the average pay commanded in the marketplace. The only evidence offered to the contrary related to the all-encompassing Bureau of Labor Statistics information, which is not tailored to Petitioner's workforce including degreed, licensed and highly trained people. Mr. Eckart further demonstrated that Petitioner's compensation package is well within the mainstream for that offered in the industry. Finally, Mr. Eckart demonstrated that a portion of the plan is proposed to be funded through rates, and a portion proposed to be funded by shareholders. Accordingly, as we found in Cause No. 42029, we find that Petitioner's incentive pay should be recoverable through rates, and we reject Ms. Gemmecke's and Ms. Stull's proposed adjustment.

3. Pension Expense

**(Publication page references are not available for this document.)**

[65, 66] Petitioner's Position. Petitioner proposed an adjustment to test year pension expense which converts to the use of the Financial Accounting Standard Board's Statement of Financial Accounting Standards No. 87 ('FAS87 '). Previously, Petitioner has reflected pension expense based upon the contribution to the pension trust fund required under the Employee Retirement Income Security Act ('ERISA'). The difference between the two (2) methodologies is that FAS87 is essentially a current year estimate of pension costs being accrued for currently employed, eligible employees and existing retirees. The ERISA method fluctuates based upon the value of the investments in the pension trust fund, and is therefore more directly influenced by short-term fluctuations of the financial markets. Petitioner's witness Wolf explained that the FAS87 level is a long-term measure that is relatively stable from year to year, while the ERISA contribution level is a short-term measure that may fluctuate significantly from year to year. Mr. Wolf testified that the conversion to the FAS87 expense method accomplishes two (2) important objectives: (1) less fluctuation in cost and resulting impact to the company and its rates for service, and (2) minimizing the impact of the increase in pension cost in this case since the pro forma expense is $132,000 less than what the pro forma amount would be if the ERISA method were used.

There are two components to Petitioner's proposed adjustment to reflect the change from ERISA to FAS87. First, the Company proposes to amortize the deferred pension assets accumulated under the ERISA method over ten (10) years. Second, the adjustment reflects an increase in the pro forma FAS87 expense over the test year ERISA contribution level. The pro forma FAS87 level was calculated based upon a six (6) year average of Petitioner's projected FAS87 expense for the years 2003 to 2008. The projection for this period was prepared by Towers Perrin, one of the world's largest global management consulting and actuarial firms. The total adjustment to test year expense, including both the average pro forma level and the amortization of the deferred amount is $1,686,130. (Petitioner's Exhibit WJW-1, Sched. 2.)

OUCC's Position. The OUCC did not oppose Petitioner's proposed conversion to FAS87, the amortization of the deferred amount or the computation of the pro forma level of FAS87 expense. The OUCC's proposed pension expense adjustment is identical to Petitioner's. (Public's Exhibit 1, OUCC Sched. 4, p. 1.) OUCC witness Gemmecke's testimony as initially prefiled specifically agreed with Petitioner's proposed adjustment. (Public's Exhibit 1, p. 24.) Ms. Gemmecke excluded this testimony from the version which was actually offered and received into evidence at the evidentiary hearing; nevertheless, she testified that she personally prepared her testimony as it was originally prefiled and was careful to assure that it accurately reflected her opinions. (Tr. p. D-18- 19.) Given that the OUCC included Petitioner's proposed pension expense adjustment in its schedules, we are left to conclude that the OUCC has no objection to Petitioner's request.

Intervenors' Positions. Both the Industrial Group and the Town of Schererville opposed Petitioner's proposed pension expense adjustment. Mr. Gorman noted that the ERISA pension expense reflects the minimum annual cash contribution the Petitioner normally makes to the pension trust fund. He explained that the FAS87 pension expense is an accrual expense recorded on a company's financial statements. (Industrial Group's Exhibit 1, p. 27.) Mr. Gorman disputed Mr. Wolf's contention that the FAS87 pension expense is more stable. He noted that Petitioner's FAS87 pension expense was a negative amount in the calendar years 2000 and 2001 compared to the $1.8 million positive expense accrual projected for the test year. (Id. at p. 28.) Mr. Gorman also noted that Petitioner's test year pension expense was based on a 2002 actuarial study which assumed that the long-term return on the trust fund assets would be 9%. According to Mr. Gorman, the 2002 projected return understates the actual return on stock investments during 2003. He provided an example that the S&P 500 has increased over 35% from January 2003 to January 2004. Consequently, he concluded that this increase in the value of the trust fund assets will lower the Petitioner's FAS87 pension expense when it is updated in 2004. Therefore, Mr. Gorman opined that the support for Petitioner's requested pension expense under FAS87 for the test year is already stale and probably overstates what the Petitioner's pension expense will be when the study is updated. (Id. at 29.) Mr. Gorman recommended that the Commission be consistent with its past ratemaking treatment of pension expense by continuing to use the ERISA pension expense method and allow Petitioner to include $677,000 as pension expense, which was the amount incurred for the test year.

Intervenor Town of Schererville offered the evidence of its witness Sommer who divided the $2.2 million adjustment increase into its three (3) components: losses, change in methodology and retired Northwest Indiana executives. The evidence thereafter offered by witness Sommer was a rejection of all three components. Witness Sommer rejected the recovery of the loss component of the $2.2 million pension adjustment, equaling $471,897 per year. The basis for witness Sommer's rejection of this pension loss recovery can be summarized as an objection to charging Petitioner's ratepayers who lost their own pension funds; the likelihood that with market changes, Petitioner will actually over-collect on these losses; and a belief that good regulatory policy is not served by such recovery. Witness Sommer's rejection of the change in methodology component of this $2.2 million increase is a rejection of $1,683,288. Witness Sommer's rejection can be summarized as being based on calculations which are wrong and, thus, not fixed, known and measurable. Finally, witness Sommer rejected the recovery of the third component, equaling $34,236, relating to retired former executives of Northwest Indiana, which is part of Petitioner's acquisition of Northwest Indiana.

Petitioner's Rebuttal. Mr. Wolf first disputed Mr. German's testimony on the relative volatility of FAS87 and ERISA for purposes of computing annual pension expense. He introduced an exhibit which shows the ERISA level goes from zero for the year 2001 to in excess of $4 million for the year 2005 and then down to $1.3 million for 2008. (Petitioner's Exhibit WJW-R2.) During the same time period, the FAS87 cost fluctuates from $0.6 million in 2001 to a lower peak of $2.4 million in 2004. The overall average of ERISA from 2003 to 2008 is much higher at $2.6 million per year as compared to the $1.9 million average for FAS87 in those same years.

He also disputed Mr. Gorman's opinions based upon recent market gains. It is the use of FAS87 which is intended to mitigate the effects of short-term fluctuations in capital markets. As a result, he testified that short-term unrealized investment gains or losses will not have a significant impact from one year to the next on the valuation but will have an average impact over longer periods of time. (Petitioner's Exhibit WJW-R, p. 10.)

Mr. Wolf further stated that Mr. Sommer is not relying on the correct information for purposes of his criticisms of the salary increase rate assumed by Towers Perrin in its valuation. He testified that a simple comparison to recent actual labor cost changes on a Company-wide basis is an apples-to-oranges comparison. Mr. Wolf testified that selection of the salary increase rate assumption for actuarial valuation of the pension plan requires more complex analysis of the salary of a pool of employees over the course of their entire careers than simply using recent labor cost changes which can be influenced by any number of factors that could vary from year to year. He testified that pension valuation depends upon the wage increases for a particular group of employees over the span of their respective careers. While wage rates may increase on average by 3% in one year, the increase for a particular employee over the span of his/her career is usually higher due to seniority, merit increases and promotions. (Id. at pp. 11- 12.) Mr. Wolf quoted the comments to FAS87, which he testified reveal that Mr. Sommer is not considering the pertinent data for purposes of his criticism. Comment 46, FAS87, states that, '[a]ssumed compensation levels shall reflect an estimate of the actual future compensation levels of the individual employees involved, including future changes attributed to general price levels, productivity, seniority, promotion and other factors.' (Id. at p. 13, lines 14-17.) Mr. Wolf further presented surveys conducted by Towers Perrin and Watson Wyatt, two nationally recognized actuaries, which show that Petitioner's wage rate assumptions are at the low end of the mainstream. (Petitioner's Exhibit WJW-R3 and WJW-R4.)

Commission Discussion and Findings. We find that Petitioner's proposed pension expense adjustment should be partially accepted. While Mr. Gorman criticized the move from ERISA to FAS87, the evidence is unrebutted that pension expense will be lower and less volatile over the ensuing years if this change is made. In addition, no other actuarial valuation was presented which would produce a level of pension expense different from that presented by Petitioner. Pensions are valuable rights which are offered to employees, many times as a result of collective bargaining.

However, the Commission believes the loss component of the pension adjustment should not be accepted. Both Schereville's witness Sommer and Industrial Intervenor's witness Gorman objected to the recovery of this pro forma adjustment. Witness Sommer specifically notes that providing this adjustment to Petitioner's operating expenses will, in essence, force Petitioner's ratepayers who lost their own pension investments to cover this loss. We note that Petitioner's witness Wolf acknowledges that Petitioner is seeking to recover additional funds from ratepayers who themselves suffered pension losses (see Transcript, B-99). Mr. Sommer goes on to point out that there is no good regulatory policy served by allowing recovery of this past loss. Finally, Mr. Sommer points out that the market in which Petitioner's pension was invested, which caused pension losses to historically occur, has more recently recovered and Petitioner, on a pro forma basis, will potentially be overcompensated if this loss is allowed as part of Petitioner's revenue request. Accordingly, we find that Petitioner's proposed pension expense adjustment, less the loss component, should be accepted.

4. Depreciation Expense on Contributions in Aid of Construction

[67, 68] OUCC's Position. Mr. Gassert requested that the Commission revisit its practice of allowing the recovery of depreciation expense on contributions in aid of construction ('CIAC') because this allegedly proliferates troubled utilities which have an eroding or negative rate base. He further testified that allowing depreciation expense on CIAC encourages larger utilities to overinvest. Further, he testified that allowing a recovery of depreciation on CIAC causes customers to pay more than one time for the same plant.

Petitioner's Rebuttal. Mr. Cutshaw testified that Mr. Gassert is requesting the Commission to reverse a long-standing policy allowing depreciation expense on CIAC. Mr. Cutshaw cited the Commission's Orders in Cause No. 37182 dated December 7, 1983, and in Cause No. 39595 dated February 2, 1994. In the latter order, the Commission said that 'the customers and the company benefit from the Commission's current practice of allowing depreciation on contributed property. ' Mr. Cutshaw testified that depreciation expense on CIAC provides additional internally generated funds to cover at least a part of replacement cost and that this results in lower external financing requirements, a factor which is particularly important for Indiana-American. Mr. Cutshaw explained that the Commission found this is the reason which supports recovery of depreciation expense on CIAC and has specifically rejected Mr. Gassert's argument that the Commission should change its policy to align with other jurisdictions. The Commission has noted that 'Indiana has a broader perspective' which 'provides that depreciation rates should be designed to provide the amounts reasonable and necessary to maintain the property in an operating state of efficiency corresponding to the progress of the industry,' and that this 'policy on CIAC depreciation better accomplishes this objective without adverse effect on the customer.' (Petitioner's Exhibit JLC-R, pp. 31-32.)

Mr. Cutshaw testified that while depreciation on CIAC may create issues for small troubled utilities, Indiana-American does not encounter the same issues because of its size. Mr. Cutshaw explained that in the case of smaller utilities facing prospects of negative or eroding rate base, the OUCC would be free to argue that depreciation expense should not be recovered on CIAC in those particular circumstances. Mr. Cutshaw testified that in the case of larger utilities with growing demand for capital improvements, depreciation on CIAC continues to provide a low cost source of internally generated funds.

Commission Discussion and Findings. We commence our consideration of Mr. Gassert's request by reviewing our findings in Indiana-American Water Co., Cause

**(Publication page references are not available for this document.)**

No. 39595:

[OUCC witness] Mr. Effron's position would require a change in the Commission's policy regarding CIAC. Presently, we allow water utilities to recover depreciation on contributed property, but (a) the accumulated CIAC balance is deducted from the Company's original cost rate base and (b) the balance of CIAC is not reduced when the contributed property is retired. Under our present methodology, CIAC is an ever increasing amount and continues to be deducted from rate base long after the property represented thereby is retired ...

* * * *

We do not agree with Mr. Effron's contention that replacements of contributed property, like replacements of other property, are not explicitly financed by depreciation expense included in the cost of service. Mr. Salser demonstrated that depreciation expense recoveries, including depreciation on CIAC, are internally generated funds used to finance replacements of property. Over time the contributed property will need to be replaced and the replacement costs will be many times more than the original cost of the property. The Commission's current policy of allowing the recovery of depreciation on the contributed property provides to the Company additional internally generated funds to cover at least a part of the replacement cost. This directly results in lower external financing requirements and is particularly important for Petitioner at this time because, as both Mr. Hargraves and Mr. Salser noted, the Company is facing significant financing requirements over the next five years.

Accounting for Public Utilities states that the ratemaking treatment for depreciation on CIAC varies from jurisdiction to jurisdiction. Mr. Effron contends we should change our policy to align with jurisdictions which do not allow recovery of such depreciation on the theory that the purpose of depreciation is only to recover the cost of property. However, Indiana law has a broader perspective than that promoted by Mr. Effron. Ind. Code § 8-1-2-19 provides that depreciation rates should be designed to provide the amounts reasonable and necessary to maintain the property in an operating state of efficiency corresponding to the progress of the industry. We think our policy on CIAC depreciation better accomplishes this objective, without adverse affect on the customers. The FERC and FCC regulations which require that contributed property be written off to utility plant are neither comparable nor appropriate for water utilities.

We believe the customers and the Company benefit from the Commission's current practice of allowing depreciation on contributed property. We find Mr. Effron's proposal to change this policy should be rejected.

Ind.-Am. Water Co., Cause No. 39595, p. 22-23 (Indiana Utility Regulatory Commission, Date Issued Feb. 2, 1994); 150 PUR4th 141, 158-59.

As we indicated previously, we are not averse to reconsidering our existing policies and practices; however, we depart from such practices only after very careful consideration convinces us that new evidence or circumstances warrant a change. We believe as a general matter that stability and predictability in regulatory policy is desirable. We do not change course simply to side with the majority. While the positions of other state commissions may be of interest, this Commission is duty-bound to make its own independent decisions on what is best for Indiana.

Reviewing Mr. Gassert's positions, we see a familiar refrain to the arguments we have already rejected. The only argument he has made which we have not previously considered is that the growing CIAC balance can lead to eroding rate base and thereby create troubled utilities. While we recognize the problems a negative rate base may cause with respect to small, thinly capitalized utilities, we would be better served to address those concerns in a particular case involving such a utility. Such is not the case with Indiana-American. Indiana-American continues to have a growing demand for capital improvements, and depreciation on CIAC continues to serve the purpose of providing internally generated funds at a significantly lower cost of capital than would otherwise be available. Our findings in Cause No. 39595 continue to apply with equal force to Petitioner's position today. Also, depreciation on CIAC does not force customers to pay for the asset twice. The developer initially pays for the asset, and the customer thereafter pays rates to recover depreciation expense which supply the capital to replace the asset, thus reducing the need for external funding and associated cost. If we were to reverse our practice, the customers would still pay rates to recover depreciation on the replacement asset after it is placed in service, and they would be forced to pay the higher cost of external funding needed for the replacement. We find that in the current case we should continue our practice of allowing depreciation on CIAC and, therefore, reject Mr. Gassert's proposal.

5. Customer Satisfaction Center and E-CIS Project

[69-73] As noted in our earlier discussion of the Petitioner's Rate Base, the OUCC's proposal to exclude the E-CIS project from rate base sufficiently relates to Petitioner's conversion to the Alton Customer Satisfaction Center to merit our consideration of both issues in this section of our Order.

Petitioner's Position. Petitioner testified that the Customer Satisfaction Center is a nation-wide customer service call center located in Alton, Illinois. This center will be open twenty-four (24) hours a day, seven (7) days a week. Petitioner states that customers will be provided with a high level of service in dealing with billing questions, scheduling service orders, establishing new service and locating convenient payment sites. Petitioner advised that once Indiana-American converts to the Illinois CSC, it will close its Indiana customer service center located in Richmond, Indiana.

Petitioner claimed that the new Customer Satisfaction Center would cost slightly more to Petitioner's customers, but it would provide new services and technologies that are not currently provided. Petitioner claimed these new services and technologies would come at a lower cost than if Richmond were to offer these services on its own. Petitioner said that the new center would use a leading edge Interactive Voice Response ('IVR') system that would pave the way for web-based interaction that would allow customers to access their accounts and pay bills online. The new IVR allows for 'automatic call distribution' software to ensure an even distribution of in-bound calls and an 'expert agent selection' software that will allow a customer call with a particular question to automatically be transferred to a representative, who has received specific training in that area.

Petitioner also testified that the other benefits of the Alton CSC related to human resources management. Petitioner explained that the CSC will utilize an 'automatic call monitoring' software to evaluate the effectiveness of call handling and associate responsiveness to inquiries and a 'workforce management' ment' software to collect data from all of the new technologies to provide resource forecasting and scheduling to predict staffing needs. (Petitioner's Exhibit DDC, pp. 14-17.) Petitioner's witness Wolf disclosed that, according to Petitioner's analysis, the closing of the Richmond Customer Service Center and the move to the Alton CSC will cause a net increase in test year expense of $91,840. This amount did not include the costs associated with the E-CIS software, which the OUCC considered to be a cost associated with the move.

Petitioner's witness James Cutshaw filed supplemental testimony and updated Petitioner's proposed rate base to include $6,248,821 related to the purchase and development of the E-CIS software. (Petitioner's Exhibit JLC-U, pp. 7-9; Petitioner's Exhibit JLC-1-UA, line 21, column 2.) In his supplemental direct testimony, Mr. Cutshaw alleged that E-CIS replaces an outdated Electronic Data Inquiry System ('EDIS') software program. He claimed that the EDIS program does not provide the functionality needed to effectively respond to increased customer demands for more detailed billing information nor does it allow for improved processes in handling customer inquiries. He explained that EDIS is not Windows-based and is not functionally compatible with other software packages and programs currently utilized. Also, Mr. Cutshaw said EDIS was not designed to support the current security threats related to network and internet technologies, does not provide a database to allow for resolution of data discrepancy issues and does not provide scalability to support 'large water company' information needs. Mr. Cutshaw testified that with E-CIS, customer data is arranged more logically on the inquiry and input screens, allowing for more efficient access to customer data and more timely responses to customer inquiries. With the new software, customer bills wall provide more detail regarding the nature and type of charges being billed. Mr. Cutshaw claimed that under EDIS, this level of detail was either unavailable or cost prohibitive due to the extensive reprogramming that would have been required to provide it.

Mr. Cutshaw testified that E-CIS was placed in service on March 8, 2004, and satisfies the definition of 'major project' for purposes of the MSFRs. Petitioner testified that it utilized an approved depreciation accrual rate of 5.54% to compute the depreciation expense relating to the capitalized E-CIS costs. (Petitioner's Exhibit JLC-U, pg. 9.)

**(Publication page references are not available for this document.)**

OUCC's Position. OUCC witness Dana Lynn stated that Petitioner's proposed net increase of $91,840 shown on page 7 of Mr. Wolf's testimony greatly understates Petitioner's true cost to participate in American's Customer Satisfaction Center initiative. Ms. Lynn noted that Petitioner has not included the $282,528 in amortization expense associated with the $1,345,305 of deferred costs it has recorded on its balance sheet related to the CSC. In addition, Petitioner has not included the return and depreciation it has requested on AWWSC's $6.2 million Orcom E-CIS software ($194,360), which is associated with the CSC. Ms. Lynn noted that if Petitioner would have calculated depreciation expense correctly, Petitioner's customers would be made to pay an additional $1,249,764 in depreciation expense and $592,174 in return. (See Public's Exhibit 3, DML Sched. 1, page 2.) In sum, Ms. Lynn determined that Indiana-American's ratepayers would pay an additional annual amount of $2,318,826 for the E-CIS conversion and Alton CSC transfer, after considering the additional depreciation expenses, return on investment and the higher operational cost of $194,360 as acknowledged by the Petitioner. ($2,318,826 = $282,528 + 194,360 + $1,249,764 + $592,174.) Thus, according to the OUCC, Petitioner substantially understated the true cost of its participation in the Alton CSC.

While Petitioner included $346,185 for depreciation expense, associated with the E-CIS software, the OUCC calculated $1,249,764 as the expense. Ms. Lynn explained her belief that there was a discrepancy between Petitioner's number and the $1,249,764 calculated by the OUCC because Petitioner multiplied the E-CIS software costs by its old depreciation accrual rate for its Mainframe Computer Software account of 5.54%. In the Commission's Final Order, in Cause No. 40703, the Commission approved an increased depreciation accrual rate for Petitioner's Mainframe Computer Software account to 20%. Ms. Lynn stated that if Petitioner would have applied the correct accrual rate in its updated schedules, the depreciation alone would cost Indiana-American's ratepayers an additional $1,249,764 over the next five (5) years.

Ms. Lynn disagreed that AWWSC'S computer software should be recorded as Utility Plant in Service, and she asserted that Petitioner's proposed adjustment requests the Commission to approve $6,248,821 in Petitioner's rate base for software it does not need. Ms. Lynn testified that American is consolidating several subsidiaries, including Indiana-American, to the Alton CSC. The $6.2 million represents Indiana-American's portion of the total software cost that will be used by the CSC in Alton, Illinois. Indiana-American's Customer Call Center in Richmond, Indiana already operates on an EDIS. According to Ms. Lynn, it is not advantageous for Indiana-American to participate in AWWSC's Customer Satisfaction Center, and the E-CIS software is not necessary for the Richmond customer service center to continue its operations.

Ms. Lynn noted that the OUCC asked Petitioner to provide a copy of the contract to purchase and develop the Orcom E-CIS software for the Alton CSC. Petitioner provided a copy of an agreement with addendums between AWWSC and Orcom Systems, Inc., which was entered into evidence during the OUCC's cross-examination of Mr. Eckart. (Public's Exhibit CX-2.) Ms. Lynn noted that Indiana-American was not a

**(Publication page references are not available for this document.)**

party to this agreement and does not own the software rights. Ms. Lynn argued that the ratepayers of the State of Indiana should not be made to pay either a return on or of an investment that the utility does not own or, as explained further below, for costs associated with an unregulated affiliate's venture that does not accrue any quantifiable benefits to the utility or its customers.

Ms. Lynn stated that the additional cost to Indiana-American's ratepayers, if the Petitioner is allowed to recover in rates its move to the CSC in Alton, Illinois, is over $2.3 million per year. Ms. Lynn provided the following table based on the OUCC's analysis to illustrate the adjustments that would be necessary if the Commission were to accept Petitioner's proposal to participate in American's CSC:

| OUCC UPDATED | Customer Service Increase/(Decrease) |
|---|---|
| Labor | $(1,007,762) |
| Purchased Power | (17,471) |
| Management Fees | 2,384,726 |
| Group Insurance | (263,031) |
| Customer Accounting | (23,684) |
| General Office | (552,303) |
| Miscellaneous (($240,878) + $282,528) | 41,650 |
| 401 (k) | (2,600) |
| Depreciation Expense | 1,249,764 |
| Return on Software | 592,174 |
| General Taxes | (82,637) |
| Net Change | $2,318,826 |

Public's Exhibit 1, Attach. Nos. 9 and 10.

Ms. Lynn noted that, while Petitioner did not provide any work papers to support the proposed cost increase for its participation in the Alton CSC, in Cause No. 42043 the Petitioner did provide the OUCC a discovery request response that reflected a pay back period of 115.44 months ($1,791,486 estimated implementation costs/$186,231 project savings X 12 months) for Indiana-American's participation in American's customer call center for an annual saving of $186,231 per year. (Public's Exhibit 3, Attach. No. 4.) However, Ms. Lynn added that Petitioner's payback calculation is flawed since it failed to include the Orcom Software cost of $6,248,821 and the amortization of the implementation cost of $282,528. She stated that after these costs are included, there are no annual savings. Therefore, there will never be a payback on this investment. Ms. Lynn stated that once Petitioner recognized there would be no payback to participate in this joint venture, it should have abandoned the program.

Ms. Lynn testified that it is neither necessary nor reasonable for Indiana-American to participate in American's initiative to consolidate its subsidiary customer call centers, noting that Indiana-American has a customer call center located in Richmond, Indiana that is open Monday through Friday, from 7:30 a.m. to 6:30 p.m., and provides quality service. Ms. Lynn also noted that Indiana-American did not perform any analysis or studies that would support the need to transfer its customer service operations to Illinois. In response to an OUCC Data Request, Mr. Cole admitted that 'No studies have been done in regard to incorporating the services provided at the Customer Satisfaction Center in the Richmond Call Center due to our inability to justify the level of expense this would generate.' (Public's Exhibit 3, p. 11, lines 4- 15.)

Ms. Lynn also advised that the 'Business Case Review' American relied upon to move forward with the customer satisfaction center contained information specifically addressing Indiana-American. Ms. Lynn added that only two (2) comparisons were made in the 'Business Case Review' of the Richmond Call Center and the Alton CSC. The first compared average handle time and the second was the abandonment rate. If Indiana transferred to Illinois, the review shows that the average handle time is projected to decrease from 7:16 minutes to 5:00-5:30 minutes, but the abandonment rate will increase from 2% to between 5% and 5.5%. American failed to complete the comparisons for the availability of consumer service representatives ('CSRs'), the cost per call or the quality of service.

Ms. Lynn observed that Indiana-American had already attained economies of scale and centralized its Customer Service Center in Richmond. Ms. Lynn added that Petitioner's witness, Mr. Cole had testified in Cause No. 42029 that its Richmond customer service facility has provided customer inquiry handling capabilities for all of Indiana-American since 1994. Mr. Cole also testified that a cost saving of $651,000 had been realized as a result of the centralized customer service center. Finally, Mr. Cole testified that Indiana-American improved its quality of service by improving its efficiency of handling and processing customer inquiries through implementation of Indiana-American's EDIS and automated service order preparation. On pages 54 and 55 of his testimony in Cause No. 42029, Mr. Cole extolled the strengths of its efforts by stating the following:

The first example would be our implementation of Indiana-American's Electronic Data Inquiry System ('EDIS') and automated service order preparation within the acquired operations [has] resulted in a more efficient method for responding to customer inquiries. With the EDIS system in place, customers can call from anywhere in the State of Indiana into our Richmond facility utilizing a toll free number and discuss their problems or concerns with a customer service representative. A service order will then automatically print out in the location in which the work needs to be done. This will improve the efficiency of handling and processing customer inquiries... . We've also made available Xpress Cheque, an automatic bill paying service, to all customers with the acquired operations as well.

Thus, Ms. Lynn asserted, Indiana-American's ratepayers have already paid for and received high quality customer service from a relatively modern system. (Id. at p. 11.)

**(Publication page references are not available for this document.)**

Describing how AWWSC charged Indiana-American for the Alton, Illinois implementation costs, Ms. Lynn noted that AWWSC charged Indiana-American an allocated portion of its implementation costs based on the number of customers that Indiana-American had on a particular date. To date, this allocation was $7,594,126 ($1,345,305 + $6,248,821). Ms. Lynn further testified that the method that AWWSC used to allocate these costs will cause Indiana ratepayers to subsidize efficiency improvements for other states. Ms. Lynn noted that the CSC is just one instance where the OUCC has found this subsidy to occur. This method of allocation causes Indiana ratepayers to subsidize the inefficiencies that exist in other states. Based on the 'Business Case Review' American expects to save over $31 million system-wide in a five (5) year period, or over $6 million annually. Thus, while some of American's subsidiaries operating in other states will share in the $6 million projected annual savings, Indiana-American ratepayers are expected to pay an additional $2.3 million every year. Ms. Lynn concluded that it is unreasonable to request Indiana-American's customers to pay significantly more so Petitioner's affiliates can attain a savings. (Id. at pp.12-13.)

Ms. Lynn also provided a schedule analyzing information contained in AWWSC's request for a proposal to receive bids on its implementation study for the Customer Satisfaction Center. As shown by that schedule, several states have more than one customer call center. Ms. Lynn reiterated the fact that Indiana-American's ratepayers paid to have its customer call center centrally located in Richmond less than ten (10) years ago. Further analysis also shows how efficient its call associates are when handling customers. Ms. Lynn testified that the associates located in Richmond are more efficient than any of AWWSC's existing call centers in its five largest states, and the Richmond call associates exceed the mean average of customers handled per associate by more than 25%. (Id. at p. 14.)

Ms. Lynn also noted that customers will incur additional costs if Indiana-American retires its assets associated with the Richmond call center before they are fully depreciated. This is because the undepreciated cost will remain in accumulated depreciation. Ms. Lynn observed that AWWSC has not shared any of its projected cost savings with Indiana-American. Instead, Indiana-American has been made to pay more than $8 million in implementation costs.

Ms. Lynn testified that the Commission should not include any of the implementation costs in Indiana-American's rates, noting that this is not truly Indiana-American's initiative but an affiliated company's initiative. It may be more economical for other sister companies to participate in American's CSC initiative but these economies of scale should not be achieved on the backs of Indiana ratepayers. The OUCC recommended removal of $6,248,821 from rate base for the software cost and claimed Petitioner should not be allowed to recover the amortization of the $1,345,305 deferred costs. Thus, Ms. Lynn removed the annual amount of $282,528 from miscellaneous expense.

Ms. Lynn also expressed concern that more implementation costs might apply. Ms. Lynn noted that Petitioner has testified that it is still transitioning to the

Alton CSC. In Cause No. 42043, Petitioner responded to the OUCC's discovery that its share of American's $17,811,898 implementation cost was $1,791,486 or 10.06%. In this Cause, Petitioner responded to OUCC discovery that the implementation costs for American's CSC have increased to $18,393,677. Thus, Indiana-American could in a subsequent rate case be allocated an additional $505,099 (($18,393,677 X 10.06%) - $1,345,305)) in implementation costs before American completes its transition. Ms. Lynn asserted any additional implementation costs associated with the CSC in Alton, Illinois should likewise be denied. (Id. at p. 15.)

Ms. Lynn concluded that Petitioner should not be permitted to recover costs recorded to Utility Plant that were not necessary. She added that the E-CIS software is not being used for Indiana-American's operations at its Richmond facilities, but that it is only necessary for participation in AWWSC's CSC. Ms. Lynn stated that Petitioner has not shown quantifiable benefits to its Indiana customers resulting from its participation in the Alton CSC. Based on the testimony provided by the OUCC, Ms. Lynn stated that Petitioner's proposed increase in management fees associated with its participation in AWWSC's Customer Satisfaction Center should be denied. The following reflects the OUCC's elimination of Petitioner's pro forma adjustments reflecting the test year cost associated with the Richmond, Indiana customer call center.

| OUCC Update | Customer Service Increase/(Decrease) |
|---|---|
| Labor | $1,007,762 |
| Purchased Power | 17,471 |
| Management Fees | (2,384,726) |
| Group Insurance | 263,031 |
| Customer Accounting | 23,684 |
| General Office | 552,303 |
| Miscellaneous | 240,878 |
| 401 (k) | 2,600 |
| General Taxes | 82,637 |
| Net Change | $(194,360) |

Public's Exhibit 1, Attach. Nos. 9 and 10.

Ms. Lynn noted the foregoing adjustment is based only on the accounts that Petitioner identified as its customer satisfaction center adjustments. The OUCC adjusted for the amortization costs, depreciation expense and rate base costs associated with American's CSC in separate adjustments. (Id. at pp. 16-17.)

Petitioner's Rebuttal. Petitioner claims that the Commission should view the purchase and development of the E-CIS software as a separate project from the conversion costs to the Alton CSC. Petitioner testified that the decision to convert to the E-CIS software was made well before the decision to consolidate all of American's affiliated utilities' call centers into one centralized location. Thus, in rebuttal, Petitioner's witness Eckart disputed Ms. Lynn's views that the E-CIS project is a cost of converting to the CSC. Mr. Eckart testified that a decision to replace EDIS with E-CIS was made in 1996. Mr. Eckart further stated that the E-CIS decision pre-dated consideration of a national call center, which did not begin until the Fall 1998. Mr. Eckart said that the acquisition of E-CIS was not a result of Petitioner's conversion to the Alton CSC because it would have occurred regardless of that fact. (Petitioner's Exhibit JEE-R, pp. 29-30.)

Petitioner also submitted the rebuttal testimony of A. Joseph Van den Berg, a principal with Deloitte Consulting, LLP, on the issues raised by Ms. Lynn. Mr. Van den Berg is the Strategy and Operations and Customer Relationship Management Lead Partner for the Energy and Utilities Practice within Deloitte. Mr. Van den Berg stated he is familiar with the Alton CSC from prior engagements and has toured the facility. In connection with his review of Ms. Lynn's testimony, Mr. Van den Berg claimed he undertook extensive data collection, including interviews with Indiana-American, Alton CSC and AWWSC personnel in various roles. (Petitioner's Exhibit AJV-R, pp. 1-6.)

Mr. Van den Berg first disputed Ms. Lynn's opinion that E-CIS was unnecessary. He repeated Mr. Cutshaw's supplemental testimony in his discussion about EDIS not being capable of various requirements that occur in today's computing environment. In particular, he stated that EDIS suffered from the inability to handle security challenges and threats resulting from an expanded network and Internet uses, the lack of a detailed database to allow for data discrepancy resolution and the inability to continue to scale to Indiana-American's growing customer needs. (Id. at p. 7, lines 20-23; Petitioner's Exhibit JLC-U, p. 8, lines 4-7.) Mr. Van den Berg testified that there was no consistency among the operating companies on EDIS and, as a result, the utilities were operating six (6) versions of EDIS out of three (3) data centers. He testified that not only was the network of systems complicated to maintain, but enhancements made in one location could not be shared in others. He said that continuing the use of EDIS would require extensive enhancements. Mr. Van den Berg testified that Indiana-American had studied the issues surrounding the inabilities of the EDIS system since the mid-1990s and had been planning to replace its EDIS software for some time. (Petitioner's Exhibit AJV-R, p. 8.) Mr. Van den Berg testified that it was not until after some states had already initiated the implementation of E-CIS that, rather than incurring the cost to expand multiple versions of E-CIS, management made the decision to implement a single platform on a basis that was cost effective for Petitioner and its utility affiliates. (Id. p. 8, lines 6-12.)

Mr. Van den Berg also repeated Mr. Cutshaw's position that E-CIS is more sophisticated, consistent and user-friendly than EDIS. Mr. Van den Berg testified E-CIS was Windows-based and has a graphical user-interface as opposed to the mainframe, 'green-screen' approach of EDIS. This allows E-CIS to be compatible with other packages and programs currently in use and supports enhanced real time reporting. (Id. at pp. 9-10; Petitioner's Exhibit JLC-U, pp. 7-8.)

Mr. Van den Berg also asserted the superiority that E-CIS will have in viewing customer account information and the planned internal website resources. Mr. Van den Berg testified that E-CIS has many more billing capabilities and allows users to personalize the customer's experience. For example, bill due dates of individual customers can be easily changed, a feature lacking in the old software. Also, more time is allowed for personnel to review bills and correct mistakes before mailing. E-CIS also provides the ability to generate detailed bills that itemize every component of the total bill amount. (Petitioner's Exhibit AJV-R, pp. 10-11; Petitioner's Exhibit JLC-U, pp. 7-8.)

Relying on a survey of twenty (20) utility companies included in Chartwell's 2002 CIS Report, Mr. Van den Berg asserted that it would have cost Petitioner $5.9 million to $7.5 million to upgrade its existing EDIS program. (Petitioner's Exhibit AJV-R, p. 12, lines 1-4.) However, according to Mr. Van den Berg, EDIS was in need of replacement and not just an overhaul. Mr. Van den Berg estimated that a full Customer Information System ('CIS') implementation would cost a company of Petitioner's size between $8.04 million and $29.48 million. (Id. at lines 19-22.) Mr. Van den Berg said this includes, but is not limited to, expenditures on vendors, consultants and integrators for hardware, software and services; payroll costs, overtime pay, bonuses, and temporary staffing; project space and training facilities; and amounts for extended capabilities, such as bill production, change management, and data warehousing. Based on his analysis, Mr. Van den Berg came to the same conclusion as stated by Mr. Cole in his testimony that, given his cost projections, replacing EDIS on its own was not Petitioner's best option. Rather, as Mr. Cole testified, by joining with the other utility subsidiaries of American in the cost of a modern CIS, the new E-CIS program could be implemented at a much lower cost than for Petitioner to do so by itself. (Id. at pp. 13-14; Petitioner's Exhibit DDC, p. 17.)

Mr. Van den Berg also disputed Ms. Lynn's testimony that the cost to Petitioner of the E-CIS software should not be included in Petitioner's rate base because Petitioner allegedly does not own the software rights. He noted that the Orcom contract was signed by AWWSC to make E-CIS available to American's utility subsidiaries, including Petitioner, at cost. He said AWWSC was acting on behalf of American's utility subsidiaries as a result of a decision of the utilities' Presidents. Mr. Van den Berg said that this was further demonstrated by Petitioner's payment directly to Orcom of its share of the initial payment. (Petitioner's Exhibit AJV-R1.) Instead of taking on by itself all the capital costs and risks associated with implementing a new CIS, Petitioner was able to benefit from the leveraging of existing assets, systems and processes within the American organization. Mr. Van den Berg testified that by implementing the software package through AWWSC, Petitioner was able to achieve substantial customer benefits at a lower cost than creating a duplicative system owned solely by Petitioner. (Id. at pp. 13-14.)

Mr. Eckart testified that the decision to implement E-CIS was separate and distinct from the decision to combine all call center operations at the Alton CSC, which was affirmed by Mr. Van den Berg. Both also testified that Petitioner made the E-CIS decision in the mid-1990s before the process of evaluating a national call center had begun. Petitioner's decision to 'go live' on E-CIS at the time of moving to the CSC was based upon a desire to minimize training and other change management costs. Mr. Van den Berg said that the Richmond Call Center could have operated with E-CIS and, likewise, the EDIS system could have been used by the Alton CSC. In Mr. Van den Berg's opinion, neither would have been the best course of action. (Id. at p. 15; Petitioner's Exhibit JEE-R, pp. 29-30.)

Mr. Van den Berg testified that today's customers have expectations that are driven by industry standards for customer service, and that the Alton CSC is a state-of-the-art facility that is capable of meeting these standards. He testified that the costs incurred by Petitioner in transitioning to the Alton CSC are reasonable and in line with industry averages required to implement such a system or to upgrade an existing system to the same level and quality as that offered by the Alton CSC. (Petitioner's Exhibit AJV-R, p. 17.)

Mr. Van den Berg reiterated the prefiled testimony of Mr. Cole that the Alton CSC operates twenty-four (24) hours per day, seven (7) days per week. He also stated that the CSC provides an IVR system that offers many advantages over the system at the Richmond facility, such as allowing customers to complete more self-service transactions, supporting automatic call distribution and computer telephony integration and enabling skill based routing. Further, an effective IVR paves the way for web-based information access and self-service transactions, such as for meter reads, service turn on/offs and customer surveys. Mr. Van den Berg noted the CSC also supports automatic call monitoring which, Mr. Van den Berg stated, greatly enhances the quality assurance process by allowing managers to record and review telephone interactions. Further, the CSC has the ability to handle call volume smoothing, which will allow greater control over staffing. (Id. at pp. 19-22; Petitioner's Exhibit DDC, pp. 15- 16.) Mr. Van den Berg also testified that a great enhancement in the Alton CSC is its bilingual capabilities. (Petitioner's Exhibit DDC, p. 15.) He noted that according to the United States Census Bureau, the Hispanic population in Indiana grew by nearly 120% from 1990 to 2000, and many of the areas with the greatest Spanish-speaking population are served by Petitioner. (Petitioner's Exhibit AJV-R, p. 22.)

Mr. Van den Berg disagreed with Ms. Lynn's contention that the Richmond facility would continue to be adequate on a going forward basis. While the Richmond facility may have been offering an acceptable level of service, Mr. Van den Berg testified that the Richmond facility was beginning to outgrow its capabilities and lagging behind the requirements of centers in today's customer service landscape. (Id. at pp. 22-23.) Mr. Van den Berg cited testimony received at the Jeffersonville Field Hearing in this Cause to demonstrate how the CSC was responsive to customer expectations. There, a customer complained about the inability of customer service representatives to access complete real-time customer service information after normal business hours. The customer was left with the impression that Petitioner is not 'consumer-friendly.' (Petitioner's Exhibit AJV-R3, p. 30.) Mr. Van den Berg explained that, since Petitioner has completed its transition to the CSC, all calls are logged real-time in a central location to which all customer service representatives have access. Further, customers are able to call and speak to a customer service representative twenty-four (24) hours a day, seven (7) days a week. Calls are routed automatically to an agent with the proper expertise to resolve the issue. Finally, customers not fluent in English will still be able to communicate about their needs.

Mr. Van den Berg estimated the cost for Petitioner to upgrade the Richmond facility to the level of service now provided at the Alton CSC. Mr. Van den Berg testified that, excluding a new CIS, Petitioner could expect to incur costs in the range of $2.7 million to $5.5 million for such upgrades, an amount significantly greater than its share of the one-time implementation cost of the Alton CSC of $1,345,305. (Petitioner's Exhibit AJV-R, p. 26.) Mr. Van den Berg also compared the annual cost in terms of return, depreciation and amortization of his estimates for both upgrading the Richmond facility and implementing a new CIS to the annual revenue requirement for E-CIS and the Alton CSC as quantified by OUCC witness Lynn. Mr. Van den Berg's analysis showed that Petitioner's E-CIS and CSC costs were significantly less than the go-it-alone alternative. (Petitioner's Exhibit AJV-R4.)

Mr. Van den Berg also believed Ms. Lynn's position that the CSC costs should have been directly charged to each participant, rather than allocated, should not be considered. Mr. Van den Berg said the cost allocation was made in accordance with the service company agreement on file with the Commission since 1989. This agreement provides that common costs incurred by AWWSC that cannot be related exclusively to one utility shall be allocated to American's utility subsidiaries based on the number of customers. Mr. Van den Berg said that the CSC was developed jointly among the operating companies and the allocation of costs was consistent with the treatment of other comparable costs and fair for all the utilities. Mr. Van den Berg noted that regardless of whether some companies may have experienced a bigger leap in their customer care operations than others, Petitioner achieved both cost savings and an increased level of service by participating in the CSC. (Id. at pp. 27-29.)

With respect to the E-CIS project depreciation rate issue, Petitioner's witness Cutshaw responded in rebuttal that Petitioner had proposed use of a 5.54% rate because it would have less of a rate impact. However, he stated that Petitioner does not oppose the OUCC's position that the 20% depreciation accrual rate should be used to determine depreciation expense for the E-CIS project. (Petitioner's Exhibit JLC-R, p. 26-27.)

Commission Discussion and Findings. As mentioned earlier in the rate base section of this Order, we believe there is enough of a relationship between the acquisition of the E-CIS software and the consolidation of customer services in Alton, Illinois to discuss these two issues jointly in this portion of the Order. We also note that as much evidence relevant to these issues was elicited during cross-examination as was presented in the parties' prefiled testimony.

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Petitioner requested we approve the return on and of $6,248,821 related to the purchase and development of the E-CIS software. In addition, there is $194,360 in increased operating costs caused by Indiana-American's participation in the Alton CSC. Petitioner also seeks $282,528 in amortization costs of the $1.3 million deferred asset balance associated with the conversion to the Alton Customer Satisfaction Center. The OUCC recommended that the $6,248,821 associated with the E-CIS software be disallowed and removed from its rate base, and that Petitioner be denied the $282,528 in amortization costs of the $1.3 million deferred asset balance associated with the conversion to the Alton CSC. In addition, the OUCC recommended that the Commission accept its $194,360 downward adjustment to offset the increased O&M costs that is embedded in Petitioner's management fee adjustment for the Customer Satisfaction Center.

Sufficient evidence was presented to lead us to conclude that Petitioner's decision to upgrade its EDIS software to Orcom's E-CIS was made prior to the decision to consolidate its customer service functions in Illinois. What is at issue, however, are the costs and the need associated with (1) the decision to abandon the Richmond, Indiana consolidated customer service center and move to an out-of-state, multi-state consolidated service center and (2) the acquisition of an upgraded customer billing/service database that has expanded significantly in cost. In the initial three-year contract (1996-1999) between American and Orcom, Orcom agreed to develop E-CIS software that would be able to 'go live' at eight (8) sites, of which Richmond, Indiana was one; Petitioner witness Eckart stated that 'going live' meant the Orcom Customer Information System was installed and being used in the production of bills. (Tr. at E-14.) Indiana-American's portion of the cost to design and implement the software was 9% of the total $7.3 million cost.

Whether the OUCC should have known or not, we derive from the cross-examination testimony of Ms. Lynn that the Public was not readily aware that the upgrade to E-CIS was not limited to the initial Orcom contract. According to testimony and rebuttal evidence from Petitioner witnesses Eckart and Van den Berg, the initial American-Orcom contract for E-CIS serving eight (8) utilities was supplemented by an October/November 2000 contract between American and Accenture (formerly Anderson Consulting). (Tr. F-18, line 22 through F-19, line 4.) As we understand Petitioner's testimony, the initial Orcom 'piece' of the E-CIS upgrade comprises only about 10% of the total work (and cost) needed to effect the E-CIS upgrade and application in the context of the consolidated customer service center. According to Petitioner, the cost of the second contract to develop and implement the E-CIS for the Alton CSC is $71,416,845. (Tr. D-49, line 21; E-69 lines 1-3.) The only contract in evidence, however, is American's 1996 through 1999 contract with Orcom.

After entering into the initial American-Orcom contract but prior to American's decision to cause Indiana-American to convert to Alton, a decision was made to include twenty-two (22) utility locations, including Petitioner, to participate in the Alton CSC and to implement the E-CIS software for all participating utilities. Mr. Van den Berg testified that, dissatisfied with Orcom's customization work, the Petitioner entered the supplemental contract with Accenture for the purpose of

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developing a single instance of E-CIS for the Alton CSC. (Tr. F-22, lines 5-12.) The total cost of developing and installing the E-CIS software rose from $7,326,422 to $71,416,845. (Tr. D-49, line 21; E-69 lines 1-3.) And, though there are now twenty-two (22) installation locations using E-CIS, instead of eight (8), Indiana-American is expected to pay roughly the same percentage of the allocation: 9% of $71,416,845, instead of 9% of $7,326,422.

Putting the cost issue aside momentarily, we find that Petitioner presented sufficient justification for the need to upgrade to the E-CIS database. In his rebuttal testimony, Mr. Van den Berg explained the need for the E-CIS database, the benefits to be derived by Petitioner's customers and the advantages it offers over the EDIS database being replaced. According to Mr. Van den Berg, when compared to EDIS, the E-CIS software is more compatible and easily adaptable to other programs or packages used by Indiana-American, is user-friendly and allows employees to generate more sophisticated and 'real time' reports. (Petitioner's Exhibit AJV-R, pp. 9-10.) He stated that the EDIS system used at the Richmond, Indiana service center could not 'handle security challenges and threats resulting from expanded network and Intenect uses, lack [ed] a detailed database to allow for data-discrepancy resolution' and could not be enhanced to meet 'growing customer needs' because it lacked space to accommodate new computer code. (Id. at pp. 8-9.) With the E-CIS system in place, Mr. Van den Berg claimed that customers would benefit by receiving additional billing information (i.e., detailed usage, separated fixed charges), having the capability to select a different payment date and receiving accurate statements since Indiana-American employees would have additional time to correct billing errors before the statements are mailed. (Id. at p. 10.)

The question still remains, however, as to the amount of costs to allow for the software upgrade. First, we are unable to determine with any specificity the identity of the additional products and/or services that caused the total price to increase from $7,326,422 to $71,416,845. In addition, other than the testimony that Indiana-American's parent allocated the cost based on its percentage of the total customers served, Petitioner has not satisfactorily explained why it is more expensive for Indiana-American to go live with E-CIS as one (1) of twenty-two (22) companies with which to share the costs, than it would have been as one (1) of only eight (8). Petitioner witness Van den Berg acknowledges that providing software for twenty-two (22) utilities, many subject to different sets of regulations, would be more costly than providing the service for eight (8) utilities. However, we would expect some economies of scale since the Petitioner is now sharing the cost with almost three (3) times the number of participants originally proposed. Instead, Petitioner is expected to pay roughly the same percentage of a much greater expense. Also, we note the recent trend of Indiana-American to speak of attaining economies of scale within the state only to subsidize smaller American utilities by paying shared costs through a suspect allocation method; a method which does not credit economies of scale reached by the individual utilities. Since the evidence is not sufficient either to justify the Petitioner's requested expense or to reconcile the discrepancy of cost allocation, we find the most reasonable cost to allow Indiana-American is the

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allocation of $659,378 (9% of $7,326,425) as agreed to in the initial, three-year Orcom contract as the E-CIS was planned to be developed and implemented before the decision to include Indiana-American in the Illinois CSC.

With respect to the move from the customer service center in Richmond to Alton, Illinois, we believe the OUCC has presented compelling reasons to find that the move was imprudent and not reasonably necessary. First, the OUCC discovered that the Petitioner failed to perform any studies regarding the transfer of the Richmond center's services to the Alton CSC before the transition occurred and, by the time the Petitioner secured an expert to testify about general customer services at Richmond, the Richmond center had ceased being Indiana-American's customer call center. Second, the OUCC testified that the cost to Petitioner's ratepayers for Petitioner to participate in the consolidated customer service center would be approximately $2.3 million additionally each year. Petitioner had filed testimony in Cause No. 42029 that suggests that 88.28% of Indiana-American's customers were very satisfied with the detailed information contained on their bills when compared to other utility bills. Third, the Public also offered evidence that suggests that the Richmond call associates were very effective in handling its customer's needs. Fourth, when Petitioner surveyed its customers about the overall quality of service received from the call associates located at the Richmond facility, Mr. Eckart testified that 84.49% of Indiana-American's customers were satisfied with the overall quality of service received from the water company's customer call associates located in Richmond. Furthermore, Mr. Eckart testified that an 85% satisfaction rating from these surveys was Petitioner's goal:, stating that an 85% rating would mean Petitioner had achieved 'world class' service. Thus, Richmond's Customer Service Center was considered 'world class' based on the customer survey results provided as Public's Exhibit CX-4.

The OUCC also recalled testimony from Petitioner in Cause No. 42029 that the centralization of Indiana customer services in Richmond resulted in economies of scale. Petitioner stated in this Cause that, by consolidating service centers for all American companies in Illinois, economies of scale can be captured because the Petitioner can provide all the new services it described at a much lower cost than it would have incurred to provide them by itself. We believe that Petitioner's rebuttal evidence is not sufficient to allow such a conclusion. We believe that Petitioner gained its economies of scale when it centralized its customer service functions into one call center in Richmond, Indiana less than ten (10) years ago when Petitioner estimated a savings of over $650,000 annually as a result of the consolidation. Moreover, the Public demonstrated that with or without the inclusion of the E-CIS software in its analysis, there would never be a payback to Petitioner for its participation in American's Alton CSC initiative.

We conclude that the Richmond center was providing adequate service to Indiana-American's customers who, for the most part, have been satisfied with the level of service provided by the Richmond center. Petitioner's evidence in this proceeding is insufficient to demonstrate the necessity to move and consolidate Indiana's customer service functions into a national customer service center. We

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find it appropriate, therefore, to limit this expense to the amount already reflected in Petitioner's rate base for the Richmond Customer Service Center.

We also share the concern expressed by the OUCC that Petitioner is asking its customers to subsidize other states' inefficiencies. The OUCC testified that according to the 'Business Case Review,' American expects to save approximately $6 million each year over the next five (5) years as a result of establishing the Alton Customer Satisfaction Center, but Indiana-American is expected to pay $2.3 million each year. As a result, some of Petitioner's inefficient affiliates will share in the savings, while Indiana customers are expected to pay more. Indiana customers benefited from the efficient customer service center in Richmond and should not now be financially penalized so that a consolidated grouping of efficient and inefficient affiliates can produce a savings for the parent company.

While we accept as a general concept that consolidations and shared services can result in greater benefits and efficiencies, we will review any such request separately and with an eye toward the impact on Indiana ratepayers. Within any such review we expect complete and substantial justification for the anticipated benefits and efficiencies.

Finally, Petitioner has openly recognized, even prior to this Cause, that the establishment of a consolidated call center could lead to the elimination of jobs in Indiana. Nonetheless, it is disturbing that what we find to be an imprudent decision to establish a consolidated call center, with respect to Indiana customer service needs, is exacerbated by the elimination of forty-seven (47) customer service jobs in Richmond, Indiana.

6. Purchased Power

[74] Petitioner's Position. Petitioner proposed an increase to pro forma purchased power costs of $259,376 to reflect an increase in electric costs paid to Cinergy. Petitioner's witness Tapp testified that Cinergy had filed for a 16.1% rate increase that was anticipated to be effective in early 2004. (Petitioner's Exhibit BIT, p. 18, lines 20-23.)

OUCC's and Intervenor's Position. The OUCC and Intervenor Schererville opposed Petitioner's adjustment to pro forma purchased power costs attributable to the Cinergy rate proceeding. OUCC witness Ms. Stull testified that the adjustment was not fixed, known or measurable because Cinergy's rate case proceeding was still being litigated before the Commission. (Public's Exhibit 2, p. 16, lines 1-6.)

Petitioner's Rebuttal. Petitioner alleged that it appeared evident the Commission would grant a rate increase in some amount to Cinergy. Petitioner's witness Cutshaw testified that the proposed orders filed in the Cinergy proceeding showed that the OUCC was recommending an across-the-board increase of 4.2%, while Cinergy was now proposing an overall increase of 11.2%. (Petitioner's Exhibit JLC-R, p. 21, lines 16-18.) Mr. Cutshaw assumed the Commission should, at a minimum, adjust Petitioner's pro forma power costs to reflect the smallest rate increase being

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proposed in the Cinergy rate proceeding. (Id. at lines 18-20.) Mr. Cutshaw stated that this would result in an adjustment of $67,665. (Petitioner's Exhibit JLC-R8.)

Commission Discussion and Findings. On May 18, 2004, we issued our order in the Cinergy rate proceeding, Cause No. 42359, and granted an 8.36% rate increase. This increase is now fixed, known and measurable. Accordingly, we find that test year purchased power costs should be increased by $134,682.

7. Purchased Water

[75] Petitioner's Position. Petitioner's witness Tapp testified that due to the addition of a new plant in Newburgh, Petitioner's demand for purchased water from the City of Evansville's municipal utility had diminished by an estimated 58%. (Petitioner's Exhibit BIT, p. 17, lines 3-8.) The costs saved by reduced demand were offset somewhat by an anticipated rate increase for Evansville for the water Petitioner still purchases. (Id. at lines 8-13.) The Commission had not issued an order in the Evansville rate proceeding at the time Mr. Tapp's prefiled testimony was submitted, so Mr. Tapp presumed that the entire increase requested by Evansville would be granted by the Commission. Adjusting for the reduced demand and increased cost, Mr. Tapp claimed a negative purchased water adjustment for Newburgh of $12,822 was warranted.

OUCC's Position. At the time that the OUCC submitted its case-in-chief, the Commission had issued an order in the Evansville's rate proceeding. OUCC witness Stull testified that the final order issued by the Commission in that proceeding had adopted a rate increase of 15.38% and recommended that this be used to calculate the Newburgh purchased water adjustment. (Public's Exhibit 2, p. 13, lines 9-15.) Ms. Stull accepted Petitioner's estimate of the decreased volumes it will purchase from Evansville. (Id. at lines 15-19.) Accepting Ms. Stull's methodology would result in a decrease to test year purchased water expense of $28,671.

Intervenor's Position. Intervenor, Town of Schererville, advocated allowing no expense for the cost of purchased water from the City of Evansville. Schererville's witness Sommer testified that the final order in the Evansville rate proceeding specifically found that the City of Evansville was not going to be selling any water to Petitioner. (Intervenor Schererville's Exhibit 1, p. 18, lines 11-16.)

Petitioner's Rebuttal. Petitioner accepted the OUCC's adjustment for purchased water costs in Newburgh. (Petitioner's Exhibit JLC-R, p. 19, lines 17-20.) Petitioner disagreed, however, with the Town of Schererville's proposal to allow no expense for the cost of purchasing water from Evansville. Mr. Cutshaw testified that regardless of what may have been said in the Evansville rate order, Petitioner was still a customer of Evansville, and should be able to recover the prudent purchased water costs it is reasonably anticipated to incur. (Id. at p. 20, lines 7-9.) Mr. Cutshaw testified that actual purchases for the most recent twelve (12) months totaled 41,535 thousand gallons. (Id. at lines 5-7.)

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Commission Discussion and Findings. All parties agree that Petitioner has constructed a new water treatment plant in Newburgh and that this plant is included in Petitioner's rate base. What is in dispute is how much, if any, water will continue to be purchased from the City of Evansville. In our Final Order in Cause No. 42176 ('Evansville Order'), we recognized that Petitioner would continue to be connected to Evansville and may need to use Evansville as a 'backup' source of water supply. (Evansville Mun. Water Works Dept., Cause No. 42176, p. 9-10 (Indiana Utility Regulatory Commission, Date Issued Feb. 18, 2004).)

That being said, this Commission intended the term 'backup' to be used in the sense of an emergency source of supply and that purchases would be infrequent and difficult to predict or budget. Indeed, in that case we rejected a request to adjust Evansville's revenues because 'any amount that Indiana-American may or may not purchase in the future is not fixed, known and measurable and therefore would not properly be included in [Evansville's] adjusted test year operating revenues.' (Id. at p. 10.)

We found in the Evansville Order that future Indiana-American purchases from Evansville were not fixed, known and measurable. Nothing in the record of this Cause leads us to disturb that finding. Accordingly, test year should exclude any purchased water costs from Evansville, and pro forma purchased water expense should be decreased by $68,202.

8. Insurance

a) Group Insurance

[76-78] Petitioner's Position. Petitioner made adjustments for current group insurance costs and costs associated with post-retirement benefits other than pensions ('PBOP'), i.e., Statement of Financial Accounting Standards No. 106 ('FAS106'). Petitioner proposed an increase over test year of $503,075 for group insurance and a decrease of $522,562 for PBOP, for a net decrease of $19,487. Petitioner further reduced test year expenses by shifting certain positions in customer service and corporate to AWWSC, which were offset by increases to 'management fees' paid by Petitioner to AWWSC.

OUCC's Position. The OUCC made adjustments consistent with its proposed labor adjustments, including the exclusion of certain vacant and new employment positions and updating the costs for an increase in premiums less the portion paid by the employee. The OUCC accepted Petitioner's adjustment for PBOP/FAS106 costs. The OUCC proposed an increase over test year of $383,826 for group insurance and a decrease of $522,562 for PBOP, for a net decrease of $138,736. The Public also recognized Petitioner's shifting of costs to management fees, as was discussed in the labor portion of this Order. (See Sect. XI. B. 1. Pro Forma Labor Positions.)

Petitioner's Rebuttal. Mr. Cutshaw testified that the originally proposed adjustment to PBOP was in error. He stated the pro forma amount should have been $2,043,667, not $1,271,240 as originally filed. Mr. Cutshaw changed the adjustment

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from ($522,562) to $249,886. Petitioner accepted Ms. Gemmecke's adjustment reflecting group insurance rates effective January 1, 2004, and employee contributions. (Petitioner's Exhibit JLC-R, pp. 14-15.)

Commission Discussion and Findings. Petitioner originally requested a decrease of $522,562 to test year PBOP expenses. The Public and Intervenors made no changes to this adjustment to test year expenses. However, Petitioner on rebuttal stated its adjustment was in error and the correct adjustment to test year expense would be an increase of $249,866, rather than the originally proposed decrease of $522,562.

We find no justification for Petitioner's disparate treatment of pension expense and PBOPs. With the pension expense, Petitioner calculated a six-year pro forma average pension (FAS87) expense. (Industrial Group's Exhibit 1, p. 28, lines 11-12.) However, with the PBOP (FAS106) calculation, Petitioner did not calculate an average. Instead, Petitioner took only the 2004 amount of $28,400,000 to calculate Indiana-American's share of the expense.

Mr. Wolf explained the reasoning behind the pension expense average, saying, '[a] six (6) year average was used because recent declines in the financial markets are causing significant increases in pension costs over the period. Using the average mitigates the short-term impact of recent events. ' (Petitioner's Exhibit WJW, p. 12, lines 1-4.) The same factors of market fluctuation are relevant in determining FAS106 expense as for FAS87 expense. Consequently, we see no justification for Petitioner to treat FAS106 differently.

The Commission finds pro forma group insurance costs to be $112,664 above the test year amount of $4,258,549, before shifting costs to management fees. The amount shifted to management fees is $417,056, consistent with our findings for labor expense.

b) Other Insurance

[79] Petitioner's Position. Petitioner adjusted test year insurance other than group expense by annualizing the current premiums for each type of coverage, including general liability, auto liability and workers' compensation. (Petitioner's Exhibit BIT, p. 22, lines 1-4.) This adjustment resulted in an increase in test year expense of $124,458. (Petitioner's Exhibit BIT, Sched. 6, p. 1.)

OUCC's Position. OUCC witness Margaret Stull proposed several adjustments increasing test year insurance other than group expense by $14,938. According to the OUCC, Petitioner overstated auto insurance expense by $89,364 and overstated liability insurance by a net $19,714. (Public's Exhibit 2, Attach. MAS-13.) Ms. Stull also proposed to eliminate the amortization of retrospective insurance premiums in the amount of $153,264. Ms. Stull noted that Petitioner did not provide any explanation or support as to what these insurance premiums related or how they would benefit future periods and, therefore, warrant multi-year amortization. (Public's Exhibit 2, page 18, lines 12-20.)

Petitioner's Rebuttal. Petitioner accepted the adjustments to auto insurance and liability insurance. However, Petitioner opposed the proposed exclusion of the retrospective premiums.

In rebuttal, Petitioner's witness Cutshaw provided a summary of the affected policies and copies of supporting invoices. (See Petitioner's Exhibit JLC-R9.) He argued that the retrospective payments are a 'true-up' of premiums for prior year policies that Petitioner is paying over a set policy period. Mr. Cutshaw further claimed that the amounts reflected by the Company were incurred in the test year and will be incurred beyond the adjustment period provided in the Prehearing Conference Order in this case. (Petitioner's Exhibit JLC-R, p. 24, lines 10-15.) Mr. Cutshaw alleged that retrospective premiums have been accepted by the OUCC and approved by the Commission in Petitioner's last four rate cases (Cause Nos. 42029, 41320, 40703 and 40103). (Id. at lines 20-24.)

Commission Discussion and Findings. First, we find that the insurance adjustments for auto insurance and liability insurance, which were accepted by Petitioner, should be approved.

Second, as to retrospective premiums, we have reviewed our rulings in Petitioner's four (4) previous rate cases and do not see any specific mention or acceptance of retrospective insurance premiums as stated by Petitioner in its rebuttal testimony.

That being said, we do not think that there is enough information on the record to disallow these retrospective insurance premium expenditures. We will allow these costs to be included in test year for this rate case, but emphasize that this issue is not closed to future examination in subsequent cases. Indeed, we encourage a more thorough investigation of these costs by the OUCC in Petitioner's next rate case.

9. Internal Audit

[80, 81] OUCC's Position. Ms. Lynn reduced Petitioner's management fee expense by $56,572 for the Internal Audit Division of an affiliated company. She based her adjustment on Petitioner's response to OUCC Data Request No. 3, Question 51, in which Petitioner stated that the Internal Audit Division had not performed an internal audit for Petitioner in over three (3) years. (Public's Exhibit 3, p. 32.)

Petitioner's Rebuttal. Petitioner's witness Wolf testified that Petitioner and its ratepayers receive benefits from the American Internal Audit department because the department does more than direct internal audits. (Petitioner's Exhibit WJW-R, p. 2, lines 9-10.) He stated that, in addition to performing periodic internal financial audits, the Internal Audit department assists with the annual independent audit performed by PricewaterhouseCoopers (thereby reducing

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audit fees allocated to Petitioner), performs reviews of Information Technology Services processes and procedures, reviews SCADA system security and administers Petitioner's Code of Ethics. (Petitioner's Exhibit WJW-R, p. 2, lines 11-21.)

Commission Discussion and Findings. We reviewed Public's Exhibit 3, Attachment DML-11, which contained the complete question and answer to the discovery question the Public relied upon as its basis for the adjustment:

Q-51: Please describe any and all internal audits, review, cost/benefit analyses, assessments or evaluations ('audits') of any aspect of Petitioner's operations performed in the last three years. Also, please state who performed the audit, the length of the document and whether the audit is complete.

Response: .... Without waiver of its objections, Indiana-American states that it has no internal audits for the referenced period. Indiana-American further states that it prepared comprehensive planning studies during the referenced period. Such studies were prepared under the supervision of Alan J. DeBoy. Copies of the comprehensive planning studies will be made available for inspection at its corporate office.

We note that this data request by the OUCC was not just a request for the internal audits that had been performed. Certainly, Mr. Wolf's rebuttal on this subject claims that the affiliated company's Internal Audit division performed audit tests for Indiana-American and a review of Indiana-American's corporate-wide Information Technology Services processes and procedures.

However, despite being clearly within the scope of the OUCC's request, no reference to, or documentation of these 'internal audits, review, cost/benefit analyses, assessments or evaluations' was provided to the OUCC. Indeed, beyond Mr. Wolf's passing assertion of their existence in his rebuttal testimony, there is no documentation whatsoever of these activities in the record of this case. (Petitioner's Exhibit WJW-R, p. 2, lines 16-21.)

We note that under the Commission's procedural rules, discovery is designed to be self-executing, and parties should be able to rely on the completeness of other parties' responses. (See, 170 IAC § 1-1.1-16 (2000).) Furthermore, Indiana courts have addressed the issue of inferences that may be drawn from a party's failure to provide evidence within that party's exclusive control, as follows:

In Indiana, the exclusive possession of facts or evidence by a party, coupled with the suppression of the facts or evidence by that party, may result in an inference that the production of the evidence would be against the interest of the party which suppresses it .... The rule not only applies when a party actively endeavors to prevent disclosure of facts, but also when the party 'merely fails to produce available evidence.'

Porter v. Irvin's Interstate Brick & Block Co., Inc., 691 N.E.2d 1363, 1364-65 (Ind. Ct. App. 1998)(quoting Morris v. Buchanan, 220 Ind. 510, 44 N.E.2d 166, 169

(1942)).

Clearly, Petitioner's records are within Petitioner's exclusive control. Furthermore, OUCC witness Lynn appropriately raised questions regarding the purposes for which Petitioner was billed by its affiliate's Internal Audit division. Therefore, without documentation of these management fees Petitioner paid to its affiliate's Internal Audit division, we may infer that these fees are properly counted as expenses in the provisioning of utility service. Consequently, we find that Petitioner should reduce its test year management fees by $56,572 for its affiliates Internal Audit Division.

We will incorporate this reduction into Petitioner's adjustment for management fees in Section XI. B. 16.

10. Employee Investment Plan

[82] OUCC's Position. OUCC witness Judith Gemmecke challenged the amount of Petitioner's adjustment for 401(k) expense, the Employee Investment Plan ('EIP ') and temporary employment services. (Public's Exhibit 1, p. 22, lines 2-17.) Ms. Gemmecke objected to the inclusion of the EIP in rates because the Internal Revenue Service had not issued a determination letter qualifying the contributions to the plan as deductible for tax purposes and, if the plan is found not to be deductible, the company will be able to recover all contributions made. (Id. at lines 10-13.) Consequently, Ms. Gemmecke asserted the EIP expense was not fixed in time or known to occur because the company may be able to reclaim the money put into the EIP accounts. (Id. at lines 14-16.)

Petitioner's Rebuttal. Mr. Cutshaw disagreed with Ms. Gemmecke, testifying that Petitioner's contributions to the EIP are fixed, known and measurable. (Petitioner's Exhibit JLC-R, p. 17, line 16 through p. 18, line 6.) Mr. Cutshaw testified that delays in obtaining a determination from the Internal Revenue Service are not uncommon and attached Petitioner's Exhibit JLC-R7, a copy of a letter from Petitioner's law firm opining that the EIP qualifies for special tax treatment, to his testimony. (Id. at lines 20-23.) Mr. Cutshaw noted that the EIP replaced Petitioner's Employee Stock Ownership Plan ('ESOP') which has been included in Petitioner's recoverable expenses for many years. (Id. at p. 17, line 23 through p. 18, line 1.) Although the tax deductibility of the contributions is not yet resolved, Mr. Cutshaw argued that Petitioner has made and continues to make contributions to the EIP and that these payments are fixed, known and measurable. (Id. at p. 18, lines 1-6.)

Commission Discussion and Findings. We have previously noted that '[t]his Commission is bound in making adjustments to a standard that those adjustments must be sufficiently fixed, known and measurable, and therefore likely to occur, for ratemaking purposes.' (Indiana Gas Company, Inc., Cause No. 38080, 86 PUR4th 241, 255 (IURC September 18, 1987).) Ms. Gemmecke's challenge to Petitioner's contributions to the EIP is not that those contributions cannot be determined with sufficient specificity, but instead goes to the likelihood of the expenses' occurrence. While the IRS may not yet have determined that the EIP will qualify for tax benefits, Petitioner has established that it is likely that the plan will receive a favorable ruling from the IRS. We therefore reject the OUCC's proposal to remove the cost of Petitioner's contributions to the EIP from its expenses.

11. Maintenance Expenses

[83, 84] Petitioner's Position. Petitioner's witness Tapp proposed an adjustment for certain maintenance items to be completed during the twelve-month adjustment period. He itemized each of the maintenance efforts, which included:

(1) Southern Indiana: well cleaning, parking lot sealing, chlorine maintenance, easement maintenance and printing;

(2) Richmond: parking lot sealing and valve maintenance and repairs;

(3) Seymour: painting and sector cleaning;

(4) Shelbyville: residuals removal and painting;

(5) Wabash Valley: well cleaning and generator maintenance; and

(6) Warsaw: well cleaning

The total proposed adjustment is $270,100.

OUCC's Position. OUCC witness Stull excluded all of the proposed pro forma adjustments from Petitioner's maintenance expenses. (Public's Exhibit 2, p. 19, lines 21-23.) Ms. Stull testified that these additional costs were requested in addition to the test year maintenance expense ($2,620,679), but the Petitioner did not adequately support the need for this amount with schedules or work papers. (Id. at p. 21, lines 8-11.)

Petitioner's Rebuttal. In rebuttal, Petitioner's witness Cole disagreed with the Public's proposal to exclude all pro forma adjustments to the Company's maintenance expenses. He explained that a decision was made to reduce the Company's maintenance in 2003 by more than $300,000 in the areas of well cleaning, residuals removal and other areas. He explained that this was done because the maintenance could be briefly delayed without impacting water quality and because the Company was anticipating budgetary constraints. (Petitioner's Exhibit DDC-R, p. 10, lines 15-17.) Mr. Cole further explained that continued delivery of water supply and delivery of service requires the reinstatement of maintenance that was curtailed in 2003. For example, the well cleaning, included in the $270,000 adjustment, commenced in March 2004 and will be completed in May 2004 in preparation for upcoming water demands in Summer 2004. All of the other delayed maintenance will be completed during the adjustment period. (Id. at p. 10, line 18 through p. 11, line 2.)

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Commission Discussion and Findings. We find that the OUCC's proposal to omit all adjustments to the Petitioner's maintenance expense should be rejected. The Petitioner has sufficiently explained why the test year maintenance expenses were reduced in 2003 and why it is necessary to reinstate maintenance expenses that have been curtailed. We further find that these expenses are required for the Petitioner's continuous provision of quality service to Indiana customers and that this amount should not be excluded.

12. Regulatory Expenses

[85] Petitioner's Position. Petitioner proposed to amortize its estimated regulatory expense over a thirty-month period, resulting in a proposed adjustment to increase the test year level by $65,268. (Petitioner's Exhibit JLC-3, Sched. 3.)

OUCC's Position. The OUCC agreed with Petitioner's thirty-month amortization period but proposed an adjustment to increase test year regulatory expenses by only $51,268. (Public's Exhibit 2, p. 10, lines 21-22.)

OUCC witness Stull evaluated the support provided by Petitioner for the various types of estimated regulatory expenses it was proposing, including legal fees and consultant fees for a cost of capital study and a cost of service study. Ms. Stull determined that the support provided was reasonable and agreed with Petitioner's estimated costs for these expenses. However, Petitioner did not provide any support for its estimates of customer notification costs and other miscellaneous expenses. Consequently, Ms. Stull compared Petitioner's estimates in this case to costs incurred in its prior rate case and determined that customer notification expenses appeared reasonable but that other miscellaneous expenses did not. (Id. at lines 17- 20.) Ms. Stull requested, through an on-site data request, further details regarding Petitioner's estimate of other miscellaneous costs but she received no response. (Id. at lines 11-17.) Based upon the limited information available to the OUCC, Ms. Stull recommended that Petitioner's miscellaneous regulatory expense be reduced from $45,000 to $10,000, the level of expenses incurred in Petitioner's prior rate case for this category of costs. (Id. at lines 9-11.)

Petitioner's Rebuttal. Petitioner claimed that the miscellaneous expense estimate of $45,000 was reasonable. (Petitioner's Exhibit JLC-R, p. 15, lines 10-24.) In fact, Mr. Cutshaw alleged that the costs incurred as of the time his rebuttal testimony was filed had actually exceeded Petitioner's original estimate by $12,000. (Id. at p. 16, lines 1-3.) Mr. Cutshaw also provided the support for the expenses included in this category as Petitioner's Exhibit JLC-R5 and explained the costs that had been incurred. The explanation Mr. Cutshaw offered as to why the supporting information for other miscellaneous regulatory expense was not provided to the OUCC was that the request was overlooked.

Mr. Cutshaw further claimed that total estimated regulatory expense had increased. The costs for customer notification had increased by $24,000 from the previous estimate. Further, he claimed that Petitioner had not originally

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anticipated retaining Mr. Van den Berg to testify and that the cost of service study and associated discovery were underestimated by approximately $12,500. Mr. Cutshaw did not discuss the status of expenditures related to legal costs or the cost of capital study.

Commission Discussion and Findings. It appears that some of the documents supporting Petitioner's miscellaneous regulatory expenses were not provided until its rebuttal evidence was filed. We are, again, concerned with Petitioner's lack of responsiveness to the OUCC. Nonetheless, we accept Petitioner's proposed pro forma regulatory expense as requested in its case-in-chief but do not accept the increased costs presented in Petitioner's rebuttal testimony. These expenses should have been presented in Petitioner's case-in-chief. Because they were not, the OUCC and Intervenors were not given adequate opportunity to review these additional costs. Further, no update was provided for legal costs, which is a substantial portion of the overall costs, or for the cost of capital study.

While Petitioner has presented evidence that certain categories of expense have increased in the intervening period between the filing of Petitioner's direct and rebuttal testimonies, we have only estimates as to the remaining expenses. Consequently, we have insufficient evidence to determine with any degree of certainty that the overall level of regulatory expense has increased. Consequently, we find Petitioner's test year regulatory expense adjustment should be limited to the amount requested in Petitioner's case-in-chief, $65,268.

13. General Office Expenses

[86] OUCC's Position. The OUCC proposed an adjustment to reduce Petitioner's general office expense by $54,907, by removing the amortization of a prior period short-term line-of-credit fee which did not appear to be a recurring expense. (Public's Exhibit 2, p. 23, lines 3-9.) The OUCC also proposed to eliminate from this category of expense $4,146 for a meter restocking fee which it believed was not reasonably necessary. (Id. at lines 10-14.)

Petitioner's Rebuttal. Petitioner accepted the disallowance of the meter restocking fee but submitted evidence that the short-term line-of-credit fee was recurring. Petitioner's witness Wolf alleged that the fee is incurred on an annual basis to maintain a syndicated line-of-credit used to provide short-term financing for Petitioner's borrowing needs. Mr. Wolf testified that the fee was incurred and paid in August 2003 to continue the line of credit. (Petitioner's Exhibit WJW-R, p. 17, lines 5-15.)

Commission Discussion and Findings. The basis for the OUCC's proposed adjustment to general office expense was that the fee attributable to short-term debt expense was nonrecurring. Petitioner provided testimony demonstrating that this fee was in fact recurring. Based on Petitioner's testimony, we find that the OUCC's proposed adjustment to remove $54,907 of short term debt fees should be rejected.

14. Taxes

a) Property Tax

[87] Originally there was considerable disagreement by Intervenor Schererville with the calculation of pro forma property taxes. Petitioner originally proposed an adjustment to increase test year expense by $2,466,662. (Petitioner's Exhibit WJW-1-U, Sched. 4.) This amount was calculated using the most recent assessed values and most recent property tax rates available. Intervenor witness Sommer opposed the adjustment because he believed the effect of the recent statewide reassessment would produce significantly lower property tax rates in the Northwest district. By the time of the final hearing, updated property tax rates were available for all counties where Petitioner has taxable property with the exception of Clark County. With the new rates, Petitioner recomputed its pro forma property taxes and reduced the proposed adjustment by $2,302,851. (Petitioner's Exhibit WJW-1-L, Sched. 2.) We approve the Petitioner's adjustment as no party opposed the recalculated pro forma property taxes.

b) Utility Receipts Tax

[88] Petitioner and the OUCC made an adjustment for utility receipts tax based upon their respective calculations of pro forma revenues. However, OUCC witness Gemmecke reduced taxable receipts by the amount of pro forma wholesale sales. On rebuttal, Petitioner's witness Cutshaw agreed with Ms. Gemmecke's exclusion of such revenue from the calculation. The Commission is in agreement with this calculation methodology and has applied the same in determining the utility receipts tax.

c) Income Tax

[89] OUCC's Position. The OUCC proposed one adjustment to Petitioner's method of calculating state income taxes. Ms. Gemmecke has deducted parent company interest as well as synchronized interest as tax-deductible interest expense. She states that interest expense is a proper business deduction to both federal and state taxable income. Indiana state tax begins with federal taxable income, which includes the deduction for interest expense.

Petitioner's Rebuttal. Petitioner opposed Ms. Gemmecke's proposal to treat any parent company interest expense as tax deductible for state income tax purposes. (Petitioner's Exhibit WJW-R, p. 25, lines 6-10 and lines 18-22.) As explained by Mr. Wolf, the allocation to Petitioner of a share of its of parent company interest expense in the federal income tax calculation was made in accordance with the procedure set forth in the Commission's Supplemental Order On Remand dated September 16, 1981, in Muncie Water Works Company, Cause No. 34571. (Id. at lines 10-18.) As explained in that Order, the parent company interest allocation is intended to reflect for ratemaking purposes the benefits of Petitioner joining in a consolidated federal income tax return. For this reason, the Order in Cause No. 34571 did not allocate parent company interest in the state income tax calculation. (Id. at lines 18-20.) Mr. Wolf testified that Petitioner does not file a consolidated state income tax return and, therefore, derives no benefits from the parent company interest. (Id. at lines 18-22.)

Commission Findings. We accept Petitioner's methodology to calculate pro forma state income taxes. The OUCC's proposal to deduct parent company interest in the state income tax calculation is rejected. We rejected this same proposal from the OUCC in our Supplemental Order on Rehearing in Cause No. 38880. (Ind.- Am. Water Co., Cause No. 38880 (Indiana Utility Regulatory Commission, Date Issued Nov. 28, 1990).) We noted in that Order that 'the Commission's calculation of state income taxes in the [34571] Order did not treat the parent company interest as tax deductible for state income tax purposes.' (Id. at p. 7.) This conclusion is likewise valid in this proceeding because Petitioner does not file a consolidated state income tax return.

15. GIS Expenses

[90] OUCC's Position. Ms. Stull proposed to reduce miscellaneous expense by $40,180 to remove the accrual of costs for 'GIS' services. (Public's Exhibit 2, p. 28, lines 14-16.) Ms. Stull also indicated that Petitioner accrued $50,000 for GIS services during the test year but had reversed $9,820 of this accrual in March 2003. (Id. at lines 19-22.) Ms. Stull concluded that the remaining $40,180 accrued for GIS services was either not necessary for the test year or should have also been reversed and that miscellaneous expense was, therefore, over-stated. (Id. at p. 28, line 19 through p. 29, line 2.)

Petitioner's Rebuttal. Mr. Wolf testified that it would be inappropriate to remove the accruals recorded to miscellaneous expense for GIS services. Mr. Wolf explained that Ms. Stull incorrectly assumed that Petitioner's reversal of a portion of these costs meant that the remaining amount should be disallowed. Mr. Wolf testified that the partial reversal was a result of a change in Petitioner's accounting for this expense. Petitioner has historically handled these expenses by first accruing them to a liability account and then processing invoices against the accrual. (Petitioner's Exhibit WJW-R, p. 18, lines 20-22.) Mr. Wolf testified that Petitioner ceased accruing the cost in March 2003 and reflected this change by adjusting the liability account to zero and crediting $9,820 to expense. (Id. at p. 18, line 23 through p. 19, line 4.) Mr. Wolf stated that the Petitioner had actually incurred $73,573 in expenses to this contractor, but had only booked $47,190 as a result of this accounting change. (Id. at p. 19, lines 4-6.)

Commission Discussion and Findings. According to the testimony of Mr. Wolf, the accrual process was streamlined during the test year and this accrual does, in fact, represent actual expenses incurred by Petitioner. Petitioner has explained the changes and demonstrated that these costs are not being counted twice. Consequently, we disallow the OUCC's adjustment.

16. Management Fees

[91] Petitioner's Position. Petitioner proposes to increase management fees from test year amounts of $5,361,157 to a pro forma amount of $10,130,448. This

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increase consists of a 4% increase in the labor portion of management fees, the annualized cost of a Vice President of Finance position plus a shifting of costs from direct expenses and of certain Indiana-American corporate personnel.

OUCC's Position. We previously accepted the OUCC's adjustment to eliminate $56,572 of charges for internal audits which were not performed. (See, Sect. XI. B. 9. Internal Audits.) This expense is an allocation from AWWSC. Ms. Stull made additional adjustments for non-recurring expenses related to a cancellation fee and a legal settlement. Ms. Stull also eliminated certain costs that the OUCC alleges provide no material benefit to ratepayers, including investor relations, lobbying costs, charitable contributions and a public relations contract. In addition, she made an adjustment for a three-year maintenance agreement which was fully expensed within the test year. Ms. Stull had concerns regarding management fees, stating she could only conduct a limited review and that information was difficult and time-consuming to obtain. Ms. Gemmecke confirmed that source documents for management fees were not as forthcoming as desired. In addition, she remarked that office rental expense, which is being shifted from a direct corporate expense to a management fee expense, is for excessive space. She also made adjustments for the elimination of incentive pay (paid through management fees). Finally, Ms. Gemmecke made adjustments to labor and benefits expenses which have an impact on the dollar amounts being shifted to management fees. Mr. Pettijohn, while not proposing an adjustment, commented on the amount of research and development charges which were being allocated to Indiana-American through management fees.

Petitioner's Rebuttal. Petitioner agreed to part of Ms. Stull's adjustment for lobbying expense, but also disagreed in part. Petitioner's witness, Mr. Wolf voiced his disagreement with the disallowance of $13,894 from the Corporate Communications Department, as this department helps prepare press releases and speeches. (Petitioner's Exhibit WJW-R, p. 4.) Mr. Wolf also categorizes the research and development charges as the American Water System Research Program and membership in AWWARF.

Commission Discussion and Findings. Petitioner is slowly moving its direct expenses to its service company where costs for all its affiliates are accumulated and then allocated as management fees. AWWSC is the hub of all accounting, administration, engineering, financing and customer service functions and most management functions. The only direct management salaries are those in the positions of management for each water treatment/delivery system. In addition, the AWWSC acts as a flow-through entity for charges from the Belleville Lab and the Customer Satisfaction Center.

Petitioner disputes neither the OUCC's elimination of charitable contributions, investor relations or certain lobbying expenses, nor the adjustments for non-recurring items or the maintenance agreement contract. Petitioner goes to great lengths describing the benefits of the Corporate Communications Department, but the OUCC has not eliminated the costs of this department; instead it has eliminated the costs related to a particular vendor that provides public relations services for Petitioner. Petitioner provided no evidence in rebuttal to show that this vendor's activities provided any material benefit to ratepayers, so we find that these costs should be eliminated.

Petitioner also discussed at length the benefits of the government affairs department. The standard for including these types of expenses in rates has been whether the expenditures provide a specific, material benefit to the ratepayers. Petitioner has failed to demonstrate any such benefit, so we find that these costs should be eliminated.

As a result, total management fees allowable in rates equals $8,992,386.

17. Other Expenses

[92-96] Petitioner's Position. Petitioner includes several adjustments under this heading. Adjustments to test year expense included the labor-related costs of the 401(k) and Employee Investment Plan (see, Sect. XI. B. 10.), the 'Call Before You Dig' program, the write-off of deferred expenses from the Shared Services Initiative and an increase of security expenses. Petitioner filed supplemental testimony on February 20, 2004, to reflect the determination in our December 30, 2003 Order on security costs in Cause No. 42029. The adjustment for security expense will be discussed separately below. (See, Sect. XI. B. 18.) Petitioner then shifts some of the miscellaneous expenses to management fees.

OUCC's Position. OUCC witness Gemmecke challenged the amount of Petitioner's adjustment for 401(k) expense, the EIP and temporary employment services. The amount of 401(k) expense is tied to the pro forma labor expense recommended by the OUCC in this Cause. Ms. Gemmecke makes an additional adjustment to eliminate temporary employment services which were included in the test year. This was done because full-employment was allowed in labor expense.

OUCC witness, Margaret Stull agreed with Petitioner's adjustment removing a one time write-off of costs associated with the Shared Services Initiative. She also agreed with the adjustment to annualize costs associated with the 'Call Before You Dig' program. Ms. Stull made additional reductions to test year miscellaneous expense for charitable contributions, advertising costs, community relations expense and lobbying expenses. Ms. Stull provided a detailed listing of items included in her adjustments. Corrected testimony was submitted by Ms. Stull on April 15, 2004, wherein she adjusted her advertising expense reductions in light of Petitioner's rebuttal testimony on this subject. In addition, Ms. Stull made adjustments to reverse accrued expenses recorded during the test year where no actual expenses were recorded to off-set these reserves during the test year. The adjustment to reverse GIS contract services is discussed under Operating Expenses, GIS Expense. (See, Sect. XI. B. 15.) The OUCC agreed with the shifting of costs from Indiana-American's miscellaneous expense to management fees, however, due to some of the adjustments indicated above, the amount of reduction to miscellaneous expense varies from that proposed by Petitioner.

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Petitioner's Rebuttal. Mr. Wolf discusses the miscellaneous expense adjustments of advertising expense, accrued expense and lobbying expense. He does not agree with the full amount of Ms. Stull's exclusion of advertising cost. He states that part of the $54,508 in advertising expenses that Ms. Stull reduced in test year level of expense did provide a benefit to the ratepayers. He indicated that $7,691 of cost was incurred for hydrant flushing notification and $17,809 was incurred for employment classified ads. Later in his rebuttal testimony he states his belief that lobbying expense provides a material benefit to the ratepayer.

Commission Discussion and Findings. There are a variety of issues which have been placed in 'Other Expenses.' We will discuss each adjustment that was contested by either party.

401(k) Expense. Both Petitioner and the OUCC propose an increase in 401(k) expenses. This expense is directly tied to the findings under labor expense. Consistent with the findings in labor expense, we now find the increase to test year 401(k) expense to be $45,403, and the amount of costs shifted to management fees is $2,600 for customer service associates and $19,063 for Indiana-American corporate employees who will be employees of AWWSC on a pro forma basis.

Advertising. While Mr. Wolf did not detail which invoices he believed had a benefit to ratepayers, he did testify as to amounts for hydrant flushing notification and employment advertising, thus leaving $29,008 which Petitioner did not contest removing from test year expenses to obtain a pro forma amount of advertising expense. The OUCC corrected its testimony and schedules to reflect the same. The Commission now finds test year advertising to be overstated by $29,008 for pro forma expense.

Charitable Contributions. The OUCC proposed adjusting test year expenses to eliminate charitable contributions for ratemaking purposes. This adjustment was unopposed by Petitioner. Consequently, the Commission accepts the OUCC's adjustment.

Community Relations. The OUCC proposed adjusting test year expenses to eliminate items related to Community Relations. This adjustment was unopposed by Petitioner. Consequently, the Commission accepts the OUCC's adjustment.

Lobbying Expense. The OUCC proposed the removal of lobbying expenses from Operations and Maintenance expenses for ratemaking purposes. Petitioner opposed the removal, stating that some of the expense was for the lobbying efforts of a membership trade association. As we have found in previous orders for this company, lobbying expenses are not includable in rates unless they can be found to have a specific, material benefit to the ratepayers which can be expected to occur during the period in which the rates being considered are applied. Petitioner did not provide evidence regarding any specific, material benefit to ratepayers and, therefore, the Commission finds the OUCC's adjustment should be approved.

Accrual Reversals. The OUCC has proposed excluding amounts recorded on

Petitioner's books from the accrual of customer survey costs. Petitioner did not rebut this adjustment. Consequently, the Commission finds the OUCC's adjustment relating to the customer survey accrued expense should be approved.

18. Security Costs

[97, 98] Petitioner's Position. Petitioner adjusted test year expenses to include $1,918,070 for security costs. (Petitioner's Exhibit JLC-3-U, Sched. 4.) This amount included annual amortization of deferred security costs in the amount of $572,742 and $1,345,328 of on-going annual expenses. Deferred security costs are being amortized over a five (5) year period. Petitioner's witness Cutshaw testified that these amounts were based upon the Commission's December 30, 2003 Order on Security Costs in Cause No. 42029. (Petitioner's Exhibit JLC-U, p. 5, lines 20-24 through p. 6, lines 1-6.)

OUCC's Position. OUCC witness Margaret Stull asserted that it is not clear from the Order issued in Cause No. 42029 what security costs have been approved by the Commission to be recovered by Petitioner. Due to confidentiality issues, the Order does not provide specifics regarding the composition of the costs approved, what or whether deferred costs can be recovered, or over what period these deferred costs should be recovered. (Public's Exhibit 2, p. 25, lines 14-23.) Since the hearing on this issue in Cause No. 42029, Petitioner's annual costs have decreased steadily from approximately $1.8 million to $1.3 million. In Cause No. 42029, Petitioner requested total annual security costs of $2,454,027, and the Commission approved $2,062,871. If the Commission did not intend for Petitioner to recover all of its current or deferred costs or intended for Petitioner to recover deferred costs over a longer period of time, then Petitioner would be over-recovering these costs based on its current test year adjustment. (Id. at p. 26, lines 9-15.) The OUCC alleged that it did not make an adjustment to Petitioner's pro forma expenses because there was insufficient information on which to base an adjustment, but did ask the Commission for clarification on this issue. (Id. at p. 27, lines 1-5.) The OUCC also expressed concern that, if the Commission has not approved recovery of all of the deferred costs, there is an issue of retroactive ratemaking. (Id. at p. 26, lines 18-22.)

Petitioner's Rebuttal. Mr. Cutshaw maintained that the Commission's Order on Security Costs authorizes it to amortize deferred costs. Mr. Cutshaw based his opinion on the fact that the Order adopted a revenue requirement that was greater than Petitioner's annual current on-going security expenditures identified and because of the language in the Order's first ordering paragraph stating that the revenue requirement is without carrying charges. (Petitioner's Exhibit JLC-R, p. 18, lines 25-29.) Mr. Cutshaw alleged that this language would not be necessary if the Commission was not approving the regulatory asset created by the deferral of security costs incurred prior to the Order. Mr. Cutshaw also argued that allowing amortization of the deferred security costs does not represent retroactive ratemaking if full recovery of these expenses in future revenues is anticipated. (Id. at p. 19, lines 6-13.)

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Commission Discussion and Findings. We first address the retroactive ratemaking issue raised by the Public. Security measures benefit the ratepayers at the time they were expensed and going forward. The Commission hereby clarifies that the amortization of the deferred security expenses over a five (5) year period is authorized consistent with our December 30, 2003 Order in Cause No. 42029.

With regard to Petitioner's proposed level of security expenses in this proceeding, we notice that the annual expense has decreased from $2,062,871 in Cause No. 42029 to the proposed $1,918,070. No other party offered evidence contradicting this amount. We find that the proposed amount is reasonable and should be authorized.

XII. NET OPERATING INCOME AT PRESENT RATES

99, 100] Based upon the evidence and the determinations made above, we find that Petitioner's adjusted operating results under its present rates are as follows:

| | Total Company | Water Groups | Wabash | Total Sewer | Northwest |
|---|---|---|---|---|---|
| Operating Revenue | $139,380,203 | $88,529,107 | $1,865,785 | $294,229 | $40,641,293 |
| O & M Expense | 52,219,786 | 31,763,606 | 923,379 | 278,877 | 15,606,943 |
| Depreciation | 21,748,977 | 15,661,330 | 307,339 | 18,938 | 4,531,314 |
| Amortization | 422,740 | 351,991 | 3,292 | 1,224 | 52,698 |
| Other Taxes | 16,224,846 | 7,852,813 | 154,878 | 14,442 | 7,487,584 |
| State Income Tax | 3,106,091 | 2,126,055 | 29,531 | (2,731) | 789,876 |
| Federal Income Tax | 10,315,740 | 7,078,790 | 91,390 | (12,514) | 2,612,823 |
| Total Operating Expenses | 104,038,180 | 64,834,585 | 1,509,809 | 298,236 | 31,081,238 |
| Net Operating Income | $35,342,023 | $23,694,522 | $355,976 | ($4,007) | $9,560,055 |
| | = | = | = | = | = |

| | Mooresville | Warsaw | West Lafayette | Winchest-er |
|---|---|---|---|---|
| Operating Revenue | $1,564,389 | $2,248,099 | $3,412,019 | $825,284 |
| O & M Expense | 673,334 | 951,508 | 1,621,555 | 400,584 |
| Depreciation | 218,803 | 308,509 | 560,904 | 141,840 |
| Amortization | 2,590 | 2,921 | 6,583 | 1,441 |
| Other Taxes | 132,858 | 178,233 | 325,478 | 78,563 |
| State Income Tax | 36,442 | 56,503 | 58,546 | 11,870 |
| Federal Income Tax | 123,962 | 191,225 | 192,794 | 37,272 |

| | | | | |
|---|---|---|---|---|
| Total Operating Expenses | 1,187,989 | 1,688,899 | 2,765,860 | 671,570 |
| Net Operating Income | $376,400 | $559,200 | $646,159 | $153,714 |
| | = | = | = | = |

In summary, we find that with appropriate adjustments for ratemaking purposes, Petitioner's annual net operating income under its present rates for water and sewer service would be $35,342,023. We have previously found that the fair value of Indiana-American's utility property is approximately $663,400,000, and that 5.38% is a fair rate of return, resulting in a NOI level of $35,669,628. A return of $35,342,023 represents a rate of return of 5.33% on the fair value rate base. Based on the evidence, we find that 5.33% is not a reasonable return and, therefore, we find that Petitioner's present rates are insufficient.

XIII. AUTHORIZED RATE INCREASE

Based on the evidence presented in this proceeding, we find that Petitioner should be authorized to increase its rates and charges to produce additional operating revenue of $564,801, resulting in total annual revenue of $139,945,004. This revenue is reasonably estimated to allow Petitioner the opportunity to earn net operating income of $35,669,628 as follows:

| | Total Company | Water Groups | Wabash | Total Sewer | Northwest |
|---|---|---|---|---|---|
| Operating Revenue | $139,945,004 | $91,061,068 | $1,967,065 | $314,857 | $38,739,937 |
| O & M Expense | 52,224,577 | 31,785,081 | 924,238 | 279,052 | 15,590,817 |
| Depreciation | 21,748,977 | 15,661,330 | 307,339 | 18,938 | 4,531,314 |
| Amortization | 422,740 | 351,991 | 3,292 | 1,224 | 52,698 |
| Other Taxes | 16,233,302 | 7,890,722 | 156,394 | 14,752 | 7,459,117 |
| State Income Tax | 3,153,640 | 2,339,211 | 38,057 | (995) | 629,807 |
| Federal Income Tax | 10,492,142 | 7,869,587 | 123,022 | (6,072) | 2,018,980 |
| 5p Total Operating Expenses | 104,275,376 | 65,897,922 | 1,552,342 | 306,899 | 30,282,733 |
| 5p Net Operating Income | $35,669,628 | $25,163,146 | $414,723 | $7,958 | $8,457,204 |
| | = | = | = | = | = |

| | Mooresville | Warsaw | West Lafayette | Winchest- |
|---|---|---|---|---|

| | | | | er |
|---|---|---|---|---|
| Operating Revenue | $1,503,374 | $2,058,158 | $3,459,305 | $841,254 |
| O & M Expense | 672,816 | 949,897 | 1,621,956 | 400,720 |
| Depreciation | 218,803 | 308,509 | 560,904 | 141,840 |
| Amortization | 2,590 | 2,921 | 6,583 | 1,441 |
| Other Taxes | 131,944 | 175,389 | 326,187 | 78,802 |
| State Income Tax | 31,305 | 40,512 | 62,527 | 13,215 |
| Federal Income Tax | 104,906 | 131,902 | 207,562 | 42,260 |
| 5p | | | | |
| Total Operating Expenses | 1,162,364 | 1,609,130 | 2,785,719 | 678,278 |
| 5p | | | | |
| Net Operating Income | $341,010 | $449,028 | $673,586 | $162,976 |
| | = | = | = | = |

XIV. COST OF SERVICE STUDY AND SINGLE TARIFF PRICING

101-105] Petitioner's Position. Kerry A. Heid, an independent rate consultant, conducted Petitioner's Cost of Service Study ('COSS') using the American Water Works Association's ('AWWA's') Base-Extra Capacity Method to allocate costs of service to customers. Mr. Heid testified that under the Base-Extra Capacity Method, the costs are allocated to cost functions according to the design and operation of the water system: base, extra capacity, customer and direct fire protection costs. Those functionalized costs are then allocated to the different classes of Petitioner's customers according to their usage and demand characteristics. These classes are: residential, commercial, industrial-large, industrial-other, public authority, sales for resale, private fire protection and public fire protection.

As a result of the COSS, Mr. Heid designed rates that recover revenues from each customer class which closely match the cost of providing service to each customer class. Mr. Heid conducted his study on a company-wide basis and not on a regional or district operational basis. Such approach resulted in a unified set of rates for each customer class statewide known as Single Tariff Pricing ('STP'). Petitioner is moving toward this goal of STP in phases, as authorized in our 1997 Rate Order and subsequent Orders. Prior to our 1997 Rate Order, Petitioner had thirteen (13) separate water rate schedules exclusive of the later acquired Northwest, United Water and other smaller systems. The Wabash district was excluded from the STP movement for a period of five (5) years, which expired in this proceeding. The original United Water system consisted of four (4) separate rate schedules. In this proceeding, Petitioner is proposing two (2) water groups in addition to Wabash, Northwest and United Water. Petitioner proposed to move the

**(Publication page references are not available for this document.)**

Wabash, Northwest and United systems closer toward STP in this proceeding.

OUCC's Position. In testifying for the Public regarding Petitioner's COSS, Scott Bell recommended that Petitioner:

(1) allocate the 'Capitalized Tank Painting' by Allocation Factor 4 rather than allocation Factor 9 to be consistent with the allocation of 'Distribution Reservoirs and Standpipes.' Similarly, he recommended that 'Accumulated Amortization-Tank Painting' be allocated by Allocation Factor No. 4.

(2) use capacity factors for Maximum Day and Maximum Hour for the residential customer class of 250 and 325 respectively, instead of 275 and 350 as proposed by Mr. Heid.

(3) correct the Equivalent Hydrant Ratios that were used to calculate the Equivalent Hydrant Units in its next COSS. (Public's Exhibit 8, p. 16.)

Intervenor's Position. Ernest Harwig, a consultant in the field of public utility regulation, testified on behalf of the Industrial Group. Mr. Harwig differed with Mr. Heid on the classification of two (2) items with respect to the Northwest District: reservoir costs and purchased power expenses. Mr. Harwig recommended that the reservoir costs are more appropriately classified as Maximum Day Extra Capacity costs and that all purchased power expenses should be classified as Maximum Day and Maximum Hour Extra Capacity costs. Mr. Harwig argued that if the total volume of a particular source of supply is the only factor to be considered then all source of supply would be classified with the Base-only factor. Hence, the Base-Maximum Day classification is more appropriate and accurate.

With respect to the reservoir costs, Mr. Harwig opined that sources of supply are capable of meeting both total annual volume and Maximum Day Demands. As for the power expenses, Mr. Harwig asserted that pumps must have adequate capacity and be in sufficient number to deliver water during peak periods as well during non-peak periods. With respect to these two items, Mr. Harwig suggested that Mr. Heid use the Maximum Hour-All Allocation Factor No. 4 rather than the Base-only factor.

Mr. Harwig finally recommended that, if Petitioner is granted the rate increase it seeks, the Commission should approve Petitioner's single tariff rates for the Northwest District and not phased-in rates, since the Northwest District was impacted the most by the most recent rate increase in Cause No. 42029 and those customers have not yet benefited from STP.

Petitioner's Rebuttal. In his rebuttal testimony, Mr. Heid accepted all of Mr. Bell's recommendations except for one recommended modification to the Equivalent Hydrant Ratio. Mr. Heid testified that Petitioner would agree to change the Equivalent Hydrant Ratio in its next COSS as recommended by Mr. Bell unless Petitioner can demonstrate that such a change would not be in the public interest. If such a demonstration can be made, Mr. Heid suggested that the Company retain the flexibility needed to implement the correct factors in a phased, or other, approach.

With regard to Mr. Harwig's testimony on behalf of the Industrial Group, Mr. Heid did not accept Mr. Harwig's recommendations and explained that following such recommendations would result in more costs being allocated to residential customers and fewer costs allocated to industrial customers. In refuting Mr. Harwig's arguments, Mr. Heid testified that the primary criterion in designing reservoirs is the total volume, which is affected by the surface area of the reservoir, watershed drainage area and expected rainfall. Mr. Heid asserted that none of these factors is related to the Maximum Day Demands, and the reservoir is capable of meeting maximum day demands only because of its total volume. Mr. Heid clarified, however, that reservoir intake structures are designed to handle maximum day flows and that he classified those in his Study on Maximum Day Extra Capacity costs.

Mr. Heid also disagreed with Mr. Harwig's suggestion that all purchased power costs should be classified as Maximum Day or Maximum Hour Extra Capacity. (Petitioner's Exhibit KAH-R, p. 10.) However, Mr. Heid did not reject the idea that it may be appropriate for part of such expenses to be allocated as Maximum Day or Maximum Hour Extra Capacity. Mr. Heid also noted that, in responding to Data Request Question No. 5(a), Mr. Harwig acknowledged that he only reviewed the tariffs of three (3) of the seventeen (17) electric utilities that serve Indiana-American. (See Petitioner's Exhibit KAH-R2.) Mr. Heid observed that Mr. Harwig, therefore, did not quantify the amount of Indiana-American's electric power costs that were actually billed pursuant to demand charges.

Commission Discussion and Findings. We have previously authorized Petitioner to move toward STP. While we affirm herein the benefits to be derived from STP, we also note that we examine the Company's approach in each case based on the evidence that supports the proposed move toward common rates. Accordingly, our original STP authorization does not constitute an automatic approval of every proposal to move further toward common rates.

In the current case, Petitioner has proposed further movement toward STP for its existing rate groups and has also initiated the process of aligning the rate structures of the above mentioned operations acquired following the 1999 rate case with the rate structures of the existing groups. Because the Wabash, Northwest, Mooresville, Warsaw, West Lafayette, and Winchester operations had not formerly been included in the derivation of the STP rates, it was necessary to establish several new rate groups. The addition of these new districts into the STP calculation also created some disparate results within some of the existing rate groups, with some groups moving closer toward STP rate levels while other groups moved away from STP rate levels. Such results are not unexpected given the relative significance of the six (6) districts that have been added. In Petitioner's next general rate proceeding we anticipate that all groups will make a consistent move toward STP. No party filed testimony opposing Petitioner's rate design proposals. Therefore, we approve the Petitioner's proposed rate design, subject to our revenue requirement findings.

Except for the Equivalent Hydrant Ratio issue, Mr. Heid accepted all of the Public's recommendations. We accept Mr. Heid's suggestion regarding the Equivalent Hydrant Ratio. As to the concern expressed by Mr. Harwig with respect to the reservoir costs allocation, we find that Mr. Harwig did not demonstrate how a reservoir designed to meet the total volume sales would fail to meet Maximum Day Demand according to the criteria described by Mr. Heid. We agree with Mr. Heid that the reservoir intake structures must be classified as Maximum Day Extra Capacity costs since these structures handle the transmission of the Peak Demand from the reservoir to the customers.

Concerning the purchased power expenses argument, we note that Mr. Heid, at least theoretically, did not reject the possibility that at least part of this expense could be classified as Maximum Day or Maximum Hour Capacity costs. However, no evidence has been provided by Mr. Harwig quantifying what, if any, amount should be allocated to the Maximum Day or Maximum Hour costs. Therefore, we find that Mr. Heid's allocation should be accepted.

Therefore, in this Cause, we find that Petitioner's COSS is sound. Petitioner's use of the Base-Extra Capacity method is consistent with previous Cost of Service Studies conducted by Indiana-American and has been accepted by this Commission in past proceedings. Where appropriate, Petitioner has followed the methodology as found in the AWWA manual.

XV. DEPRECIATION STUDY

OUCC's Position. Harold L. Rees, Principal Utility Analyst for the OUCC, testified that Petitioner:

(1) conducted its last full book depreciation study with data ending December 31, 1995;

(2) has experienced substantial growth in its plant including the purchase of several utility properties resulting in the depreciable plant being tripled since the last study; and

(3) has made many substantial additions of new technology plant, which would increase the remaining lives of certain facilities. (Public's Exhibit No. 7, pp. 3-4.)

Mr. Rees recommended that Petitioner:

(1) prepare a new depreciation study to be filed in a separate procedure prior to filing its next rate case;

(2) use the depreciation rates previously authorized if the addition of depreciable plant is no more than $10 million from acquisitions; and

(3) within thirty (30) days of this Order, file with the Commission and the

**(Publication page references are not available for this document.)**

OUCC, a report on whether it is maintaining in its records the type of plant data needed for an equal life group ('ELG') depreciation study. (Id. at p. 15.)

Petitioner's Position. James Cutshaw testified that Petitioner is not opposed to preparing a new depreciation study. However, Mr. Cutshaw expressed concern about the time frame suggested by the Public, citing that this would restrain Petitioner's ability to file a new rate case prior to completing the depreciation study. Mr. Cutshaw pointed to the substantial growth in Petitioner's plant due to recent acquisitions which, because of the detailed and costly record keeping needed for ELG studies, would require even more resources and time devoted to classifying and reviewing data in preparing the study.

Mr. Cutshaw also disagreed with the limitations on depreciation rates for plants under $10 million added by future acquisitions. Mr. Cutshaw opined that the Commission should continue to follow its past and current practice of setting depreciation rates based on the outcome of reviewing depreciation studies. Also, Mr. Cutshaw did not accept Mr. Rees' final recommendation that Petitioner file a report within thirty (30) days, detailing its ability to file an ELG study.

106, 107] Commission Discussion and Findings. Both Petitioner and the Public agree as to the need for a new depreciation rates study. We find it reasonable that Petitioner should file a depreciation case prior to filing its next rate case, and that such depreciation case be filed reasonably far enough in advance of the next rate case to allow updated and approved depreciation rates to be used in the next rate case. In addition, Petitioner should, within thirty (30) days of the date of this Order, file a report stating whether it is maintaining the detail to support the ELG method, but no other demonstration need be made at this time. We also find it is inappropriate to issue a blanket order regarding depreciation rates in future acquisitions and will continue to address this issue as a part of such acquisitions on a case-by-case basis.. Both Petitioner and the Public agree as to the need for a new depreciation rates study. We find it reasonable that Petitioner should file a depreciation case prior to filing its next rate case, and that such depreciation case be filed reasonably far enough in advance of the next rate case to allow updated and approved depreciation rates to be used in the next rate case. In addition, Petitioner should, within thirty (30) days of the date of this Order, file a report stating whether it is maintaining the detail to support the ELG method, but no other demonstration need be made at this time. We also find it is inappropriate to issue a blanket order regarding depreciation rates in future acquisitions and will continue to address this issue as a part of such acquisitions on a case-by-case basis.

XVI. COMMISSION ORDER

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

1. Indiana-American Water Co., Inc. is hereby authorized to adjust and increase its rates and charges for water and sewer utility service by approximately 0.4% in accordance with the Findings herein, which rates and charges shall be designed to

produce total annual operating revenues of $139,945,004 which, after annual operating expenses of $104,275,376, are expected to result in annual net operating income of $35,669,628.

2. Petitioner shall file new schedules of rates and charges with the Gas/Water/Sewer Division of the Commission on the basis set forth in Finding No. XIII of this Order. Such new schedules of rates and charges shall be effective upon filing and approval by the Gas/Water/Sewer Division and shall apply to water and sewer usage from and after the date of approval.

3. Petitioner shall file a depreciation case and ELG report in accordance with our determinations in Finding No. XV of this Order.

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

APPROVED: **NOV. 18, 2004**

FOOTNOTES

FN1 Petitioner witness Mr. James L. Cutshaw, a Senior Financial Analyst for Indiana-American, filed supplemental testimony and requested that the Commission approve the return on and of $6,248,821 related to the purchase and development of the E-CIS software. (Petitioner's Exhibit JLC-U, pp. 7-9; Petitioner's Exhibit JLC-UA, line 21, col. 2.) The OUCC recommended that the $6.2 million associated with the E-CIS software be disallowed and removed from rate base and that Petitioner be denied the $282,528 in amortization costs of the $1.3 million deferred asset balance associated with the conversion to the Alton CSC. Finally, the OUCC recommended that the Commission accept its $194,360 downward adjustment to offset the increased O&M costs that are embedded in Petitioner's management fee adjustment for the Customer Satisfaction Center. Given the assertions of the OUCC and the relationship between the Alton CSC and the E-CIS software, we will address both of these items in the Operating Expense section of this Order. (See Sect. XI. B. 5. Operating Results Under Present Rates.)

FN2 The amortization accrued from the time of the acquisition to the issuance of the 1996 Rate Order was deferred so the effective amortization period is 37.25 years, i.e., forty (40) years less the period between the acquisition and the 1996 Rate Order. This is why the amortization expense is $467,436 per year, rather than the amount of $435,300 calculated by Mr. Gassert. (Public's Exhibit 5, p. 5, n. 1.)

FN3 According to the Fama-French model, a firm's book-to-market ratio is a measure of financial distress. Firms with a high book-to-market ratio (a low market-to-book ratio) are financially distressed and require a higher rate of return.

FN4 Dr. Boquist recommended an 11.5% cost of equity in Cause No. 42029 and an 11.25% cost of equity in Cause No. 41320.

**(Publication page references are not available for this document.)**

EDITOR'S APPENDIX

PUR Citations in Text

IND.] Re Indianapolis Water Co., 112 PUR4th 520, Cause No. 38868, May 16, 1990.

IND.] Re Muncie Water Works Co., 44 PUR4th 331, Cause No. 34571, Sept. 16, 1981.

IND.] Re PSI Energy, Inc., 173 PUR4th 393, Cause No. 40003, Sept. 27, 1996.

IND.] Re PSI Energy, Inc., 234 PUR4th 1, Cause No. 42359, May 18, 2004.

IND.Sup.Ct.] Boone County Rural Electric Membership v. Indiana Pub. Service Commission, 239 Ind. 525, 29 PUR3d 409, 159 N.E.2d 121 (1959).

IND.Sup.Ct.] Indiana Pub. Service Commission v. City of Indianapolis, 235 Ind. 70, 12 PUR3d 320, 131 N.E.2d 308 (1956).

U.S.Sup.Ct.] Duquesne Light Co. v. Barasch, 488 U.S. 299, 98 PUR4th 253, 102 L.Ed.2d 646, 109 S.Ct. 60 (1989).

WIS.Sup.Ct.] Oshkosh Waterworks Co. v. Railroad Commission, 161 Wis. 122, P.U.R.1915D 336, 152 N.W. 859 (1915).

END OF DOCUMENT

## FOR PUBLICATION

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## IN THE
## COURT OF APPEALS OF INDIANA

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| | | |
|---|---|---|
| INDIANA-AMERICAN WATER COMPANY, INC., | ) | |
| Appellant-Petitioner, | ) | |
| vs. | ) | No. 93A02-0412-EX-1067 |
| INDIANA OFFICE OF UTILITY CONSUMER COUNSELOR, TOWN OF SCHERERVILLE, INDIANA-AMERICAN INDUSTRIAL GROUP, | ) | |
| Appellees-Statutory Party Intervenors. | ) | |

APPEAL FROM THE INDIANA UTILITY REGULATORY COMMISSION
The Honorable William D. McCarty, Chairman
The Honorable David W. Hadley, The Honorable Larry S. Landis,
The Honorable Judith G. Ripley, The Honorable David E. Ziegner, Commissioners
Cause No. 42520

**March 10, 2006**

**OPINION - FOR PUBLICATION**

**CRONE, Judge**

## Case Summary

Indiana-American Water Company, Inc. ("IAWC"), appeals the order of the Indiana Utility Regulatory Commission ("the Commission") on its petition to increase rates and charges for water and sewer service. We affirm.

## Issues

IAWC raises seven issues, which we reorder and restate as follows:

I. Whether the Commission properly excluded one high-service pump from rate base;

II. Whether the Commission properly excluded most of the cost of a customer information system from rate base;

III. Whether the Commission properly disallowed the cost of relocating IAWC's customer call center from Indiana to Illinois;

IV. Whether the Commission properly disallowed IAWC's Internal Audit Department expenses;

V. Whether the Commission properly disallowed a certain portion of IAWC's pension expense;

VI. Whether the Commission properly calculated the cost of common equity; and

VII. Whether the Commission properly calculated IAWC's federal income tax expense at the existing rates.

## Facts and Procedural History[1]

IAWC is an Indiana corporation regulated by the Commission that provides water utility service to approximately 272,000 customers in twenty-one counties. IAWC is a subsidiary of American Water Works Company, Inc. ("American"). In 2003, American was acquired by Thames Water Aqua Holdings GmbH, a subsidiary of RWE AG, an international multi-utility service provider based in Germany. On September 30, 2003, IAWC petitioned the Commission to increase its rates and charges for water and sewer service. On November 6, 2003, IAWC and the Indiana Office of Utility Consumer Counselor ("OUCC") attended a prehearing conference. The Town of Schererville, Indiana-American Industrial Group

[1] We thank the parties for their well-organized and well-written briefs, which greatly facilitated our review of the Commission's 127-page order and the twenty-two-volume record.

("Industrial Group"), and the Town of Merrillville subsequently intervened.[2] An evidentiary hearing was held on various dates between January and April 2004. On November 18, 2004, the Commission issued an order in which it found that IAWC's rate base was approximately $663,400,000 and that IAWC was entitled to a return of 5.38%. The Commission authorized IAWC to increase its rates and charges by approximately 0.4%, "designed to produce total annual operating revenues of $139,945,004 which, after annual operating expenses of $104,275,376, are expected to result in annual net operating income of $35,669,628." Appellant's App. at 134. IAWC now appeals certain portions of the Commission's order. Additional facts will be provided as necessary.

**Discussion and Decision**

Our review of the Commission's order is two-tiered:

> we inquire if specific findings exist as to all factual determinations material to the ultimate conclusions, and we inquire if substantial evidence exists within the record as a whole to support the Commission's basic findings of fact. When reviewing the Commission's order, we give great deference to its rate making methodology. In determining whether the evidence supports the Commission's decision, we neither reweigh the evidence nor substitute our judgment for that of the Commission. We set aside the Commission's finding of facts only when a review of the whole record clearly indicates that the agency's decision lacks a reasonably sound basis of evidentiary support.
>
> In addition, we inquire to see if the Commission's order is contrary to law, that is, whether the order is the result of considering or failing to consider some factor or element which improperly influenced the final decision. The Commission must remain within its jurisdiction and conform to all relevant statutes, standards and legal principles.

*Lincoln Utils., Inc. v. Office of Util. Consumer Counselor*, 661 N.E.2d 562, 564 (Ind. Ct. App. 1996) (citations omitted), *trans. denied.*

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[2] The Town of Merrillville did not file a brief in this appeal. Unless otherwise indicated, we refer to

## *I. Exclusion of Pump from Rate Base*

"The Commission's primary objective in every rate proceeding is to establish a level of rates and charges sufficient to permit the utility to meet its operating expenses plus a return on investments which will compensate its investors." *City of Evansville v. S. Indiana Gas & Elec. Co.*, 167 Ind. App. 472, 478, 339 N.E.2d 562, 568 (1975). In so doing, the Commission must determine the utility's rate base, which "consists of that utility property employed in providing the public with the service for which rates are charged and constitutes the investment upon which the 'return' is to be earned." *Id.* at 479, 339 N.E.2d at 569. The rate base "is usually defined as that utility property 'used and useful' in rendering the particular utility service." *Id.* (citing Ind. Code § 8-1-2-6).[3] "The Commission's 'used and useful' standard requires: (1) that the utility plant be actually devoted to providing utility service, and (2) that the plant's utilization be reasonably necessary to the provision of utility service." *Id.* at 516, 339 N.E.2d at 589. More specifically, this Court has stated that "[u]nnecessary plant capacity is not used and useful for rate making purposes and should not be included." *L.S. Ayres & Co. v. Indpls. Power & Light Co.*, 169 Ind. App. 652, 683, 351 N.E.2d 814, 834 (1976), *trans. denied.*

In previous rate proceedings, the Commission had included in IAWC's rate base five high-service pumps at its Southern Indiana Operations and Treatment Center ("SIOTC"). In this proceeding, the OUCC proposed that one of those pumps be removed from IAWC's rate

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the remaining appellees either individually or collectively as "Appellees."

[3] *See* Ind. Code § 8-1-2-6(a) ("The commission shall value all property of every public utility actually used and useful for the convenience of the public at its fair value, giving such consideration as it deems appropriate in each case to all bases of valuation which may be presented or which the commission is authorized to consider by the following provisions of this section.").

base as excess capacity. The OUCC presented evidence that pursuant to the Recommended Standards for Waterworks (also known as Ten State Standards), only four "pumps were necessary to meet peak demand with the largest pumping unit out of service." Appellant's App. at 20. On rebuttal, IAWC's Alan J. DeBoy presented evidence that three of the five pumps serve one million-gallon reservoir compartment, and two of the pumps serve another million-gallon reservoir compartment, either of which could be removed from service for maintenance or rehabilitation. DeBoy testified that all five pumps are necessary to ensure that IAWC can meet its peak demand with one of the reservoir compartments out of service. DeBoy acknowledged, however, that the reservoir-isolation technique had "not yet been used but will be needed 'at some point in the future.'" *Id.* at 22.

On this issue, the Commission found as follows:

> The non-contradicted evidence established that [IAWC], with the largest unit out of service, has 15.7 MGD [million gallons per day] more capacity than the required 22 MGD. Since [IAWC's] case to reject the alleged excess capacity is founded on justifying the need to have this reservoir-isolation technique, we thus need to determine whether this feature is used and useful. Mr. DeBoy's testimony on this point is limited to testifying that reservoir maintenance will be needed at some point in the future. We note that this is the first time this specific feature has been brought to our attention and has not been a contested issue in [IAWC's] previous cases. Therefore, we shall make our decision based on the evidence of record that we now have before us. We find that [IAWC] did not provide evidence to support the time frame within which this engineering feature will be used and useful. Further, we find [IAWC's] evidence lacked information that we deem necessary in order to allow this plant[4] in rate base, this information includes but is not limited to:

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[4] IAWC states, "It is not clear whether the Commission's reference to 'plant' means the reservoir, the pumps, or both, but the penalty imposed by the Commission for this lack of evidence was a reduction in the Company's rate base of $753,378, the amount of the OUCC's proposed pump adjustment." Appellant's Br. at 20-21. As such, we think it reasonable to presume that "plant" refers to the fifth pump, not the reservoir compartment it serves.

- the frequency that the reservoir maintenance occurs,
- the amount of time necessary to carry out the maintenance of the reservoir,
- the time of year when [IAWC] plans to carry out the maintenance of the reservoir,
- whether [IAWC] could implement the reservoir maintenance during non-peak months, and
- whether [IAWC] needs five (5) pumps at the SIOTC if the reservoir's maintenance could be implemented during non-peak months.

> We find that [IAWC's] rate base should be reduced by $753,378 for excess capacity at the SIOTC and that the accumulated depreciation should be also reduced by $232,248.

*Id.* at 22-23.

IAWC challenges the Commission's finding of excess capacity, noting that "the OUCC's challenge was to the number of pumps and not the number of reservoir compartments[,]" i.e., the reservoir's two-compartment design. Appellant's Br. at 20.[5] We must decline IAWC's invitation to separate these clearly interrelated issues. It is undisputed that IAWC's asserted need for the fifth pump's capacity is based on the closing of one of the two reservoir compartments for maintenance or rehabilitation, which IAWC's own witness

[5] IAWC does not dispute the Commission's finding that even with the largest pump out of service, it has 15.7 MGD over the required 22 MGD capacity, i.e., an excess capacity of over two-thirds. Neither does it contend that this excess capacity was "reasonably needed over a reasonable planning horizon at the time the plant was constructed[,]" let alone at the present time. Appellant's Br. at 19 (citing *Office of Util. Consumer Counselor v. Pub. Serv. Co.*, 463 N.E.2d 499, 504 (Ind. Ct. App. 1984)).

admitted had not yet been done and would not be done until some unknown future date.[6] Thus, the fifth pump represents unnecessary capacity that is not used and useful for ratemaking purposes.[7] We acknowledge that the Commission's order specifically addresses the use and usefulness of the reservoir's two-compartment design, rather than the fifth pump itself, but in view of their obvious interrelationship, we find this to be a distinction without a substantive difference. The Commission's findings are supported by substantial evidence, and therefore we affirm its exclusion of the fifth pump from IAWC's rate base.

### *II. Exclusion of Cost of Customer Information System from Rate Base*

IAWC sought to include in its rate base the cost of developing and purchasing a computerized customer information system, known as E-CIS, which came online after IAWC moved its customer call center in Richmond, Indiana, to a customer service center ("CSC") in Alton, Illinois. IAWC shares the CSC with other American subsidiaries. We excerpt the Commission's findings relevant to this issue and the next issue, which is closely related:

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[6] Consequently, we reject IAWC's argument that the Commission violated its state and federal procedural due process rights by helpfully identifying evidence regarding reservoir maintenance that IAWC may offer in future cases to establish that the reservoir's two-compartment design (and therefore the fifth pump) is used and useful for ratemaking purposes.

[7] For the first time on appeal, IAWC argues that the "two compartment design is used and useful because it is required by IDEM's regulations[,]" which incorporate by reference the Ten State Standards. *Id.* at 24 and n.4 (citing 327 IAC 8-3-8). IAWC observes that Standard 7.1.2d requires "a minimum of two clearwell compartments" and that the Commission stated in a prior order that the Ten State Standards "routinely require water facilities to be designed so that projected maximum day demands can be satisfied with the largest unit (e.g. well, pump, filter, etc.) out of service." *Indiana-American Water Co.*, No. 40703, 1997 Ind. PUC LEXIS at *24. IAWC then asserts, "Applying the Commission's previously announced test for capacity, one compartment (and its associated pumping capacity) would need to be sufficient to supply the historical maximum day of 22 million gallons with the other compartment out of service." Appellant's Br. at 24. Not only has IAWC waived this argument by presenting it for the first time on appeal, *see Brenneman v. Slusher*, 768 N.E.2d 451, 463 (Ind. Ct. App. 2002), *trans. denied*, but it has also failed to cite a specific standard to support its assertion.

As mentioned earlier in the rate base section of this Order, we believe there is enough of a relationship between the acquisition of the E-CIS software and the consolidation of customer services in Alton, Illinois to discuss these two issues jointly in this portion of the Order....

[IAWC] requested we approve the return on and of $6,248,821 related to the purchase and development of the E-CIS software.... The OUCC recommended that the $6,248,821 associated with the E-CIS software be disallowed and removed from its rate base ....

Sufficient evidence was presented to lead us to conclude that [IAWC's] decision to upgrade its EDIS software to Orcom's E-CIS was made prior to the decision to consolidate its customer service functions in Illinois. What is at issue, however, are the costs and the need associated with (1) the decision to abandon the Richmond, Indiana consolidated customer service center and move to an out-of-state, multi-state consolidated service center and (2) the acquisition of an upgraded customer billing/service database that has expanded significantly in cost. In the initial three-year contract (1996-1999) between American and Orcom, Orcom agreed to develop E-CIS software that would be able to "go live" at eight (8) sites, of which Richmond, Indiana was one; [IAWC] witness Eckart stated that "going live" meant the Orcom Customer Information System was installed and being used in the production of bills. [IAWC's] portion of the cost to design and implement the software was 9% of the total $7.3 million cost.

Whether the OUCC should have known or not, we derive from the cross-examination testimony of [OUCC witness] Ms. Lynn that the [OUCC] was not readily aware that the upgrade to E-CIS was not limited to the initial Orcom contract. According to testimony and rebuttal evidence from [IAWC] witnesses Eckart and Van den Berg, the initial American-Orcom contract for E-CIS serving eight (8) utilities was supplemented by an October/November 2000 contract between American and Accenture (formerly Anders[e]n Consulting). As we understand [IAWC's] testimony, the initial Orcom "piece" of the E-CIS upgrade comprises only about 10% of the total work (and cost) needed to effect the E-CIS upgrade and application in the context of the consolidated customer service center. According to [IAWC], the cost of the second contract to develop and implement the E-CIS for the Alton CSC is $71,416,845. *The only contract in evidence, however, is American's 1996 through 1999 contract with Orcom.*

After entering into the initial American-Orcom contract but prior to American's decision to cause [IAWC] to convert to Alton, a decision was made to include twenty-two (22) utility locations, including [IAWC], to participate in the Alton CSC and to implement the E-CIS software for all participating utilities. Mr. Van den Berg testified that, dissatisfied with Orcom's customization work, [IAWC] entered the supplemental contract with Accenture for the purpose of developing a single instance of E-CIS for the Alton CSC. The total cost of developing and installing the E-CIS software rose from $7,326,422 to $71,416,845. And, though there are now twenty-two (22) installation locations using E-CIS, instead of eight (8), [IAWC] is expected to pay roughly the same percentage of the allocation: 9% of $71,416,845, instead of 9% of $7,326,422.

Putting aside the cost issue aside momentarily, we find that [IAWC] presented sufficient justification for the need to upgrade to the E-CIS database....

The question still remains, however, as to the amount of costs to allow for the software upgrade. First, we are unable to determine with any specificity the identity of the additional products and/or services that caused the total price to increase from $7,326,422 to $71,416,845. In addition, other than the testimony that [IAWC's] parent allocated the cost based on its percentage of the total customers served, [IAWC] has not satisfactorily explained why it is more expensive for [IAWC] to go live with E-CIS as one (1) of twenty-two (22) companies with which to share the costs, than it would have been as one (1) of only eight (8). [IAWC] witness Van den Berg acknowledges that providing software for twenty-two (22) utilities, many subject to different sets of regulations, would be more costly than providing the service for eight (8) utilities. However, we would expect some economies of scale since [IAWC] is now sharing the cost with almost three (3) times the number of participants originally proposed. Instead, [IAWC] is expected to pay roughly the same percentage of a much greater expense. Also, we note the recent trend of [IAWC] to speak of attaining economies of scale within the state only to subsidize smaller American utilities by paying shared costs through a suspect allocation method; a method which does not credit economies of scale reached by the individual utilities. Since the evidence is not sufficient *either* to justify [IAWC's] requested expense *or* to reconcile the discrepancy of cost allocation, we find the most reasonable cost to allow [IAWC] is the allocation of $659,378 (9% of $7,326,425) as agreed to in the initial, three-year Orcom contract as the E-CIS was planned to be developed and implemented before the decision to include [IAWC] in the Illinois CSC.

*With respect to the move from the customer service center in Richmond to Alton, Illinois, we believe the OUCC has presented compelling reasons to find that the move was imprudent and not reasonably necessary.* First, the OUCC discovered that [IAWC] had failed to perform any studies regarding the

> We also share the concern expressed by the OUCC that [IAWC] is asking its customers to subsidize other states' inefficiencies. The OUCC testified that according to the "Business Case Review," American expects to save approximately $6 million each year over the next five (5) years as a result of establishing the Alton Customer Satisfaction Center, but [IAWC] is expected to pay $2.3 million each year. As a result, some of [IAWC's] inefficient affiliates will share in the savings, while Indiana customers are expected to pay more. Indiana customers benefited from the efficient customer service center in Richmond and should not now be financially penalized so that a consolidated grouping of efficient and inefficient affiliates can produce a savings for the parent company.
>
> While we accept as a general concept that consolidations and shared services can result in greater benefits and efficiencies, we will review any such request separately and with an eye toward the impact on Indiana ratepayers. Within any such review we expect complete and substantial justification for the anticipated benefits and efficiencies.
>
> Finally, [IAWC] has openly recognized, even prior to this Cause, that the establishment of a consolidated call center could lead to the elimination of jobs in Indiana. Nonetheless, it is disturbing that what we find to be an imprudent decision to establish a consolidated call center, with respect to Indiana customer service needs, is exacerbated by the elimination of forty-seven (47) customer service jobs in Richmond, Indiana.

Appellant's App. at 110-13 (italicized emphases added) (citations to hearing transcript omitted).

"While the utility may incur any amount of operating expenses it chooses, the Commission is invested with broad discretion to disallow for ratemaking purposes any excessive or imprudent expenditures." *Office of Util. Consumer Counselor v. Indiana Cities Water Corp.*, 440 N.E.2d 14, 15 (Ind. Ct. App. 1982), *trans. denied.* In challenging the Commission's disallowance of all but $659,378 of the cost of the E-CIS, IWAC directs our attention to Indiana Code Section 8-1-2-48(a):

> The commission shall inquire into the management of the business of all public utilities, and shall keep itself informed as to the manner and method in which the same is conducted and shall have the right to obtain from any public utility all necessary information to enable the commission to perform its duties. *If, in its inquiry into the management of any public utility, the commission finds* that the amount paid for the services of its officers, employees, or any of them, is excessive, or that the number of officers or persons employed by such utility is not justified by the actual needs of the utility, or *that any other item of expense is being incurred by the utility which is either unnecessary or excessive, the commission shall designate such item or items, and such item or items so designated, or such parts thereof as the commission may deem unnecessary or excessive, shall not be taken into consideration in determining and fixing the rates which such utility is permitted to charge for the service which it renders.*

(Emphases added.)

IAWC claims that reversal is required because the Commission did not specifically find the cost of the E-CIS to be unnecessary or excessive. We disagree. Where the Commission's findings are sufficiently specific to enable intelligent review and indicate on their face that the statutory prescribed considerations have been made, we will not remand "for the repetitive and unnecessary task of including the exact statutory language in the findings." *Fred J. Stewart Trucking, Inc. v. Bunn Trucking Co.*, 151 Ind. App. 157, 163, 278 N.E.2d 310, 314 (1972), *trans. denied.* A fair reading of the Commission's detailed findings clearly indicates that it considered the cost of the E-CIS to be unnecessary or excessive, and we will not remand for insertion of that statutory language.

IAWC also accuses the Commission of rewriting or rejecting its agreement with American's Service Company, which provides for the allocation of common costs (such as for the E-CIS) based on a subsidiary's number of customers. IAWC notes that the agreement has been on file with the Commission since 1989, has been applied in several intervening rate cases, "and was the basis for the Orcom contract cost allocation that the Commission did not disallow." Appellant's Br. at 33. We note, however, that the Commission merely questioned the cost allocation methodology with respect to the Accenture contract and did not rely on its skepticism regarding economies of scale as the sole basis for denying the E-CIS costs exceeding those of the Orcom contract; the Commission also found that IAWC did not present sufficient evidence to justify those costs.[8] In effect, the Commission upheld the terms of the Orcom contract, cost allocation and all. IAWC has failed to establish that the Commission erred in doing so.

### *III. Disallowance of Cost of Relocating Customer Call Center*

Next, IAWC challenges the Commission's disallowance of the cost of relocating the Richmond customer call center to the Alton CSC based on its finding that the decision was imprudent and not reasonably necessary. IAWC touts its testimony regarding the CSC's multilingual communication capabilities, extended customer service hours, and improved technological and billing capabilities, while downplaying the Commission's findings regarding customer satisfaction with the Richmond call center and the economies of scale achieved by its relatively recent construction. IAWC states that "[a] utility is not obligated to wait until its customers are dissatisfied before implementing technological improvements. Good management dictates doing so before that happens." Appellant's Br. at 41. Perhaps IAWC's customers would be dissatisfied to learn that IAWC's management would never be

[8] We must decline IAWC's request to reweigh the OUCC's evidence as to the project's original cost and Van den Berg's general observations about the reasons for the project's cost increase.

able to recoup the investment in the CSC, as the Commission found. IAWC's argument is simply a request to reweigh the evidence in its favor, which we may not do.[9]

### *IV. Disallowance of Internal Audit Department Expenses*

IAWC asserts that the Commission improperly disallowed $56,572 in test year[10] management fee expenses for its affiliate's Internal Audit Department. We excerpt the Commission's findings on this issue:

> **OUCC's Position.** Ms. Lynn reduced [IAWC's] management fee expense by $56,572 for the Internal Audit Division of an affiliated company. She based her adjustment on [IAWC's] response to OUCC Data Request No. 3, Question 51, in which [IAWC] stated that the Internal Audit Division had not performed an internal audit for [IAWC] in over three (3) years.
>
> **[IAWC's] Rebuttal.** [IAWC's] witness Wolf testified that [IAWC] and its ratepayers receive benefits from the American Internal Audit department because the department does more than direct internal audits. He stated that, in addition to performing periodic internal financial audits, the Internal Audit department assists with the annual independent audit performed by Pricewaterhouse Coopers (thereby reducing audit fees allocated to [IAWC]), performs reviews of Information Technology Services processes and procedures, reviews SCADA system security and administers [IAWC's] Code of Ethics.

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[9] IAWC further contends that the Commission's mention of the elimination of forty-seven jobs in Richmond violates the Commerce Clause of the United States Constitution. We disagree. This passing remark at the close of the Commission's discussion of the E-CIS/CSC issue is clearly an editorial comment and not a basis for its ultimate decision.

[10] *See L.S. Ayres & Co.*, 169 Ind. App. at 657, 351 N.E.2d at 819 ("The Commission's primary objective in every rate proceeding is to establish a level of rates and charges sufficient to permit the utility to meet its operating expenses plus a return on investment which will compensate its investors. Accordingly, the initial determination that the Commission must make concerns the future revenue requirement of the utility. This determination is made by the selection of a 'test year'–normally the most recent annual period for which complete financial data are available–and the calculation of revenues, expenses and investment during the test year. The test year concept assumes that the operating results during the test period are sufficiently representative of the time in which new rates will be in effect to provide a reliable testing vehicle for new rates.") (citations and footnote omitted). The test year for purposes of this rate proceeding is the twelve months ended June 30, 2003. Appellant's App. at 15.

**Commission Discussion and Findings.** We reviewed [the OUCC's] Exhibit 3, Attachment DML-11, which contained the complete question and answer to the discovery question the [OUCC] relied upon as its basis for the adjustment:

Q-51: Please describe any and all internal audits, review[s], cost/benefit analyses, assessments or evaluations ("audits") of any aspect of [IAWC's] operations performed in the last three years. Also, please state who performed the audit, the length of the document and whether the audit is complete.

Response: ....[11]Without waiver of its objections, [IAWC] states that it has no internal audits for the referenced period. [IAWC] further states that it prepared comprehensive planning studies during the referenced period. Such studies were prepared under the supervision of Alan J. DeBoy. Copies of the comprehensive planning studies will be made available for inspection at its corporate office.

We note that this data request by the OUCC was not just a request for the internal audits that had been performed. Certainly, Mr. Wolf's rebuttal on this subject claims that the affiliated company's Internal Audit division performed audit tests for [IAWC] and a review of [IAWC's] corporate-wide Information Technology Services processes and procedures.

However, despite being clearly within the scope of the OUCC's request, no reference to, or document of these "internal audits, review, cost/benefit analyses, assessments or evaluations" was provided to the OUCC. Indeed, beyond Mr. Wolf's passing assertion of their existence in his rebuttal testimony, there is no documentation whatsoever of these activities in the record of this case.

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[11] The sentence replaced by the ellipsis states: "[IAWC] objects to the request to the extent it requests documents other than internal audits on the grounds that it is over-broad, vague, ambiguous, unduly burdensome and irrelevant to the subject of the proceeding." Appellant's App. at 226. IAWC states that it "objected to the request because, taken literally, it would require production of every piece of paper that could be characterized as an analysis, review, assessment or evaluation of 'any aspect of [IAWC's] operation' for a three year period." Appellant's Br. at 28. We note that the OUCC specifically requested a *description* of audits and reviews, etc., not the audits themselves.

We note that under the Commission's procedural rules, discovery is designed to be self-executing, and parties should be able to rely on the completeness of other parties' responses. Furthermore, Indiana courts have addressed the issue of inferences that may be drawn from a party's failure to provide evidence within that party's exclusive control, as follows:

> In Indiana, the exclusive possession of facts or evidence by a party, coupled with the suppression of facts or evidence by that party, may result in an inference that the production of the evidence would be against the interest of the party which suppresses it.... The rule not only applies when a party actively endeavors to prevent disclosure of facts, but also when the party "merely fails to provide available evidence."

*Porter v. Irvin's Interstate Brick & Block Co., Inc.*, 691 N.E.2d 1363, 1364-65 (Ind. Ct. App. 1998)(quoting *Morris v. Buchanan*, 220 Ind. 510, 44 N.E.2d 166, 169 (1942)).

Clearly, [IAWC's] records are within [IAWC's] exclusive control. Furthermore, OUCC witness Lynn appropriately raised questions regarding the purposes for which [IAWC] was billed by its affiliate's Internal Audit division. Therefore, without documentation of these management fees [IAWC] paid to its affiliate's Internal Audit division, we may infer that these fees are [not[12]] properly counted as expenses in the provisioning of utility service. Consequently, we find that [IAWC] should reduce its test year management fees by $56,572 for its [affiliate's] Internal Audit Division.

Appellant's App. at 117-18 (some citations omitted).

IAWC asserts that the Commission improperly disallowed the management fees as a discovery sanction. We disagree. IAWC offered no documentation to support Wolf's claims regarding the services performed by the Internal Audit Department. Under these circumstances, the Commission was well within its discretion to disregard Wolf's testimony and disallow the challenged expenses. *See Morphew v. Morphew*, 419 N.E.2d 770, 777 (Ind.

[12] We agree with the OUCC's contention that the drafter of the Commission's order "inadvertently omitted the word 'not' from this sentence." OUCC's Br. at 11 (footnote omitted). IAWC's argument to the contrary disregards the Commission's ultimate finding on this issue.

Ct. App. 1981) ("In Indiana, uncontroverted evidence is not necessarily binding on the trier of fact. It may be disbelieved and given no weight."), *superseded by statute on other grounds*; *Gemmer v. Anthony Wayne Bank*, 181 Ind. App. 379, 386, 391 N.E.2d 1185, 1189 (1979) ("The trier of fact may not arbitrarily disregard evidence, but the evidence as a whole and the circumstances of trial may justify rejection of evidence not directly controverted[.]"), *trans. denied*.

## *V. Exclusion of Pension Expense*

IAWC proposed an adjustment to test year pension expense based on its proposed conversion from the Employee Retirement Income Security Act ("ERISA") method to the Financial Accounting Standard Board's Statement of Financial Accounting Standards No. 87 ("FAS87") method of computing annual pension expense. According to the Commission, "[t]he difference between the two (2) methodologies is that FAS87 is essentially a current year estimate of pension costs being accrued for currently employed, eligible employees and existing retirees. The ERISA method fluctuates based upon the value of the investments in the pension trust fund, and is therefore more directly influenced by short-term fluctuations of the financial markets." Appellant's App. at 95.

The Commission entered the following findings on this issue:

> **[IAWC's] Position.** ....
>
> There are two components to [IAWC's] proposed adjustment to reflect the change from ERISA to FAS87. First, the Company proposes to amortize the deferred pension assets accumulated under the ERISA method over ten (10) years. Second, the adjustment reflects an increase in the pro forma FAS87 expense over the test year ERISA contribution level. The pro forma FAS87 level was calculated based upon a six (6) year average of [IAWC's] projected FAS87 expense for the years 2003 to 2008. The projection for this

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The Commission entered the following findings on this issue:

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period was prepared by Towers Perrin, one of the world's largest global management consulting and actuarial firms. The total adjustment to test year expense, including both the average pro forma level and the amortization of the deferred amount is $1,686,130.

**OUCC's Position.** The OUCC did not oppose [IAWC's] proposed conversion to FAS87, the amortization of the deferred amount or the computation of the pro forma level of FAS87 expense. The OUCC's proposed pension expense adjustment is identical to [IAWC's].... Given that the OUCC included [IAWC's] proposed pension expense adjustment in its schedules, we are left to conclude that the OUCC has no objection to [IAWC's'] request.

**Intervenors' Positions.** Both the Industrial Group and the Town of Schererville opposed [IAWC's] proposed pension expense adjustment. [Industrial Group witness] Mr. Gorman noted that the ERISA pension expense reflects the minimum annual cash contribution [IAWC] normally makes to the pension trust fund. He explained that the FAS87 pension expense is an accrual expense recorded on a company's financial statements. Mr. Gorman disputed [IAWC witness] Mr. Wolf's contention that the FAS87 pension expense is more stable. He noted that [IAWC's] pension expense was a negative amount in the calendar years 2000 and 2001 compared to the $1.8 million positive expense accrual projected for the test year. Mr. Gorman also noted that [IAWC's] test year pension expense was based on a 2002 actuarial study which assumed that the long-term return on the trust fund assets would be 9%. According to Mr. Gorman, the 2002 projected return understates the actual return on stock investments during 2003. He provided an example that the S&P 500 has increased over 35% from January 2003 to January 2004. Consequently, he concluded that this increase in the value of the trust fund assets will lower [IAWC's] FAS87 pension expense when it is updated in 2004. Therefore, Mr. Gorman opined that the support for [IAWC's] requested pension expense under FAS87 for the test year is already stale and probably overstates what [IAWC's] pension expense will be when the study is updated. Mr. Gorman recommended that the Commission be consistent with its past ratemaking treatment of pension expense by continuing to use the ERISA pension expense method and allow [IAWC] to include $677,000 as pension expense, which was the amount incurred for the test year.

Intervenor Town of Schererville offered the evidence of its witness Sommer who divided the $2.2 million adjustment increase into its three (3) components: losses, change in methodology and retired Northwest Indiana executives. The evidence thereafter offered by witness Sommer was a rejection of all three components. Witness Sommer rejected the recovery of the loss component of the $2.2 million pension adjustment, equaling $471,897 representative of a prospective level of ongoing operating expenses." Town of Schererville's Br. at 19.

This Court has explained that

> the determination of a utility's revenue requirement is primarily an exercise in informed regulatory judgment. [I]f that judgment is to be exercised properly, the Commission must examine every aspect of the utility's operations and the economic environment in which the utility functions to ensure that the data it has received are representative of operating conditions that will, or should, prevail in future years.

*City of Evansville*, 167 Ind. App. at 482, 339 N.E.2d at 570-71.[14] Here, the Commission heard evidence that IAWC's estimate for the return on its pension fund assets was low in light of recent market trends and that it would potentially be overcompensated for past losses, notwithstanding any change in its computation method. We may not reweigh the conflicting evidence on this issue in favor of IAWC, and we must once again reject its invitation to remand for insertion of the words "unnecessary or excessive." We affirm the Commission's resolution of this issue.

### *VI. Calculation of Cost of Common Equity*

By way of introduction, we note that

> [i]n determining what constitutes a "fair rate of return," the Commission generally calculates a composite "cost of capital" by adding together the weighted costs of various components of the utility's capital structure, e.g., its long term debt, preferred stock, and common stock. The resulting figure, when expressed as a percentage of the utility's combined debt and equity accounts, is then compared to the utility's existing rate of return. This serves as an initial point of reference in establishing a "fair rate of return" for utility operations.

[14] IAWC cites no authority for its assertion that "[i]n the case of pension expense, the Commission is obligated to follow the same test year and adjustment methods prescribed in its Prehearing Conference Order as it did for the other components of [IAWC's] operating expenses." Appellant's Br. at 44-45.

*Gary-Hobart Water Corp. v. Indiana Util. Regulatory Comm'n*, 591 N.E.2d 649, 653 (citation omitted). "[T]he Commission may consider a myriad of factors when determining a fair rate of return." *Id.*

IAWC challenges the Commission's rejection of its proposed adjustment to the cost of common equity to reflect its size and other company-specific risk characteristics. The parties offered conflicting testimony regarding and methods of calculating that cost. We excerpt the relevant findings made by the Commission on this issue:

> We are also mindful, as was the OUCC in this Cause, of the assertions made by Thames Water and [IAWC] during our investigation in Cause No. 42250 of the effect that American's recent acquisition by Thames Water, a subsidiary of RWE AG, would have on [IAWC] ratepayers. In our Order in Cause No. 42250, we recalled the testimony of James McGivern, Managing Director-Americas of Thames Water, that [IAWC's] rates would not be increased as a result of the acquisition; that, to the contrary, [IAWC's] access to capital at reasonable rates should be enhanced by its affiliation with Thames Water and RWE AG, thereby providing long-term benefits to ratepayers in what is an extremely capital intensive industry.
>
> In its testimony in this Cause, the OUCC quoted [IAWC's] President, Mr. Eckart, as testifying in Cause No. 42250 that American's acquisition by Thames Water would increase [IAWC's] access to capital markets. Our Order in Cause No. 42250 also recognized Mr. Eckart's assertion that Thames Water and RWE AG have strong credit quality and large financial resources that are devoted to their subsidiary utility businesses in general and water and wastewater utility businesses in particular. Our Order in Cause No. 42250, therefore, recognized Mr. Eckart's assertion that [IAWC's] affiliation with Thames Water and RWE AG would enhance [IAWC's] ability to meet its financial requirements.
>
> The OUCC and Intervenors have put forth a number of reasons to disallow risk premiums in the calculations used to determine a cost of equity in this Cause. In particular, we agree with the testimony of the OUCC that [IAWC] should not be subjected to a downward adjustment because of its subsidiary or otherwise affiliated relationship with American, Thames Water and RWE AG. Likewise, it would not be appropriate to determine [IAWC's]

cost of equity by delving into American's, Thames Water's, or RWE AG's financial requirements or resources. But it is a reasonable conclusion that the benefits of being associated with such large and obviously credit-worthy companies should offset the company-specific risk adjustments that [IAWC] has maintained should be applicable in this Cause. The standard financial models that all parties have relied upon to some extent in this Cause, that are useful in determining [IAWC's] cost of equity, are based upon calculation of a number of components, including the inclusion or exclusion of a company-specific risk adjustment. The fact of [IAWC's] relationship with a large international water company is a reasonable factor to consider in analyzing the applicability of the company-specific risk adjustment component. To be blind to the fact of [IAWC's] relationship with a large international water company, when determining the appropriateness of applying a company-specific risk adjustment component to the standard models used to determine a reasonable cost of equity, would be to ignore reality. In addition, it is disconcerting to this Commission that [IAWC] gives no recognition in its models for a rate adjustment in this Cause to the financial benefits that it claimed, in Cause No. 42250, its ratepayers would enjoy as a result of the relationship with a large international water company.

[IAWC] recommended a return of 11.00% on equity capital. However, the foregoing discussion of the evidence indicates that [IAWC's] recommendation is too high given current levels of capital costs, prevailing economic conditions and because of adjustments made to [IAWC witness] Mr. Boquist's raw results to reflect [IAWC's] increased level of risk relative to that of the proxy group. [IAWC's] unadjusted DCF [discounted cash flow] and CAPM [capital asset pricing model] results were 10.0% and 9.59%, respectively. These were then adjusted upward to reflect the alleged special circumstances of [IAWC] and resulted in values of 11% for the DCF and 11.65% for the CAPM. The [OUCC] recommended a return on equity capital of 8.75% based on DCF results of approximately 8.5% and CAPM results ranging from 7.52% to 9.08% with no special adjustments. [Industrial Group witness] Mr. Gorman recommended a return of 9.75% based on the results of his DCF and CAPM analysis, while [Town of Schererville witness] Mr. Sommer recommended a return of no more than 10%.

Our review of the evidence indicates that [IAWC's] circumstances, as well as economic conditions, have changed significantly since [IAWC's] last rate case. [IAWC's] size has significantly increased; its ability to attract capital has improved as a result of being associated with a large international water company; and the cost of capital is substantially below that which prevailed at the time of [IAWC's] last rate case. Taken together, [IAWC] is no longer more risky than the proxy group companies and is less risky than in the

> past. Ignoring [IAWC's] adjustments to its cost of equity estimates establishes a range of 9.59% to 10.0%.
>
> Overall, the evidence does not support a cost of equity as low as the [OUCC] recommended. We recognize that capital costs have declined and that the cost of equity should follow suit. However, we have already opined that unadjusted DCF results can understate the cost of equity, and we are mindful of improved economic conditions which will continue to increase the cost of capital over time.
>
> Based on our discussions above, we find [IAWC's] cost of common equity to be 9.25%. This figure is slightly below [IAWC's] unadjusted range of results, but compares favorably to the recommended range of results of both the OUCC and the Intervenors of 8.75% to 10.0%. It affords [IAWC] an opportunity to earn a pre-tax interest coverage ratio that will preserve an "A" bond rating, is high enough to compensate [IAWC] for any marginal risks it faces and anticipates small but continuous increases in the cost of capital in the future.

Appellant's App. at 67-68.

The U.S. Supreme Court has stated that "[a] public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties[.]" *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n*, 262 U.S. 679, 692 (1923). In challenging the Commission's cost of equity determination, IAWC asserts that the Commission must consider "the risks of the Indiana utility that it regulates, not its parent company's." Appellant's Br. at 37. IAWC cites *Public Service Commission of Indiana v. Indiana Bell Telephone Company*, 130 N.E.2d 467, 235 Ind. 1 (1955), in which our supreme court faulted the Commission for lowering Indiana Bell's rate of return based on its required contribution to its parent company's overall return:

> Appellee is entitled to a fair return upon its intrastate property actually used and useful for the convenience of the public, without regard to the amount of contribution by way of dividends on its stock, and other reasonable charges which it pays annually to the parent company, A. T. & T.
>
> Appellee is an Indiana corporation, a separate and distinct utility as defined by statute and it is the duty of the Commission to establish for it a schedule of rates which will produce a fair and nonconfiscatory return upon its used and useful intrastate property, whether its stockholders are one or many, and without regard to its relationship to other companies.
>
> The fact that appellee has not used its own credit with which to raise additional capital is immaterial, and its ability to do so cannot be measured by the yardstick of the ability of the parent company to raise additional capital. The intrastate properties and operations of appellee are the ones to be considered in fixing a fair rate of return upon its used and useful property and not those of the entire Bell System.
>
> The acts of appellants in considering the cost of money to the parent company, A. T. & T., and the "entire Bell System" rather than considering only the properties and operations of appellee is in violation of [the property valuation statute, now Indiana Code Section 8-1-2-6], and is unlawful.

*Id.* at 28-29, 130 N.E.2d at 480 (footnote omitted).

IAWC argues that the Commission unlawfully disregarded its company-specific risks, "(which include risks associated with its size, lack of geographic diversity and the limited stock liquidity) because it is a subsidiary of a 'large international water company.'" Appellant's Br. at 38. We find IAWC's reliance on *Indiana Bell* inapposite for two reasons. First and foremost, the Commission did not base its determination of cost of equity on IAWC's parent company's ability to attract capital, which would be forbidden under *Indiana Bell*, but rather on IAWC's ability to attract capital, which is undisputedly enhanced due to its affiliation with a "large international water company." Consequently, IAWC's company-specific risks are lower than they would otherwise be given its size, geographic diversity, and stock liquidity.[15] Second, the Commission based its determination on additional factors, such as the significant increase in IAWC's size and a decrease in the cost of capital since the last rate proceeding. In sum, IAWC has failed to establish that the Commission's decision is contrary to law.

### *VII. Calculation of Federal Income Tax Expense*

Finally, IAWC challenges the Commission's calculation of its federal income tax expense at the existing rates. IAWC's argument rests primarily on its comparison of the Commission's final order with the OUCC's hearing testimony (as opposed to its proposed final order). IAWC observes that whereas the Commission's net operating income figure at the existing rates is approximately $300,000 higher than the OUCC's income figure, the Commission's federal income tax figure is approximately $500,000 lower than the OUCC's tax figure. IAWC points to this discrepancy and contends that the Commission's tax figure must be "significantly understated." Appellant's Br. at 47. IAWC claims that "the Commission has not made sufficient findings to explain how it arrived at its calculation." *Id.*

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[15] We therefore decline IAWC's invitation to sift through ten rate case orders involving various utilities, many of which are electric and natural gas utilities, all of which vary in size and financial circumstances, and none of which are in the proxy group considered by the parties' experts in this case. We do not reach the question of whether review of these extra-record orders would be prohibited under *Teledyne Portland Forge v. Ohio Valley Gas Corp.*, 666 N.E.2d 1278 (Ind. Ct. App. 1996), or whether *Teledyne* remains good law. *Compare id.* at 1282 n.2 (refusing to consider Commission orders included in parties' appendices: "Our review is limited to matters properly in the record of the proceedings below. Matters included in an appendix are not a part of the record, and we therefore may not consider them."), *with Indiana Bell Tel. Co. v. Indiana Util. Regulatory Comm'n*, 715 N.E.2d 351, 357 (Ind. 1999) (citing prior orders in reviewing Commission's interpretation of statute).

We disagree. Simply because the Commission's final calculations differ from those of the OUCC's preliminary calculations does not mean that the Commission must have gotten it wrong. The OUCC notes that IAWC's total federal income tax expense as calculated by the Commission is within $2.00 of the sum of the federal income tax figures for all of IAWC's divisions as calculated by the Commission. OUCC's Br. at 48 (citing Appellant's App. at 121). IAWC does not claim that any of those figures are incorrect or that its total federal income tax expense must be less than the sum of those figures. "We are governed by the presumption that an agency's decision is correct in view of its expertise." *Teledyne Portland Forge v. Ohio Valley Gas Corp.*, 666 N.E.2d 1278, 1283 (Ind. Ct. App. 1996). That expertise certainly extends to calculating a utility's federal income tax expense. IAWC has failed to rebut the presumption of correctness, and we will not remand for the Commission to "show its work" in this regard.[16] We affirm the Commission's order in all respects.

Affirmed.

FRIEDLANDER, J., and MAY, J., concur.

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[16] We note that the Commission did not "show its work" or specify the applicable federal income tax rate in the two previous IAWC rate cases cited in IAWC's brief.

# STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 109— ACCOUNTING FOR INCOME TAXES


## SUMMARY

This Statement establishes financial accounting and reporting standards for the effects of income taxes that result from an enterprise's activities during the current and preceding years. It requires an asset and liability approach for financial accounting and reporting for income taxes. This Statement supersedes FASB Statement No. 96, *Accounting for Income Taxes*, and amends or supersedes other accounting pronouncements listed in Appendix D.

### Objectives of Accounting for Income Taxes

The objectives of accounting for income taxes are to recognize (a) the amount of taxes payable or refundable for the current year and (b) deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an enterprise's financial statements or tax returns.

### Basic Principles of Accounting for Income Taxes

The following basic principles are applied in accounting for income taxes at the date of the financial statements:

**a.** A current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year.

**b.** A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary' differences and carryforwards.

**c.** The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.

**d.** The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

### Temporary Differences

The tax consequences of most events recognized in the financial statements for a year are included in determining income taxes currently payable. However, tax laws often differ from the recognition and measurement requirements of financial accounting standards, and differences can arise between (a) the amount of taxable income and pretax financial income for a year and (b) the tax bases of assets or liabilities and their reported amounts in financial statements.

APB Opinion No. 11, *Accounting for Income Taxes*, used the term *timing differences* for differences between the years in which transactions affect taxable income and the years in which they enter into the determination of pretax financial income. Timing differences create differences (sometimes accumulating over more than one year) between the tax basis of an asset or liability and its reported amount in financial statements. Other events such as business combinations may also create differences between the tax basis of an asset or liability and its reported amount in financial statements. All such differences collectively are referred to as *temporary differences* in this Statement.

### Deferred Tax Consequences of Temporary Differences

Temporary differences ordinarily become taxable or deductible when the related asset is recovered or the related liability is settled. A deferred tax liability or asset represents the increase or decrease in taxes payable or refundable in future years as a result of temporary differences and carryforwards at the end of the current year.

### Deferred Tax Liabilities

A deferred tax liability is recognized for temporary differences that will result in taxable amounts in future years. For example, a temporary difference is created between the reported amount and the tax basis of an installment sale receivable if, for tax purposes, some or all of the gain on the installment sale will be included in the determination of taxable income in future years. Because amounts received upon recovery of that receivable will be taxable, a deferred tax liability is recognized in the current year for the related taxes payable in future years.

### Deferred Tax Assets

A deferred tax asset is recognized for temporary differences that will result in deductible amounts in future years and for carryforwards. For example, a temporary difference is created between the reported amount and the tax basis of a liability for estimated expenses if, for tax purposes, those estimated expenses are not deductible until a future year. Settlement of that liability will result in tax deductions in future years, and a deferred tax asset is recognized in the current year for the reduction in taxes payable in future years. A valuation allowance is recognized if, based on the weight of available evidence, it is *more likely than not* that some portion or all of the deferred tax asset will not be realized.

### Measurement of a Deferred Tax Liability or Asset

This Statement establishes procedures to (a) measure deferred tax liabilities and assets using a tax rate convention and (b) assess whether a valuation allowance should be established for deferred tax assets. Enacted tax laws and rates are considered in determining the applicable tax rate and in assessing the need for a valuation allowance.

All available evidence, both positive and negative, is considered to determine whether, based on the weight of that evidence, a valuation allowance is needed for some portion or all of a deferred tax asset. Judgment must be used in considering the relative impact of negative and positive evidence. The weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which it can be objectively verified. The more negative evidence that exists (a) the more positive evidence is necessary and (b) the more difficult it is to support a conclusion that a valuation allowance is not needed.

### Changes in Tax Laws or Rates

This Statement requires that deferred tax liabilities and assets be adjusted in the period of enactment for the effect of an enacted change in tax laws or rates. The effect is included in income from continuing operations.

### Effective Date

This Statement is effective for fiscal years beginning after December 15, 1992. Earlier application is encouraged.




## CONTENTS

## INTRODUCTION

**1.** This Statement addresses financial accounting and reporting for the effects of **income taxes**[1] that result from an enterprise's activities during the current and preceding years.

**2.** FASB Statement No. 96, *Accounting for Income Taxes*, which was issued in December 1987, superseded APB Opinion No. 11, *Accounting for Income Taxes*. The effective date of Statement 96 was delayed to fiscal years that begin after December 15, 1992. In March 1989, the Board began consideration of requests to amend Statement 96 to (a) change the criteria for recognition and measurement of deferred tax assets and various other requirements of Statement 96 and (b) reduce complexity. This Statement is the result of that reconsideration.

## STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

### Scope

**3.** This Statement establishes standards of financial accounting and reporting for income taxes that are currently payable and for the tax consequences of:

**a.** Revenues, expenses, gains, or losses that are included in **taxable income** of an earlier or later year than the year in which they are recognized in financial income

**b.** Other **events** that create differences between the tax bases of assets and liabilities and their amounts for financial reporting

**c.** Operating loss or tax credit **carrybacks** for refunds of taxes paid in prior years and **carryforwards** to reduce taxes payable in future years.

This Statement supersedes Statement 96 and supersedes or amends other accounting pronouncements listed in Appendix D.

**4.** The principles and requirements of this Statement are applicable to:

**a.** Domestic federal (national) income taxes (U.S. federal income taxes for U.S. enterprises) and foreign, state, and local (including franchise) taxes based on income

**b.** An enterprise's[2] domestic and foreign operations that are consolidated, combined, or accounted for by the equity method

**c.** Foreign enterprises in preparing financial statements in accordance with U.S. generally accepted accounting principles.

**5.** This Statement does not address:

**a.** The basic methods of accounting for the U.S. federal investment tax credit (ITC) and for foreign, state, and local investment tax credits or grants (The deferral and flow-through methods as set forth in APB Opinions No. 2 and No. 4, *Accounting for the "Investment Credit,"* continue to be acceptable methods to account for the U.S. federal ITC.)

**b.** Discounting (Paragraph 6 of APB Opinion No. 10, *Omnibus Opinion—1966*, addresses that subject.)

**c.** Accounting for income taxes in interim periods (other than the criteria for recognition of tax benefits and the effect of enacted changes in tax laws or rates and changes in valuation allowances). (APB Opinion No. 28, *Interim Financial Reporting*, and other accounting pronouncements address that subject.)

### Objectives and Basic Principles

**6.** One objective of accounting for income taxes is to recognize the amount of taxes payable or refundable for the current year. A second objective is to recognize **deferred tax liabilities** and **assets** for the future **tax consequences** of events[3] that have been recognized in an enterprise's financial statements or tax returns.

**7.** Ideally, the second objective might be stated more specifically to recognize the *expected* future tax consequences of events that have been recognized in the financial statements or tax returns. However, that objective is realistically constrained because (a) the tax payment or refund that results from a particular tax return is a joint result of all the items included in that return, (b) taxes that will be paid or refunded in future years are the joint result of events of the current or prior years and events of future years, and (c) information available about the future is limited. As a result, attribution of taxes to individual items and events is arbitrary and, except in the simplest situations, requires estimates and approximations.

**8.** To implement the objectives in light of those constraints, the following basic principles (the only exceptions are identified in paragraph 9) are applied in accounting for income taxes at the date of the financial statements:

**a.** A current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year.

**b.** A deferred tax liability or asset is recognized for the estimated future tax effects attributable to **temporary differences** and carryforwards.

**c.** The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.

**d.** The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

**9.** The only exceptions in applying those basic principles are that this Statement:

**a.** Continues certain exceptions to the requirements for recognition of deferred taxes for the areas addressed by APB

[1] Words that appear in the glossary are set in **boldface type** the first time they appear.

[2] The term *enterprise* is used throughout this Statement because accounting for income taxes is primarily an issue for business enterprises. However, the requirements of this Statement apply to the activities of a not-for-profit organization that are subject to income taxes.

[3] Some events do not have tax consequences. Certain revenues are exempt from taxation and certain expenses are not deductible. In the United States, for example, interest earned on certain municipal obligations is not taxable and fines are not deductible.

Opinion No. 23, *Accounting for Income Taxes—Special Areas*, as amended by this Statement (paragraphs 31-34)

**b.** Provides special transitional procedures for temporary differences related to deposits in statutory reserve funds by U.S. steamship enterprises (paragraph 32)

**c.** Does not amend accounting for leveraged leases as required by FASB Statement No. 13, *Accounting for Leases*, and FASB Interpretation No. 21, *Accounting for Leases in a Business Combination* (paragraphs 256-258)

**d.** Prohibits recognition of a deferred tax liability or asset related to goodwill (or the portion thereof) for which amortization is not deductible for tax purposes (paragraph 30)

**e.** Does not amend Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, for income taxes paid on intercompany profits on assets remaining within the group, and prohibits recognition of a deferred tax asset for the difference between the tax basis of the assets in the buyer's tax jurisdiction and their cost as reported in the consolidated financial statements

**f.** Prohibits recognition of a deferred tax liability or asset for differences related to assets and liabilities that, under FASB Statement No. 52, *Foreign Currency Translation*, are remeasured from the local currency into the functional currency using historical exchange rates and that result from (1) changes in exchange rates or (2) indexing for tax purposes.

### Temporary Differences

**10. Income taxes currently payable**[4] for a particular year usually include the tax consequences of most events that are recognized in the financial statements for that year. However, because tax laws and financial accounting standards differ in their recognition and measurement of assets, liabilities, equity, revenues, expenses, gains, and losses, differences arise between:

**a.** The amount of taxable income and pretax financial income for a year

**b.** The tax bases of assets or liabilities and their reported amounts in financial statements.

**11.** An assumption inherent in an enterprise's statement of financial position prepared in accordance with generally accepted accounting principles is that the reported amounts of assets and liabilities will be recovered and settled, respectively. Based on that assumption, a difference between the tax basis of an asset or a liability and its reported amount in the statement of financial position will result in taxable or deductible amounts in some future year(s) when the reported amounts of assets are recovered and the reported amounts of liabilities are settled. Examples follow:

**a.** *Revenues or gains that are taxable after they are recognized in financial income.* An asset (for example, a receivable from an installment sale) may be recognized for revenues or gains that will result in future taxable amounts when the asset is recovered.

**b.** *Expenses or losses that are deductible after they are recognized in financial income.* A liability (for example, a product warranty liability) may be recognized for expenses or losses that will result in future tax deductible amounts when the liability is settled.

**c.** *Revenues or gains that are taxable before they are recognized in financial income.* A liability (for example, subscriptions received in advance) may be recognized for an advance payment for goods or services to be provided in future years. For tax purposes, the advance payment is included in taxable income upon the receipt of cash. Future sacrifices to provide goods or services (or future refunds to those who cancel their orders) will result in future tax deductible amounts when the liability is settled.

**d.** *Expenses or losses that are deductible before they are recognized in financial income.* The cost of an asset (for example, depreciable personal property) may have been deducted for tax purposes faster than it was depreciated for financial reporting. Amounts received upon future recovery of the amount of the asset for financial reporting will exceed the remaining tax basis of the asset, and the excess will be taxable when the asset is recovered.

**e.** *A reduction in the tax basis of depreciable assets because of tax credits.*[5] Amounts received upon future recovery of the amount of the asset for financial reporting will exceed the remaining tax basis of the asset, and the excess will be taxable when the asset is recovered.

**f.** *ITC accounted for by the deferral method.* Under Opinion 2, ITC is viewed and accounted for as a reduction of the cost of the related asset (even though, for financial statement presentation, deferred ITC may be reported as deferred income). Amounts received upon future recovery of the reduced cost of the asset for financial reporting will be less than the tax basis of the asset, and the difference will be tax deductible when the asset is recovered.

**g.** *An increase in the tax basis of assets because of indexing whenever the local currency is the functional currency.* The tax law for a particular tax jurisdiction might require adjustment of the tax basis of a depreciable (or other) asset for the effects of inflation. The inflation-adjusted tax basis of the asset would be used to compute future tax deductions for depreciation or to compute gain or loss on sale of the asset. Amounts received upon future recovery of the local currency historical cost of the asset will be less than the remaining tax basis of the asset, and the difference will be tax deductible when the asset is recovered.

**h.** *Business combinations accounted for by the purchase method.* There may be differences between the assigned values and the tax bases of the assets and liabilities recognized in a business combination accounted for as a purchase under APB Opinion No. 16, *Business Combinations*. Those differences will result in taxable or deductible amounts when the reported amounts of the assets and liabilities are recovered and settled, respectively.

**12.** Examples (a)-(d) in paragraph 11 illustrate revenues, expenses, gains, or losses that are included in taxable income of an earlier or later year than the year in which they are recognized in pretax financial income. Those differences between taxable income and pretax financial income also create differences (sometimes accumulating over more than one year) between the tax basis of an asset or liability and its reported amount in the financial statements. Examples (e)-(h) in paragraph 11 illustrate other events that create differences between the tax basis of an asset or liability and its reported amount in the financial statements. For all eight examples, the differences result in taxable or deductible amounts when the reported amount of an asset or liability in the financial statements is recovered or settled, respectively.

**13.** This Statement refers collectively to the types of differences illustrated by those eight examples and to the ones described in paragraph 15 as *temporary differences*. Temporary differences that will result in taxable amounts in future

[4]References in this Statement to income taxes currently payable and (total) **income tax expense** are intended to include also **income taxes currently refundable** and (total) **income tax benefit**, respectively.

[5]The Tax Equity and Fiscal Responsibility Act of 1982 provided taxpayers with the choice of either (a) taking the full amount of Accelerated Cost Recovery System (ACRS) deductions and a reduced tax credit (that is, investment tax credit and certain other tax credits) or (b) taking the full tax credit and a reduced amount of ACRS deductions.

years when the related asset or liability is recovered or settled are often referred to in this Statement as **taxable temporary differences** (examples (a), (d), and (e) in paragraph 11 are taxable temporary differences). Likewise, temporary differences that will result in deductible amounts in future years are often referred to as **deductible temporary differences** (examples (b), (c), (f), and (g) in paragraph 11 are deductible temporary differences). Business combinations accounted for by the purchase method (example (h)) may give rise to both taxable and deductible temporary differences.

**14.** Certain basis differences may not result in taxable or deductible amounts in future years when the related asset or liability for financial reporting is recovered or settled and, therefore, may not be temporary differences for which a deferred tax liability or asset is recognized. One example under current U.S. tax law is the excess of cash surrender value of life insurance over premiums paid. That excess is a temporary difference if the cash surrender value is expected to be recovered by surrendering the policy, but is not a temporary difference if the asset is expected to be recovered without tax consequence upon the death of the insured (there will be no taxable amount if the insurance policy is held until the death of the insured).

**15.** Some temporary differences are deferred taxable income or tax deductions and have balances only on the income tax balance sheet and therefore cannot be identified with a particular asset or liability for financial reporting. That occurs, for example, when a long-term contract is accounted for by the percentage-of-completion method for financial reporting and by the completed-contract method for tax purposes. The temporary difference (income on the contract) is deferred income for tax purposes that becomes taxable when the contract is completed. Another example is organizational costs that are recognized as expenses when incurred for financial reporting and are deferred and deducted in a later year for tax purposes. In both instances, there is no related, identifiable asset or liability for financial reporting, but there is a temporary difference that results from an event that has been recognized in the financial statements and, based on provisions in the tax law, the temporary difference will result in taxable or deductible amounts in future years.

## Recognition and Measurement

**16.** An enterprise shall recognize a deferred tax liability or asset for all temporary differences[6] and operating loss and tax credit carryforwards in accordance with the provisions of paragraph 17. **Deferred tax expense or benefit** is the change during the year in an enterprise's deferred tax liabilities and assets.[7] For deferred tax liabilities and assets acquired in a purchase business combination during the year, it is the change since the combination date. Total income tax expense or benefit for the year is the sum of deferred tax expense or benefit and income taxes currently payable or refundable.

### Annual Computation of Deferred Tax Liabilities and Assets

**17.** Deferred taxes shall be determined separately for each tax-paying component (an individual entity or group of entities that is consolidated for tax purposes) in each tax jurisdiction. That determination includes the following procedures:

**a.** Identify (1) the types and amounts of existing temporary differences and (2) the nature and amount of each type of operating loss and tax credit carryforward and the remaining length of the carryforward period

**b.** Measure the total deferred tax liability for taxable temporary differences using the applicable tax rate (paragraph 18)

**c.** Measure the total deferred tax asset for deductible temporary differences and operating loss carryforwards using the applicable tax rate

**d.** Measure deferred tax assets for each type of tax credit carryforward

**e.** Reduce deferred tax assets by a **valuation allowance** if, based on the weight of available evidence, it is *more likely than not* (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized. The valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized.

**18.** The objective is to measure a deferred tax liability or asset using the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized. Under current U.S. federal tax law, if taxable income exceeds a specified amount, all taxable income is taxed, in substance, at a single flat tax rate. That tax rate shall be used for measurement of a deferred tax liability or asset by enterprises for which graduated tax rates are not a significant factor. Enterprises for which graduated tax rates are a significant factor shall measure a deferred tax liability or asset using the average graduated tax rate applicable to the amount of estimated annual taxable income in the periods in which the deferred tax liability or asset is estimated to be settled or realized (paragraph 236). Other provisions of enacted tax laws should be considered when determining the tax rate to apply to certain types of temporary differences and carryforwards (for example, the tax law may provide for different tax rates on ordinary income and capital gains). If there is a phased-in change in tax rates, determination of the applicable tax rate requires knowledge about when deferred tax liabilities and assets will be settled and realized.

**19.** In the U.S. federal tax jurisdiction, the applicable tax rate is the regular tax rate, and a deferred tax asset is recognized for alternative minimum tax credit carryforwards in accordance with the provisions of paragraph 17(d) and (e) of this Statement. If alternative tax systems exist in jurisdictions other than the U.S. federal jurisdiction, the applicable tax rate is determined in a manner consistent with the tax law after giving consideration to any interaction (that is, a mechanism similar to the U.S. alternative minimum tax credit) between the two systems.

**20.** All available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, a valuation allowance is needed. Information about an enterprise's current financial position and its results of operations for the current and preceding years ordinarily is readily available. That historical information is supplemented by all currently available information about future years. Sometimes, however, historical information may not be available (for example, start-up operations) or it may not be as relevant (for example, if there has been a significant, recent change in circumstances) and special attention is required.

**21.** Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law. The following four possible sources

[6] Refer to paragraph 9. A deferred tax liability shall be recognized for the temporary differences addressed by Opinion 23 in accordance with the requirements of this Statement (paragraphs 31-34) and that Opinion, as amended.

[7] Paragraph 230 addresses the manner of reporting the transaction gain or loss that is included in the net change in a deferred foreign tax liability or asset when the reporting currency is the functional currency.

of taxable income may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards:

**a.** Future reversals of existing taxable temporary differences

**b.** Future taxable income exclusive of reversing temporary differences and carryforwards

**c.** Taxable income in prior carryback year(s) if carryback is permitted under the tax law

**d.** Tax-planning strategies (paragraph 22) that would, if necessary, be implemented to, for example:

**(1)** Accelerate taxable amounts to utilize expiring carryforwards

**(2)** Change the character of taxable or deductible amounts from ordinary income or loss to capital gain or loss

**(3)** Switch from tax-exempt to taxable investments.

Evidence available about each of those possible sources of taxable income will vary for different tax jurisdictions and, possibly, from year to year. To the extent evidence about one or more sources of taxable income is sufficient to support a conclusion that a valuation allowance is not necessary, other sources need not be considered. Consideration of each source is required, however, to determine the amount of the valuation allowance that is recognized for deferred tax assets.

**22.** In some circumstances, there are actions (including elections for tax purposes) that (a) are prudent and feasible, (b) an enterprise ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused, and (c) would result in realization of deferred tax assets. This Statement refers to those actions as *tax-planning strategies*. An enterprise shall consider tax-planning strategies in determining the amount of valuation allowance required. Significant expenses to implement a tax-planning strategy or any significant losses that would be recognized if that strategy were implemented (net of any recognizable tax benefits associated with those expenses or losses) shall be included in the valuation allowance. Refer to paragraphs 246-251 for additional guidance.

**23.** Forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years. Other examples of negative evidence include (but are not limited to) the following:

**a.** A history of operating loss or tax credit carryforwards expiring unused

**b.** Losses expected in early future years (by a presently profitable entity)

**c.** Unsettled circumstances that, if unfavorably resolved, would adversely affect future operations and profit levels on a continuing basis in future years

**d.** A carryback, carryforward period that is so brief that it would limit realization of tax benefits if (1) a significant deductible temporary difference is expected to reverse in a single year or (2) the enterprise operates in a traditionally cyclical business.

**24.** Examples (not prerequisites) of positive evidence that might support a conclusion that a valuation allowance is not needed when there is negative evidence include (but are not limited to) the following:

**a.** Existing contracts or firm sales backlog that will produce more than enough taxable income to realize the deferred tax asset based on existing sales prices and cost structures

**b.** An excess of appreciated asset value over the tax basis of the entity's net assets in an amount sufficient to realize the deferred tax asset

**c.** A strong earnings history exclusive of the loss that created the future deductible amount (tax loss carryforward or deductible temporary difference) coupled with evidence indicating that the loss (for example, an unusual, infrequent, or extraordinary item) is an aberration rather than a continuing condition.

**25.** An enterprise must use judgment in considering the relative impact of negative and positive evidence. The weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which it can be objectively verified. The more negative evidence that exists (a) the more positive evidence is necessary and (b) the more difficult it is to support a conclusion that a valuation allowance is not needed for some portion or all of the deferred tax asset.

### A Change in the Valuation Allowance

**26.** The effect of a change in the beginning-of-the-year balance of a valuation allowance that results from a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years ordinarily shall be included in income from continuing operations. The only exceptions are the initial recognition (that is, by elimination of the valuation allowance) of certain tax benefits that are allocated as required by paragraph 30 and paragraph 36 (items (c) and (e)-(g)). The effect of other changes in the balance of a valuation allowance are allocated among continuing operations and items other than continuing operations as required by paragraph 35.

### An Enacted Change in Tax Laws or Rates

**27.** Deferred tax liabilities and assets shall be adjusted for the effect of a change in tax laws or rates. The effect shall be included in income from continuing operations for the period that includes the enactment date.

### A Change in the Tax Status of an Enterprise

**28.** An enterprise's tax status may change from nontaxable to taxable or from taxable to nontaxable. An example is a change from a partnership to a corporation and vice versa. A deferred tax liability or asset shall be recognized for temporary differences in accordance with the requirements of this Statement at the date that a nontaxable enterprise becomes a taxable enterprise. A deferred tax liability or asset shall be eliminated at the date an enterprise ceases to be a taxable enterprise. In either case, the effect of (a) an election for a voluntary change in tax status is recognized on the approval date or on the filing date if approval is not necessary and (b) a change in tax status that results from a change in tax law is recognized on the enactment date. The effect of recognizing or eliminating the deferred tax liability or asset shall be included in income from continuing operations.

### Regulated Enterprises

**29.** Regulated enterprises that meet the criteria for application of FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*, are not exempt from the requirements of this Statement. Specifically, this Statement:

**a.** Prohibits net-of-tax accounting and reporting

**b.** Requires recognition of a deferred tax liability (1) for tax benefits that are flowed through to customers when temporary differences originate and (2) for the equity component of the allowance for funds used during construction

**c.** Requires adjustment of a deferred tax liability or asset for an enacted change in tax laws or rates.

If, as a result of an action by a regulator, it is probable that the future increase or decrease in taxes payable for items (b) and (c) above will be recovered from or returned to customers through future rates, an asset or liability is recognized for that probable future revenue or reduction in future revenue pursuant to paragraphs 9-11 of Statement 71. That asset or liability also is a temporary difference for which a deferred tax liability or asset shall be recognized.

**Business Combinations**

**30.** A deferred tax liability or asset shall be recognized in accordance with the requirements of this Statement for differences between the assigned values and the tax bases of the assets and liabilities (except the portion of goodwill for which amortization is not deductible for tax purposes, unallocated "negative goodwill," leveraged leases, and acquired Opinion 23 differences[8]) recognized in a purchase business combination (refer to paragraphs 259-272 for additional guidance). If a valuation allowance is recognized for the deferred tax asset for an acquired entity's deductible temporary differences or operating loss or tax credit carryforwards at the acquisition date, the tax benefits for those items that are first recognized (that is, by elimination of that valuation allowance) in financial statements after the acquisition date shall be applied (a) first to reduce to zero any goodwill related to the acquisition, (b) second to reduce to zero other noncurrent intangible assets related to the acquisition, and (c) third to reduce income tax expense.

**Opinion 23 and U.S. Steamship Enterprise Temporary Differences**

**31.** A deferred tax liability is not recognized for the following types of temporary differences unless it becomes apparent that those temporary differences will reverse in the foreseeable future:

**a.** An excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign corporate joint venture as defined in APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, that is essentially permanent in duration

**b.** Undistributed earnings of a domestic subsidiary or a domestic corporate joint venture that is essentially permanent in duration that arose in fiscal years beginning on or before December 15, 1992[9]

**c.** "Bad debt reserves" for tax purposes of U.S. savings and loan associations (and other "qualified" thrift lenders) that arose in tax years beginning before December 31, 1987 (that is, the base-year amount)

**d.** "Policyholders' surplus" of stock life insurance companies that arose in fiscal years beginning on or before December 15, 1992.

The indefinite reversal criterion in Opinion 23 shall not be applied to analogous types of temporary differences.

**32.** A deferred tax liability shall be recognized for the following types of taxable temporary differences:

**a.** An excess of the amount for financial reporting over the tax basis of an investment in a domestic subsidiary that arises in fiscal years beginning after December 15, 1992

**b.** An excess of the amount for financial reporting over the tax basis of an investment in a 50-percent-or-less-owned investee except as provided in paragraph 31(a) and (b) for a corporate joint venture that is essentially permanent in duration

**c.** "Bad debt reserves" for tax purposes of U.S. savings and loan associations (and other "qualified" thrift lenders) that arise in tax years beginning after December 31, 1987 (that is, amounts in excess of the base-year amount).

The tax effects of temporary differences related to deposits in statutory reserve funds by U.S. steamship enterprises that arose in fiscal years beginning on or before December 15, 1992 and that were not previously recognized shall be recognized when those temporary differences reverse or in their entirety at the beginning of the fiscal year for which this Statement is first applied.

**33.** Whether an excess of the amount for financial reporting over the tax basis of an investment in a more-than-50-percent-owned domestic subsidiary is a taxable temporary difference must be assessed. It is not a taxable temporary difference if the tax law provides a means by which the reported amount of that investment can be recovered tax-free and the enterprise expects that it will ultimately use that means. For example, under current U.S. federal tax law:

**a.** An enterprise may elect to determine taxable gain or loss on the liquidation of an 80-percent-or-more-owned subsidiary by reference to the tax basis of the subsidiary's net assets rather than by reference to the parent company's tax basis for the stock of that subsidiary.

**b.** An enterprise may execute a statutory merger whereby a subsidiary is merged into the parent company, the minority shareholders receive stock of the parent, the subsidiary's stock is cancelled, and no taxable gain or loss results if the continuity of ownership, continuity of business enterprise, and certain other requirements of the tax law are met.

Some elections for tax purposes are available only if the parent company owns a specified percentage of the subsidiary's stock. The parent company sometimes may own less than that specified percentage, and the price per share to acquire a minority interest may significantly exceed the per share equivalent of the amount reported as minority interest in the consolidated financial statements. In those circumstances, the excess of the amount for financial reporting over the tax basis of the parent's investment in the subsidiary is not a taxable temporary difference if settlement of the minority interest is expected to occur at the point in time when settlement would not result in a significant cost. That could occur, for example, toward the end of the life of the subsidiary, after it has recovered and settled most of its assets and liabilities, respectively. The fair value of the minority interest ordinarily will approximately equal its percentage of the subsidiary's net assets if those net assets consist primarily of cash.

**34.** A deferred tax asset shall be recognized for an excess of the tax basis over the amount for financial reporting of an investment in a subsidiary or corporate joint venture that is essentially permanent in duration only if it is apparent that the temporary difference will reverse in the foreseeable future. The need for a valuation allowance for that deferred tax asset and other deferred tax assets related to Opinion 23 temporary differences (for example, a deferred tax asset for foreign tax credit carryforwards or for a savings and loan association's bad-debt reserve for financial reporting) shall be assessed. Paragraph 21 identifies four sources of taxable income to be considered in determining the need for and amount of a valuation allowance for those and other deferred tax assets. One source is future reversals of temporary differences. Future reversals of taxable differences for which a deferred tax liability has not been recognized based on the exceptions cited in paragraph 31, however, shall not be considered. Another source is future taxable income exclusive of reversing temporary differences and carryforwards. Future distributions of future earnings of a subsidiary or corporate joint venture, however, shall not be considered except to the extent that a deferred tax liability has been recognized for existing undistributed earnings or earnings have been remitted in the past.

**Intraperiod Tax Allocation**

**35.** Income tax expense or benefit for the year shall be allocated among continuing operations, discontinued operations, extraordinary items, and items charged or credited directly to shareholders' equity (paragraph 36). The

[8] Acquired Opinion 23 differences are accounted for in accordance with the requirements of Opinion 23, as amended by this Statement.

[9] A last-in, first-out (LIFO) pattern determines whether reversals pertain to differences that arose in fiscal years beginning on or before December 15, 1992.

amount allocated to continuing operations is the tax effect of the pretax income or loss from continuing operations that occurred during the year, plus or minus income tax effects of (a) changes in circumstances that cause a change in judgment about the realization of deferred tax assets in future years (paragraph 26), (b) changes in tax laws or rates (paragraph 27), (c) changes in tax status (paragraph 28), and (d) tax-deductible dividends paid to shareholders (except as set forth in paragraph 36 for dividends paid on unallocated shares held by an employee stock ownership plan [ESOP] or any other stock compensation arrangement). The remainder is allocated to items other than continuing operations in accordance with the provisions of paragraph 38.

**36.** The tax effects of the following items occurring during the year are charged or credited directly to related components of shareholders' equity:

**a.** Adjustments of the opening balance of retained earnings for certain changes in accounting principles or a correction of an error

**b. Gains and losses included in comprehensive income but excluded from net income** (for example, translation adjustments under Statement 52 and changes in the carrying amount of marketable securities under FASB Statement No. 12, *Accounting for Certain Marketable Securities*)

**c.** An increase or decrease in contributed capital (for example, deductible expenditures reported as a reduction of the proceeds from issuing capital stock)

**d.** An increase in the tax basis of assets acquired in a taxable business combination accounted for as a pooling of interests and for which a tax benefit is recognized at the date of the business combination

**e.** Expenses for employee stock options recognized differently for financial reporting and tax purposes (refer to paragraph 17 of APB Opinion No. 25, *Accounting for Stock Issued to Employees*)

**f.** Dividends that are paid on unallocated shares held by an ESOP and that are charged to retained earnings

**g.** Deductible temporary differences and carryforwards that existed at the date of a quasi reorganization (except as set forth in paragraph 39).

**37.** The tax benefit of an operating loss carryforward or carryback (other than those carryforwards referred to at the end of this paragraph) shall be reported in the same manner as the source of the income or loss in the current year and not in the same manner as (a) the source of the operating loss carryforward or taxes paid in a prior year or (b) the source of expected future income that will result in realization of a deferred tax asset for an operating loss carryforward from the current year. The only exceptions are as follows:

**a.** Tax effects of deductible temporary differences and carryforwards that existed at the date of a purchase business combination and for which a tax benefit is initially recognized in subsequent years in accordance with the provisions of paragraph 30

**b.** Tax effects of deductible temporary differences and carryforwards that are allocated to shareholders' equity in accordance with the provisions of paragraph 36 (items (c) and (e)-(g)).

**38.** If there is only one item other than continuing operations, the portion of income tax expense or benefit for the year that remains after the allocation to continuing operations is allocated to that item. If there are two or more items other than continuing operations, the amount that remains after the allocation to continuing operations shall be allocated among those other items in proportion to their individual effects on income tax expense or benefit for the year. When there are two or more items other than continuing operations, the sum of the separately calculated, individual effects of each item sometimes may not equal the amount of income tax expense or benefit for the year that remains after the allocation to continuing operations. In those circumstances, the procedures to allocate the remaining amount to items other than continuing operations are as follows:

**a.** Determine the effect on income tax expense or benefit for the year of the total net loss for all net loss items

**b.** Apportion the tax benefit determined in (a) ratably to each net loss item

**c.** Determine the amount that remains, that is, the difference between (1) the amount to be allocated to all items other than continuing operations and (2) the amount allocated to all net loss items

**d.** Apportion the tax expense determined in (c) ratably to each net gain item. Refer to paragraphs 273-276 for additional guidance.

### Certain Quasi Reorganizations

**39.** The tax benefits of deductible temporary differences and carryforwards as of the date of a quasi reorganization as defined and contemplated in ARB No. 43, Chapter 7, "Capital Accounts," ordinarily are reported as a direct addition to contributed capital if the tax benefits are recognized in subsequent years. The only exception is for enterprises that have previously both adopted Statement 96 and effected a quasi reorganization that involves only the elimination of a deficit in retained earnings by a concurrent reduction in contributed capital prior to adopting this Statement. For those enterprises, subsequent recognition of the tax benefit of prior deductible temporary differences and carryforwards is included in income and reported as required by paragraph 37 (without regard to the referenced exceptions) and then reclassified from retained earnings to contributed capital. Those enterprises should disclose (a) the date of the quasi reorganization, (b) the manner of reporting the tax benefits and that it differs from present accounting requirements for other enterprises and (c) the effect of those tax benefits on income from continuing operations, income before extraordinary items, and on net income (and on related per share amounts).

### Separate Financial Statements of a Subsidiary

**40.** The consolidated amount of current and deferred tax expense for a group that files a consolidated tax return shall be allocated among the members of the group when those members issue separate financial statements. This Statement does not require a single allocation method. The method adopted, however, shall be systematic, rational, and consistent with the broad principles established by this Statement. A method that allocates current and deferred taxes to members of the group by applying this Statement to each member as if it were a separate taxpayer[10] meets those criteria. Examples of methods that are not consistent with the broad principles established by this Statement include:

**a.** A method that allocates only current taxes payable to a member of the group that has taxable temporary differences

**b.** A method that allocates deferred taxes to a member of the group using a method fundamentally different from the asset and liability method described in this Statement (for example, the Opinion 11 deferred method)

**c.** A method that allocates no current or deferred tax expense to a member of the group that has taxable income because the consolidated group has no current or deferred tax expense.

[10] In that situation, the sum of the amounts allocated to individual members of the group may not equal the consolidated amount. That may also be the result when there are intercompany transactions between members of the group. The criteria are satisfied, nevertheless, after giving effect to the type of adjustments (including eliminations) normally present in preparing consolidated financial statements.

Certain disclosures are also required (paragraph 49).

**Financial Statement Presentation**

**41.** In a classified statement of financial position, an enterprise shall separate deferred tax liabilities and assets into a current amount and a noncurrent amount. Deferred tax liabilities and assets shall be classified as current or noncurrent based on the classification of the related asset or liability for financial reporting. A deferred tax liability or asset that is not related to an asset or liability for financial reporting (paragraph 15), including deferred tax assets related to carryforwards, shall be classified according to the expected reversal date of the temporary difference pursuant to FASB Statement No. 37, *Balance Sheet Classification of Deferred Income Taxes*. The valuation allowance for a particular tax jurisdiction shall be allocated between current and noncurrent deferred tax assets for that tax jurisdiction on a pro rata basis.

**42.** For a particular tax-paying component of an enterprise and within a particular tax jurisdiction, (a) all current deferred tax liabilities and assets shall be offset and presented as a single amount and (b) all noncurrent deferred tax liabilities and assets shall be offset and presented as a single amount. However, an enterprise shall not offset deferred tax liabilities and assets attributable to different tax-paying components of the enterprise or to different tax jurisdictions.

**Financial Statement Disclosure**

**43.** The components of the net deferred tax liability or asset recognized in an enterprise's statement of financial position shall be disclosed as follows:

**a.** The total of all deferred tax liabilities measured in procedure (b) of paragraph 17

**b.** The total of all deferred tax assets measured in procedures (c) and (d) of paragraph 17

**c.** The total valuation allowance recognized for deferred tax assets determined in procedure (e) of paragraph 17.

The net change during the year in the total valuation allowance also shall be disclosed. A **public enterprise** shall disclose the approximate tax effect of each type of temporary difference and carryforward that gives rise to a significant portion of deferred tax liabilities and deferred tax assets (before allocation of valuation allowances). A **nonpublic enterprise** shall disclose the types of significant temporary differences and carryforwards but may omit disclosure of the tax effects of each type. A public enterprise that is not subject to income taxes because its income is taxed directly to its owners shall disclose that fact and the net difference between the tax bases and the reported amounts of the enterprise's assets and liabilities.

**44.** The following information shall be disclosed whenever a deferred tax liability is not recognized because of the exceptions to comprehensive recognition of deferred taxes for any of the areas addressed by Opinion 23 (as amended by this Statement) or for deposits in statutory reserve funds by U.S. steamship enterprises:

**a.** A description of the types of temporary differences for which a deferred tax liability has not been recognized and the types of events that would cause those temporary differences to become taxable

**b.** The cumulative amount of each type of temporary difference

**c.** The amount of the unrecognized deferred tax liability for temporary differences related to investments in foreign subsidiaries and foreign corporate joint ventures that are essentially permanent in duration if determination of that liability is practicable or a statement that determination is not practicable

**d.** The amount of the deferred tax liability for temporary differences other than those in (c) above (that is, undistributed domestic earnings, the bad-debt reserve for tax purposes of a U.S. savings and loan association or other qualified thrift lender, the policyholders' surplus of a life insurance enterprise, and the statutory reserve funds of a U.S. steamship enterprise) that is not recognized in accordance with the provisions of paragraphs 31 and 32.

**45.** The significant components of income tax expense attributable to continuing operations for each year presented shall be disclosed in the financial statements or notes thereto. Those components would include, for example:

**a. Current tax expense or benefit**

**b.** Deferred tax expense or benefit (exclusive of the effects of other components listed below)

**c.** Investment tax credits

**d.** Government grants (to the extent recognized as a reduction of income tax expense)

**e.** The benefits of operating loss carryforwards

**f.** Tax expense that results from allocating certain tax benefits either directly to contributed capital or to reduce goodwill or other noncurrent intangible assets of an acquired entity

**g.** Adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates or a change in the tax status of the enterprise

**h.** Adjustments of the beginning-of-the-year balance of a valuation allowance because of a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years.

**46.** The amount of income tax expense or benefit allocated to continuing operations and the amounts separately allocated to other items (in accordance with the provisions of paragraphs 35-39) shall be disclosed for each year for which those items are presented.

**47.** A public enterprise shall disclose a reconciliation using percentages or dollar amounts of (a) the reported amount of income tax expense attributable to continuing operations for the year to (b) the amount of income tax expense that would result from applying domestic federal statutory tax rates to pretax income from continuing operations. The "statutory" tax rates shall be the regular tax rates if there are alternative tax systems. The estimated amount and the nature of each significant reconciling item shall be disclosed. A nonpublic enterprise shall disclose the nature of significant reconciling items but may omit a numerical reconciliation. If not otherwise evident from the disclosures required by this paragraph and paragraphs 43-46, all enterprises shall disclose the nature and effect of any other significant matters affecting comparability of information for all periods presented.

**48.** An enterprise shall disclose (a) the amounts and expiration dates of operating loss and tax credit carryforwards for tax purposes and (b) any portion of the valuation allowance for deferred tax assets for which subsequently recognized tax benefits will be allocated to reduce goodwill or other noncurrent intangible assets of an acquired entity or directly to contributed capital (paragraphs 30 and 36).

**49.** An entity that is a member of a group that files a consolidated tax return shall disclose in its separately issued financial statements:

**a.** The aggregate amount of current and deferred tax expense for each statement of earnings presented and the amount of any tax-related balances due to or from affiliates as of the date of each statement of financial position presented

**b.** The principal provisions of the method by which the consolidated amount of current and deferred tax expense is allocated to members of the group and the nature and effect of any changes in that method (and in determining related balances to or from affiliates) during the years for which the disclosures in (a) above are presented.

**Effective Date and Transition**

**50.** This Statement shall be effective for fiscal years beginning after December 15, 1992. Earlier application is encouraged. Financial statements for any number of consecutive fiscal years before the effective date may be restated to conform to the provisions of this Statement. Initial application of this Statement shall be as of the beginning of an enterprise's fiscal year (that is, if the Statement is adopted prior to the effective date and during an interim period other than the first interim period, all prior interim periods of that fiscal year shall be restated). Application of the requirements for recognition of a deferred tax liability or asset for a restated interim or annual period shall be based on the facts and circumstances as they existed at that prior date and without the benefit of hindsight.

**51.** The effect of initially applying this Statement shall be reported as the effect of a change in accounting principle in a manner similar to the cumulative effect of a change in accounting principle (APB Opinion No. 20, *Accounting Changes*, paragraph 20) except for initially recognized tax benefits of the type required by this Statement to be excluded from comprehensive income. If the earliest year restated is not presented in the financial statements, the beginning balance of retained earnings and, if necessary, any other components of shareholders' equity for the earliest year presented shall be adjusted for the effect of the restatement as of that date. Paragraph 30 addresses the manner of reporting acquired tax benefits initially recognized subsequent to a business combination and paragraph 36 identifies five items ((c)-(g)) for which tax benefits are excluded from comprehensive income and allocated directly to contributed capital or retained earnings. Pro forma effects of retroactive application (Opinion 20, paragraph 21) are not required if statements of earnings presented for prior years are not restated.

**52.** When initially presented, the financial statements for the year this Statement is first adopted shall disclose:

**a.** The effect, if any, of adopting this Statement on pretax income from continuing operations (for example, the effect of adjustments for prior purchase business combinations and for regulated enterprises) for the year of adoption if restated financial statements for the prior year are not presented

**b.** The effect of any restatement on income from continuing operations, income before extraordinary items, and net income (and on related per share amounts) for each year for which restated financial statements are presented.

**Prior Business Combinations**

**53.** If financial statements for prior years are restated, all purchase business combinations that were consummated in those prior years shall be remeasured in accordance with the requirements of this Statement.

**54.** For a purchase business combination consummated prior to the beginning of the year for which this Statement is first applied, any balance remaining as of that date for goodwill or negative goodwill shall not be adjusted to equal the amount it would be if financial statements for the year of the combination and subsequent years were restated. However, except for leveraged leases and except as provided in paragraph 55, (a) remaining balances as of the date of initially applying this Statement for assets and liabilities acquired in that combination shall be adjusted from their net-of-tax amounts to their pretax amounts and (b) any differences between those adjusted remaining balances and their tax bases are temporary differences. A deferred tax liability or asset shall be recognized for those temporary differences pursuant to the requirements of this Statement as of the beginning of the year for which this Statement is first applied.

**55.** If, for a particular business combination, determination of the adjustment for any or all of the assets and liabilities referred to in paragraph 54 is impracticable, either because the necessary information is no longer available or because the cost to develop that information is excessive, none of the remaining balances of any assets and liabilities acquired in that combination shall be adjusted to pretax amounts, that is, all remaining amounts that were originally assigned on a net-of-tax basis pursuant to paragraph 89 of Opinion 16 shall not be adjusted. Any differences between those unadjusted remaining balances and their tax bases are temporary differences, and a deferred tax liability or asset shall be recognized for those temporary differences pursuant to the requirements of this Statement as of the beginning of the year for which this Statement is first applied.

**56.** The net effect of the adjustments required by paragraphs 54 and 55 shall be included in the effect of initially applying this Statement and reported in accordance with the provisions of paragraph 51.

**Assets of Regulated Enterprises Reported on a Net-of-Tax or After-Tax Basis**

**57.** Some regulated enterprises that apply Statement 71 have accounted for certain components of construction in progress on either a net-of-tax or after-tax basis, or both. Upon initial application of this Statement, those enterprises shall make appropriate adjustments required by this Statement to account for the net-of-tax and after-tax components of construction in progress as if the requirements of this Statement were applied to that construction in progress in all prior years. Except as provided in paragraph 58, the reported amount of plant in service at the beginning of the year for which this Statement is first applied shall be similarly adjusted.

**58.** If determination of the adjustment to plant in service referred to in paragraph 57 is impracticable, either because the necessary information is no longer available or because the cost to develop that information is excessive, any difference between the reported amount and the tax basis of that plant in service is a temporary difference, and a deferred tax liability shall be recognized for that temporary difference. If, as a result of an action by a regulator, it is probable that amounts required for settlement of that deferred tax liability will be recovered from customers through future rates, an asset and the related deferred tax liability for that additional temporary difference shall be recognized for that probable future revenue.

**59.** The net effect of the adjustments required by paragraphs 57 and 58 shall be included in the effect of initially applying this Statement and reported in accordance with the provisions of paragraph 51.

**The provisions of this Statement need not be applied to immaterial items.**

*This Statement was adopted by the unanimous vote of the six members of the Financial Accounting Standards Board:*

Dennis R. Beresford, *Chairman*
Joseph V. Anania
Victor H. Brown
James J. Leisenring
A. Clarence Sampson
Robert J. Swieringa

APPENDIX B

## APPLICATION OF THE STANDARDS TO SPECIFIC ASPECTS OF ACCOUNTING FOR INCOME TAXES

### CONTENTS



### Introduction

**223.** This appendix provides additional discussion and examples[14] that illustrate application of the standards to specific aspects of accounting for income taxes.

### Recognition of Deferred Tax Assets and Deferred Tax liabilities

**224.** A deferred tax liability is recognized for all taxable temporary differences,[15] and a deferred tax asset is recognized for all deductible temporary differences and operating loss and tax credit carryforwards. A valuation allowance is recognized if it is more likely than not that some portion or all of the deferred tax asset will not be realized.

**225.** The following example illustrates recognition of deferred tax assets and liabilities. At the end of year 3 (the current year), an enterprise has $2,400 of deductible temporary differences and $1,500 of taxable temporary differences.

A deferred tax liability is recognized at the end of year 3 for the $1,500 of taxable temporary differences, and a deferred tax asset is recognized for the $2,400 of deductible temporary differences. All available evidence, both positive and negative, is considered to determine whether, based on the weight of that evidence, a valuation allowance is needed for some portion or all of the deferred tax asset. If evidence about one or more sources of taxable income (refer to paragraph 21) is sufficient to support a conclusion that a valuation allowance is not needed, other sources of taxable income need not be considered. For example, if the weight of available evidence indicates that taxable income will exceed $2,400 in each future year, a conclusion that no valuation allowance is needed can be reached without considering the pattern and timing of the reversal of the temporary differences, the existence of qualifying tax-planning strategies, and so forth.

Similarly, if the deductible temporary differences will reverse within the next 3 years and taxable income in the current year exceeds $2,400, nothing needs to be known about future taxable income exclusive of reversing temporary differences because the deferred tax asset could be realized by carryback to the current year. A valuation allowance is needed, however, if the weight of available evidence indicates that some portion or all of the $2,400 of tax deductions from future reversals of the deductible temporary differences will not be realized by offsetting:

**a.** The $1,500 of taxable temporary differences and $900 of future taxable income exclusive of reversing temporary differences

**b.** $2,400 of future taxable income exclusive of reversing temporary differences

**c.** $2,400 of taxable income in the current or prior years by loss carryback to those years

**d.** $2,400 of taxable income in one or more of the circumstances described above and as a result of a qualifying tax-planning strategy (refer to paragraphs 246–251).

To the extent that evidence about one or more sources of taxable income is sufficient to eliminate any need for a valuation allowance, other sources need not considered. Detailed forecasts, projections, or other types of analyses[16] are unnecessary if expected future taxable income is more than sufficient to realize a tax benefit. Detailed analyses are not necessary, for example, if the enterprise earned $500 of taxable income in each of years 1-3 and there is no evidence to suggest it will not continue to earn that level of taxable income in future years. That level of future taxable income is more than sufficient to realize the tax benefit of $2,400 of tax deductions over a period of at least 19 years (the year(s) of the deductions, 3 carryback years, and 15 carryforward years) in the U.S. federal tax jurisdiction.

**226.** The following example illustrates recognition of a valuation allowance for a portion of a deferred tax asset in one year and a subsequent change in circumstances that requires adjust-

[14] The discussion and examples in this appendix assume that the tax law requires offsetting net deductions in a particular year against net taxable amounts in the 3 preceding years and then in the 15 succeeding years. Assumptions in this appendix about the tax law are for illustrative purposes only. The enacted tax law for a particular tax jurisdiction should be used for recognition and measurement of deferred tax liabilities and assets.

[15] Refer to paragraph 9.

[16] The terms *forecast* and *projection* refer to any process by which available evidence is accumulated and evaluated for purposes of estimating whether future taxable income will be sufficient to realize a deferred tax asset. Judgment is necessary to determine how detailed or formalized that evaluation process should be. Furthermore, information about expected future taxable income is necessary only to the extent positive evidence available from other sources (refer to paragraph 21) is not sufficient to support a conclusion that a valuation allowance is not needed. This Statement does not require either a *financial forecast* or *financial projection* within the meaning of those terms in the Statements on Standards for Accountants' Services on Prospective Financial Information issued by the Auditing Standards Board of the American Institute of Certified Public Accountants.

ment of the valuation allowance at the end of the following year. The assumptions are as follows:

**a.** At the end of the current year (year 3), an enterprise's only temporary differences are deductible temporary differences in the amount of $900.

**b.** Pretax financial income, taxable income, and taxes paid for each of years 1-3 are all positive, but relatively negligible, amounts.

**c.** The enacted tax rate is 40 percent for all years.

A deferred tax asset in the amount of $360 ($900 at 40 percent) is recognized at the end of year 3. If management concludes, based on an assessment of all available evidence (refer to guidance in paragraphs 20-25), that it is more likely than not that future taxable income will not be sufficient to realize a tax benefit for $400 of the $900 of deductible temporary differences at the end of the current year, a $160 valuation allowance ($400 at 40 percent) is recognized at the end of year 3.

Assume that pretax financial income and taxable income for year 4 turn out to be as follows:

| | |
|---|---|
| Pretax financial loss | $ (50) |
| Reversing deductible temporary differences | (300) |
| Loss carryforward for tax purposes | $(350) |

The $50 pretax loss in year 4 is additional negative evidence that must be weighed against available positive evidence to determine the amount of valuation allowance necessary at the end of year 4. Deductible temporary differences and carryforwards at the end of year 4 are as follows:

| | |
|---|---|
| Loss carryforward from year 4 for tax purposes (see above) | $350 |
| Unreversed deductible temporary differences ($900 – $300) | 600 |
| | $950 |

The $360 deferred tax asset recognized at the end of year 3 is increased to $380 ($950 at 40 percent) at the end of year 4. Based on an assessment of all evidence available at the end of year 4, management concludes that it is more likely than not that $240 of the deferred tax asset will not be realized and, therefore, that a $240 valuation allowance is necessary. The $160 valuation allowance recognized at the end of year 3 is increased to $240 at the end of year 4. The $60 net effect of those 2 adjustments (the $80 increase in the valuation allowance less the $20 increase in the deferred tax asset) results in $60 of deferred tax expense that is recognized in year 4.

### Offset of Taxable and Deductible Amounts

**227.** The tax law determines whether future reversals of temporary differences will result in taxable and deductible amounts that offset each other in future years. The tax law also determines the extent to which deductible temporary differences and carryforwards will offset the tax consequences of income that is expected to be earned in future years. For example, the tax law may provide that capital losses are deductible only to the extent of capital gains. In that case, a tax benefit is not recognized for temporary differences that will result in future deductions in the form of capital losses unless those deductions will offset either (a) other existing temporary differences that will result in future capital gains, (b) capital gains that are expected to occur in future years, or (c) capital gains of the current year or prior years if carryback (of those capital loss deductions from the future reversal years) is expected.

### Pattern of Taxable or Deductible Amounts

**228.** The particular years in which temporary differences result in taxable or deductible amounts generally are determined by the timing of the recovery of the related asset or settlement of the related liability. However, there are exceptions to that general rule. For example, a temporary difference between the tax basis and the reported amount of inventory for which cost is determined on a LIFO basis does not reverse when present inventory is sold in future years if it is replaced by purchases or production of inventory in those same future years. A LIFO inventory temporary difference becomes taxable or deductible in the future year that inventory is liquidated and not replaced.

**229.** For some assets or liabilities, temporary differences may accumulate over several years and then reverse over several years. That pattern is common for depreciable assets. Future originating differences for existing depreciable assets and their subsequent reversals are a factor to be considered when assessing the likelihood of future taxable income (paragraph 21(b)) for realization of a tax benefit for existing deductible temporary differences and carryforwards.

### Change in Deferred Foreign Tax Assets and Liabilities

**230.** When the reporting currency (not the foreign currency) is the functional currency, remeasurement of an enterprise's deferred foreign tax liability or asset after a change in the exchange rate will result in a transaction gain or loss that is recognized currently in determining net income. Statement 52 requires disclosure of the aggregate transaction gain or loss included in determining net income but does not specify how to display that transaction gain or loss or its components for financial reporting. Accordingly, a transaction gain or loss that results from remeasuring a deferred foreign tax liability or asset may be included in the reported amount of deferred tax benefit or expense if that presentation is considered to be more useful. If reported in that manner, that transaction gain or loss is still included in the aggregate transaction gain or loss for the period to be disclosed as required by Statement 52.

### Special Deductions

**231.** Statement 96 amended FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, to require recognition of statutory depletion that would result from generating future revenues exactly equal to the amount of the related assets (that is, the assets subject to statutory depletion) to the extent that the statutory depletion offsets a deferred tax liability for taxable temporary differences attributable to those assets. This Statement eliminates that amendment of Statement 19. The Board concluded that, under the basic approach to recognition of deferred tax benefits required by this Statement, the necessary past event for recognition of the tax benefit of statutory depletion is producing oil, mining copper, and so forth (or its subsequent sale). The tax benefit of statutory depletion and other types of special deductions such as those for Blue Cross-Blue Shield and small life insurance companies in future years should not be anticipated for purposes of offsetting a deferred tax liability for taxable temporary differences at the end of the current year.

**232.** As required above, the tax benefit of special deductions ordinarily is recognized no earlier than the year in which those special deductions are deductible on the tax return. However, some portion of the future tax effects of special deductions are implicitly recognized in determining (a) the average graduated tax rate to be used for measuring deferred taxes when graduated tax rates are a significant factor and (b) the need for a valuation allowance for deferred tax assets. In those circumstances, implicit recognition is unavoidable because (1) those special deductions are one of the determinants of future taxable income and (2) future taxable income determines the average graduated tax rate and sometimes determines the need for a valuation allowance.

**Measurement of Deferred Tax Liabilities and Assets**

**233.** The tax rate that is used to measure deferred tax liabilities and deferred tax assets is the enacted tax rate(s) expected to apply to taxable income in the years that the liability is expected to be settled or the asset recovered. Measurements are based on elections (for example, an election for loss carryforward instead of carryback) that are expected to be made for tax purposes in future years. Presently enacted changes in tax laws and rates that become effective for a particular future year or years must be considered when determining the tax rate to apply to temporary differences reversing in that year or years. Tax laws and rates for the current year are used if no changes have been enacted for future years. An asset for deductible temporary differences that are expected to be realized in future years through carryback of a future loss to the current or a prior year (or a liability for taxable temporary differences that are expected to reduce the refund claimed for the carryback of a future loss to the current or a prior year) is measured using tax laws and rates for the current or a prior year, that is, the year for which a refund is expected to be realized based on loss carryback provisions of the tax law.

**234.** The following example illustrates determination of the tax rate for measurement of a deferred tax liability for taxable temporary differences when there is a phased-in change in tax rates. At the end of year 3 (the current year), an enterprise has $2,400 of taxable temporary differences, which are expected to result in taxable amounts of approximately $800 on the future tax returns for each of years acted tax rates are 35 percent for years 1-3, 40 percent for years 4-6, and 45 percent for year 7 and thereafter.

The tax rate that is used to measure the deferred tax liability for the $2,400 of taxable temporary differences differs depending on whether the tax effect of future reversals of, those temporary differences is on taxes payable for years 1-3, years 4-6, or year 7 and thereafter. The tax rate for measurement of the deferred tax liability is 40 percent whenever taxable income is expected in years 4-6. If tax losses are expected in years 4-6, however, the tax rate is:

**a.** 35 percent if realization of a tax benefit for those tax losses in years 4-6 will be by loss carryback to years 1-3

**b.** 45 percent if realization of a tax benefit for those tax losses in years 4-6 will be by loss carryforward to year 7 and thereafter.

**235.** The following example illustrates determination of the tax rate for measurement of a deferred tax asset for deductible temporary differences when there is a change in tax rates. The assumptions are as follows:

**a.** Enacted tax rates are 30 percent for years 1-3 and 40 percent for year 4 and thereafter.

**b.** At the end of year 3 (the current year), an enterprise has $900 of deductible temporary differences, which are expected to result in tax deductions of approximately $300 on the future tax returns for each of years 4-6.

The tax rate is 40 percent if the enterprise expects to realize a tax benefit for the deductible temporary differences by offsetting taxable income earned in future years. Alternatively, the tax rate is 30 percent if the enterprise expects to realize a tax benefit for the deductible temporary differences by loss carryback refund.

Assume that (a) the enterprise recognizes a $360 ($900 at 40 percent) deferred tax assset to be realized by offsetting taxable income in future years and (b) taxable income and taxes payable in each of years 1-3 were $300 and $90, respectively. Realization of a tax benefit of at least $270 ($900 at 30 percent) is assured because carryback refunds totalling $270 may be realized even if no taxable income is earned in future years. Recognition of a valuation allowance for the other $90 ($360 - $270) of the deferred tax asset depends on management's assessment of whether, based on the weight of available evidence, a portion or all of the tax benefit of the $900 of deductible temporary differences will not be realized at 40 percent tax rates in future years.

Alternatively, if enacted tax rates are 40 percent for years 1-3 and 30 percent for year 4 and thereafter, measurement of the deferred tax asset at a 40 percent tax rate could only occur if tax losses are expected in future years 4-6.

**236.** The following example illustrates determination of the average graduated tax rate for measurement of deferred tax liabilities and assets by an enterprise for which graduated tax rates ordinarily are a significant factor. At the end of year 3 (the current year), an enterprise has $1,500 of taxable temporary differences and $900 of deductible temporary differences, which are expected to result in net taxable amounts of approximately $200 on the future tax returns for each of years 4-6. Enacted tax rates are 15 percent for the first $500 of taxable income, 25 percent for the next $500, and 40 percent for taxable income over $1,000. This example assumes that there is no income (for example, capital gains) subject to special tax rates.

The deferred tax liability and asset for those reversing taxable and deductible temporary differences in years 4-6 are measured using the average graduated tax rate for the estimated amount of annual taxable income in future years. Thus, the average graduated tax rate will differ depending on the expected level of annual taxable income (including reversing temporary differences) in years 4-6. The average tax rate will be:

**a.** 15 percent if the estimated annual level of taxable income in years 4-6 is $500 or less

**b.** 20 percent if the estimated annual level of taxable income in years 4-6 is $1,000

**c.** 30 percent if the estimated annual level of taxable income in years 4-6 is $2,000.

Temporary differences usually do not reverse in equal annual amounts as in the example above, and a different average graduated tax rate might apply to reversals in different future years. However, a detailed analysis to determine the net reversals of temporary differences in each future year usually is not warranted. It is not warranted because the other variable (that is, taxable income or losses exclusive of reversing temporary differences in each of those future years) for determination of the average graduated tax rate in each future year is no more than an estimate. For that reason, an aggregate calculation using a single estimated average graduated tax rate based on estimated average annual taxable income in future years is sufficient. Judgment is permitted, however, to deal with unusual situations, for example, an abnormally large temporary difference that will reverse in a single future year, or an abnormal level of taxable income that is expected for a single future year. The lowest graduated tax rate should be used whenever the estimated average graduated tax rate otherwise would be zero.

**237.** Deferred tax liabilities and assets are measured using enacted tax rates applicable to capital gains, ordinary income, and so forth, based on the expected type of taxable or deductible amounts in future years. For example, evidence based on all facts and circumstances should determine whether an investor's liability for the tax consequences of temporary differences related to its equity in the earnings of an investee should be measured using enacted tax rates applicable to a capital gain or a dividend. Computation of a deferred tax liability for undistributed earnings based on dividends should also reflect any related dividends received deductions or foreign tax credits, and taxes that would be withheld from the dividend.

### Alternative Minimimum Tax

**238.** Temporary differences such as depreciation differences are one reason why TMT may exceed regular tax. Temporary differences, however, ultimately reverse and, absent a significant amount of preference items, total taxes paid over the entire life of the enterprise will be based on the regular tax system. Preference items are another reason why TMT may exceed regular tax. If preference items are large enough, an enterprise could be subject, over its lifetime, to the AMT system; and the cumulative amount of AMT credit carryforwards would expire unused. No one can know beforehand which scenario will prevail because that determination can only be made after the fact. In the meantime, this Statement requires procedures that provide a practical solution to that problem.

**239.** Under the requirements of this Statement, an enterprise should:

**a.** Measure the total deferred tax liability and asset for regular tax temporary differences and carryforwards using the regular tax rate

**b.** Measure the total deferred tax asset for all AMT credit carryforward

**c.** Reduce the deferred tax asset for AMT credit carryforward by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of that deferred tax asset will not be realized.

Paragraph 21 identifies four sources of taxable income that should be considered in determining the need for and amount of a valuation allowance. No valuation allowance is necessary if the deferred tax asset for AMT credit carryforward can be realized:

**1.** Under paragraph 21(a), by reducing a deferred tax liability from the amount of regular tax on regular tax temporary differences to not less than the amount of TMT on AMT temporary differences

**2.** Under paragraph 21(b), by reducing taxes on future income from the amount of regular tax on regular taxable income to not less than the amount of TMT on AMT income

**3.** Under paragraph 21(c), by loss carryback

**4.** Under paragraph 21(d), by a tax-planning strategy such as switching from tax-exempt to taxable interest income.

## Operating Loss and Tax Credit Carryforwards and Carrybacks

### Recognition of a Tax Benefit for Carrybacks

**240.** An operating loss, certain deductible items that are subject to limitations, and some tax credits arising but not utilized in the current year may be carried back for refund of taxes paid in prior years or carried forward to reduce taxes payable in future years. A receivable is recognized for the amount of taxes paid in prior years that is refundable by carryback of an operating loss or unused tax credits of the current year.

### Recognition of a Tax Benefit for Carryforwards

**241.** A deferred tax asset is recognized for an operating loss or tax credit carryforward.[17] In assessing the need for a valuation allowance, provisions in the tax law that limit utilization of an operating loss or tax credit carryforward are applied in determining whether it is more likely than not that some portion or all of the deferred tax asset will not be realized by reduction of taxes payable on taxable income during the carryforward period.

**242.** The following example illustrates recognition of the tax benefit of an operating loss in the loss year and in subsequent carryforward years when a valuation allowance is necessary in the loss year. The assumptions are as follows:

**a.** The enacted tax rate is 40 percent for all years.

**b.** An operating loss occurs in year 5.

**c.** The only difference between financial and taxable income results from use of accelerated depreciation for tax purposes. Differences that arise between the reported amount and the tax basis of depreciable assets in years 1-7 will result in taxable amounts before the end of the loss carryforward period from year 5.

**d.** Financial income, taxable income, and taxes currently payable or refundable are as follows:

| | Year 1 | Years 2-4 | Year 5 | Year 6 | Year 7 |
|---|---|---|---|---|---|
| Pretax financial income (loss) | $2,000 | $5,000 | $(8,000) | $2,200 | $7,000 |
| Depreciation differences | (800) | (2,200) | (800) | (700) | (600) |
| Loss carryback | — | — | 2,800 | — | — |
| Loss carryforward | — | — | — | (6,000) | (4,500) |
| Taxable income (loss) | $1,200 | $2,800 | $(6,000) | $(4,500) | $1,900 |
| Taxes payable (refundable) | $ 480 | $1,120 | $(1,120) | $ — | $ 760 |

**e.** At the end of year 5, profits are not expected in years 6 and 7 and later years, and it is concluded that a valuation allowance is necessary to the extent realization of the deferred tax asset for the operating loss carryforward depends on taxable income (exclusive of reversing temporary differences) in future years.

The deferred tax liability for the taxable temporary differences is calculated at the end of each year as follows:

| | Year 1 | Years 2-4 | Year 5 | Year 6 | Year 7 |
|---|---|---|---|---|---|
| Unreversed differences: | | | | | |
| Beginning amount | $ — | $ 800 | $3,000 | $3,800 | $4,500 |
| Additional amount | 800 | 2,200 | 800 | 700 | 600 |
| Total | $ 800 | $3,000 | $3,800 | $4,500 | $5,100 |
| Deferred tax liability (40 percent) | $ 320 | $1,200 | $1,520 | $1,800 | $2,040 |

[17] This requirement pertains to all ITC carryforwards regardless of whether the flow-through or deferral method is used to account for ITC.

The deferred tax asset and related valuation allowance for the loss carryforward are calculated at the end of each year as follows:

| | Year 1 | Years 2-4 | Year 5 | Year 6 | Year 7 |
|---|---|---|---|---|---|
| Loss carry-forward for tax purposes | $ — | $ — | $6,000 | $4,500 | $ — |
| Deferred tax asset (40 percent) | $ — | $ — | $2,400 | $1,800 | $ — |
| Valuation allowance equal to the amount by which the deferred tax asset exceeds the deferred tax liability | — | — | (800) | — | — |
| Net deferred tax asset | $ — | $ — | $1,520 | $1,800 | $ — |

Total tax expense for each period is as follows:

| | Year 1 | Years 2-4 | Year 5 | Year 6 | Year 7 |
|---|---|---|---|---|---|
| Deferred tax expense (benefit): | | | | | |
| Increase in deferred tax liability | $320 | $ 880 | $ 320 | $ 280 | $ 240 |
| (Increase) decrease in net deferred tax asset | — | — | (1,520) | (280) | 1,800 |
| | 320 | 880 | (1,200) | — | 2,040 |
| Currently payable (refundable) | 480 | 1,120 | (1,120) | — | 760 |
| Total tax expense (benefit) | $800 | $2,000 | $(2,320) | $ — | $2,800 |

In year 5, $2,800 of the loss is carried back to reduce taxable income in years 2-4, and $1,120 of taxes paid for those years is refunded. In addition, a $1,520 deferred tax liability is recognized for $3,800 of taxable temporary differences, and a $2,400 deferred tax asset is recognized for the $6,000 loss carryforward. However, based on the conclusion described in assumption (e), a valuation allowance is recognized for the amount by which that deferred tax asset exceeds the deferred tax liability.

In year 6, a portion of the deferred tax asset for the loss carryforward is realized because taxable income is earned in that year. The remaining balance of the deferred tax asset for the loss carryforward at the end of year 6 equals the deferred tax liability for the taxable temporary differences. A valuation allowance is not needed.

In year 7, the remaining balance of the loss carryforward is realized, and $760 of taxes are payable on net taxable income of $1,900. A $2,040 deferred tax liability is recognized for the $5,100 of taxable temporary differences.

**243.** An operating loss or tax credit carryforward from a prior year (for which the deferred tax asset was reduced by a valuation allowance) may sometimes reduce taxable income and taxes payable that are attributable to certain revenues or gains that the tax law requires be included in taxable income for the year that cash is received. For financial reporting, however, there may have been no revenue or gain and a liability is recognized for the cash received. Future sacrifices to settle the liability will result in deductible amounts in future years. Under those circumstances, the reduction in taxable income and taxes payable from utilization of the operating loss or tax credit carryforward gives no cause for recognition of a tax benefit because, in effect, the operating loss or tax credit carryforward has been replaced by temporary differences that will result in deductible amounts when a nontax liability is settled in future years. The requirements for recognition of a tax benefit for deductible temporary differences and for operating loss carryforwards are the same, and the manner of reporting the eventual tax benefit recognized (that is, in income or as required by paragraph 37) is not affected by the intervening transaction reported for tax purposes.

**244.** The following example illustrates the interaction of loss carryforwards and temporary differences that will result in net deductible amounts in future years. The assumptions are as follows:

**a.** The financial loss and the loss reported on the tax return for an enterprise's first year of operations are the same.

**b.** In year 2, a gain of $2,500 from a transaction that is a sale for tax purposes but a sale and leaseback for financial reporting is the only difference between pre-tax financial income and taxable income.

| | | Financial Income | Taxable Income |
|---|---|---|---|
| Year 1: | Income (loss) from operations | $(4,000) | $(4,000) |
| Year 2: | Income (loss) from operations | $ — | $ — |
| | Taxable gain on sale | | 2,500 |
| | Taxable income before loss carryforward | | 2,500 |
| | Loss carryforward from year 1 | | (4,000) |
| | Taxable income | | $ — |

The $4,000 operating loss carryforward at the end of year 1 is reduced to $1,500 at the end of year 2 because $2,500 of it is used to reduce taxable income. The $2,500 reduction in the loss carryforward becomes $2,500 of deductible temporary differences that will reverse and result in future tax deductions when lease payments are made. The enterprise has no deferred tax liability to be offset by those future tax deductions, the future tax deductions cannot be realized by loss carryback because no taxes have been paid, and the enterprise has had pretax losses for financial reporting since inception. Unless positive evidence exists that is sufficient to overcome the negative evidence associated with those losses, a valuation allowance is recognized at the end of year 2 for the full amount of the deferred tax asset related to the $2,500 of deductible temporary differences and the remaining $1,500 of operating loss carryforward.

### Reporting the Tax Benefit of Operating Loss Carryforwards or Carrybacks

**245.** Except as noted in paragraph 37, the manner of reporting the tax benefit of an operating loss carryforward or carryback is determined by the source of the income or loss in the current year and not by (a) the source of the operating loss carryforward or taxes paid in a prior year or (b) the source of expected future income that will result in realization of a deferred tax asset for an operating loss carryforward from the current year. Deferred tax expense or benefit that results because a change in circumstances causes a change in judgment about the future realization of the tax benefit of an operating loss carryforward is allocated to continuing operations (refer to paragraph 26). Thus, for example:

**a.** The tax benefit of an operating loss carryforward that resulted from an extraordinary loss in a prior year and that is first recognized in the financial statements for the current year:

**(1)** Is allocated to continuing operations if it offsets the current or deferred tax consequences of income from continuing operations

**(2)** Is allocated to an extraordinary gain if it offsets the current or deferred tax consequences of that extraordinary gain

**(3)** Is allocated to continuing operations if it results from a change in circumstances that causes a change in judgment about future realization of a tax benefit

**b.** The current or deferred tax benefit of a loss from continuing operations in the current year is allocated to continuing operations regardless of whether that loss offsets the current or deferred tax consequences of an extraordinary gain that:

**(1)** Occurred in the current year

**(2)** Occurred in a prior year (that is, if realization of the tax benefit will be by carryback refund)

**(3)** Is expected to occur in a future year.

### Tax-Planning Strategies

**246.** Expectations about future taxable income incorporate numerous assumptions about actions, elections, and strategies to minimize income taxes in future years. For example, an enterprise may have a practice of deferring taxable income whenever possible by structuring sales to qualify as installment sales for tax purposes. Actions such as that are not *tax-planning strategies*, as that term is used in this Statement, because they are actions that management takes in the normal course of business. For purposes of applying the requirements of this Statement, a *tax-planning strategy* is an action that management ordinarily might not take but would take, if necessary, to realize a tax benefit for a carryforward before it expires. For example, a strategy to sell property and lease it back for the expressed purpose of generating taxable income to utilize a carryforward before it expires is not an action that management takes in the normal course of business. A qualifying tax-planning strategy is an action that:

**a.** *Is prudent and feasible.* Management must have the ability to implement the strategy and expect to do so unless the need is eliminated in future years. For example, management would not have to apply the strategy if income earned in a later year uses the entire amount of carryforward from the current year.

**b.** *An enterprise ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused.* All of the various strategies that are expected to be employed for business or tax purposes other than utilization of carryforwards that would otherwise expire unused are, for purposes of this Statement, implicit in management's estimate of future taxable income and, therefore, are not tax-planning strategies as that term is used in this Statement.

**c.** *Would result in realization of deferred tax assets.* The effect of qualifyinig tax-planning strategies must be recognized in the determination of the amount of a valuation allowance. Tax-planning strategies need not be considered, however, if positive evidence available from other sources (refer to paragraph 21) is sufficient to support a conclusion that a valuation allowance is *not* necessary.

**247.** Tax-planning strategies may shift estimated future taxable income between future years. For example, assume that an enterprise has a $1,500 operating loss carryforward that expires at the end of next year and that its estimate of taxable income exclusive of the future reversal of existing temporary differences and carryforwards is approximately $1,000 per year for each of the next several years. That estimate is based, in part, on the enterprise's present practice of making sales on the installment basis and on provisions in the tax law that result in temporary deferral of gains on installment sales. A tax-planning strategy to increase taxable income next year and resize the full tax benefit of that operating loss carryforward might be to structure next year's sales in a manner that does not meet the tax rules to qualify as installment sales. Another strategy might be to change next year's depreciation procedures for tax purposes.

**248.** Tax-planning strategies also may shift the estimated pattern and timing of future reversals of temporary differences. For example, if an operating loss carryforward otherwise would expire unused at the end of next year, a tax-planning strategy to sell the enterprise's installment sale receivables next year would accelerate the future reversal of taxable temporary differences for the gains on those installment sales. In other circumstances, a tax-planning strategy to accelerate the future reversal of *deductible* temporary differences in time to offset taxable income that is expected in an early future year might be the only means to realize a tax benefit for those deductible temporary differences if they otherwise would reverse and provide no tax benefit in some later future year(s). Examples of actions that would accelerate the future reversal of deductible temporary differences include:

**a.** An annual payment that is larger than an enterprise's usual annual payment to reduce a long-term pension obligation (recognized as a liability in the financial statements) might accelerate a tax deduction for pension expense to an earlier year than would otherwise have occurred.

**b.** Disposal of obsolete inventory that is reported at net realizable value in the financial statements would accelerate a tax deduction for the amount by which the tax basis exceeds the net realizable value of the inventory.

**c.** Sale of loans at their reported amount (that is, net of an allowance for bad debts) would accelerate a tax deduction for the allowance for bad debts.

**249.** A significant expense might need to be incurred to implement a particular tax-planning strategy, or a significant loss might need to be recognized as a result of implementing a particular tax-planning strategy. In either case, that expense or loss (net of any future tax benefit that would result from that expense or loss) reduces the amount of tax benefit that is recognized for the expected effect of a qualifying tax-planning strategy. For that purpose, the future effect of a differential in interest rates (for example, between the rate that would be earned on installment sale receivables and the rate that could be earned on an alternative investment if the tax-planning strategy is to sell those receivables to accelerate the future reversal of related taxable temporary differences) is not considered.

**250.** The following example illustrates recognition of a deferred tax asset based on the expected effect of a qualifying tax-planning strategy when a significant expense would be incurred to implement the strategy. The assumptions are as follows:

**a.** A $900 operating loss carryforward expires at the end of next year.

**b.** Based on historical results and the weight of other available evidence, the estimated level of taxable income exclusive of the future reversal of existing temporary differences and the oper-

ating loss carryforward next year is $100.
**c.** Taxable temporary differences in the amount of $1,200 ordinarily would result in taxable amounts of approximately $400 in each of the next 3 years.
**d.** There is a qualifying tax-planning strategy to accelerate the future reversal of all $1,200 of taxable temporary differences to next year.
**e.** Estimated legal and other expenses to implement that tax-planning strategy are $150.
**f.** The enacted tax rate is 40 percent for all years.

Without the tax-planning strategy, only $500 of the $900 operating loss carryforward could be realized next year by offsetting (a) $100 of taxable income exclusive of reversing temporary differences and (b) $400 of reversing taxable temporary differences. The other $400 of operating loss carryforward would expire unused at the end of next year. Therefore, the $360 deferred tax asset ($900 at 40 percent) would be offset by a $160 valuation allowance ($400 at 40 percent), and a $200 net deferred tax asset would be recognized for the operating loss carryforward.

With the tax-planning strategy, the $900 operating loss carryforward could be applied against $1,300 of taxable income next year ($100 of taxable income exclusive of reversing temporary differences and $1,200 of reversing taxable temporary differences). The $360 deferred tax asset is reduced by a $90 valuation allowance recognized for the net-of-tax expenses necessary to implement the tax-planning strategy. The amount of that valuation allowance is determined as follows:

| | |
|---|---|
| Legal and other expenses to implement the tax-planning strategy | $150 |
| Future tax benefit of those legal and other expenses—$150 at 40 percent | 60 |
| | $ 90 |

In summary, a $480 deferred tax liability is recognized for the $1,200 of taxable temporary differences, a $360 deferred tax asset is recognized for the $900 operating loss carryforward, and a $90 valuation allowance is recognized for the net-of-tax expenses of implementing the tax-planning strategy.

**251.** Under this Statement, the requirements for consideration of tax-planning strategies pertain only to the determination of a valuation allowance for a deferred tax asset. A deferred tax liability ordinarily is recognized for all taxable temporary differences. The only exceptions are identified in paragraph 9. Certain seemingly taxable temporary differences, however, may or may not result in taxable amounts when those differences reverse in future years. One example is an excess of cash surrender value of life insurance over premiums paid (paragraph 14). Another example is an excess of the book over the tax basis of an investment in a domestic subsidiary (paragraph 33). The determination of whether those differences are taxable temporary differences does not involve a tax-planning strategy as that term is used in this Statement.

**Regulated Enterprises**

**252.** Paragraph 9 of Statement 71 requires a regulated enterprise that applies Statement 71 to capitalize an incurred cost that would otherwise be charged to expense if the following criteria are met:
**a.** It is probable that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes.
**b.** Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs.

If the income taxes that result from recording a deferred tax liability in accordance with this Statement meet those criteria, an asset is recognized for those income taxes when the deferred tax liability is recognized. That asset and the deferred tax liability are not offset for general-purpose financial reporting; rather, each is displayed separately.

**253.** The following example illustrates recognition of an asset for the probable future revenue to recover future income taxes related to the deferred tax liability for the equity component of the allowance for funds used during construction (AFUDC). The assumptions are as follows:
**a.** During year 1, the first year of operations, total construction costs for financial reporting and tax purposes are $400,000 (exclusive of AFUDC).
**b.** The enacted tax rate is 34 percent for all future years.
**c.** AFUDC (consisting entirely of the equity component) is $26,000. The asset for probable future revenue to recover the related income taxes is calculated as follows:

34 percent of ($26,000 + A) = A (where A equals the asset for probable future revenue)

A = $13,394

At the end of year 1, the related accounts[18] are as follows:

| | |
|---|---|
| Construction in progress | $426,000 |
| Probable future revenue | $ 13,394 |
| Deferred tax liability [34 percent of ($26,000 + $13,394)] | $ 13,394 |

**254.** The following example illustrates adjustment of a deferred tax liability for an enacted change in tax rates. The assumptions are the same as for the example in paragraph 253 except that a change in the tax rate from 34 percent to 30 percent is enacted on the first day of year 2. As of the first day of year 2, the related accounts are adjusted so that the balances are as follows:

| | |
|---|---|
| Construction in progress | $426,000 |
| Probable future revenue | $ 11,143 |
| Deferred tax liability [30 percent of ($26,000 + $11,143)] | $ 11,143 |

**255.** The following example illustrates adjustment of a deferred tax liability for an enacted change in tax rates when that deferred tax liability represents amounts already collected from customers for the future payment of income taxes. In that case, there would be no asset for "probable future revenue." The assumptions are as follows:

**a.** Amounts at the end of year 1, the current year, are as follows:

| | |
|---|---|
| Construction in progress for financial reporting | $400,000 |
| Tax basis of construction in progress | $300,000 |
| Deferred tax liability (34 percent of $100,000) | $ 34,000 |

**b.** A change in the tax rate from 34 percent to 30 percent is enacted on the first day of year 2. As a result of the reduction in tax rates, it is probable that $4,000 of the $34,000 (previously collected from customers for the future payment of income

[18] In this example, if AFUDC had consisted of a net-of-tax debt component in the amount of $26,000, the related accounts and their balances at the end of year 1 would be construction in progress in the amount of $439,394 and a deferred tax liability in the amount of $13,394.

taxes) will be refunded to customers, together with the tax benefit of that refund, through a future rate reduction. The liability for the future rate reduction to refund a portion of the deferred taxes previously collected from customers is calculated as follows:

$4,000 + (30 percent of R) = R (where R equals the probable future reduction in revenue)

R = $5,714

As of the first day of year 2, the related accounts are adjusted so that the balances are as follows:

| | |
|---|---|
| Construction in progress | $400,000 |
| Probable reduction in future revenue | $ 5,714 |
| Deferred tax liability [30 percent of ($100,000 − $5,714)] | $ 28,286 |

**Leveraged Leases**

**256.** This Statement does not change (a) the pattern of recognition of after-tax income for leveraged leases as required by Statement 13 or (b) the allocation of the purchase price in a purchase business combination to acquired leveraged leases as required by Interpretation 21. Integration of the results of income tax accounting for leveraged leases with the other results of accounting for income taxes under this Statement is required when deferred tax credits related to leveraged leases are the only source (refer to paragraph 21) for recognition of a tax benefit for deductible temporary differences and carryforwards not related to leveraged leases. A valuation allowance is not necessary if deductible temporary differences and carryforwards will offset taxable amounts from future recovery of the net investment in the leveraged lease. However, to the extent that the amount of deferred tax credits for a leveraged lease as determined under Statement 13 differs from the amount of the deferred tax liability related to the leveraged lease that would otherwise result from applying the requirements of this Statement, that difference is preserved and is not a source of taxable income for recognition of the tax benefit of deductible temporary differences and operating loss or tax credit carryforwards.

**257.** Interpretation 21 requires that the tax effect of any difference between the assigned value and the tax basis of a leveraged lease at the date of a business combination not be accounted for as a deferred tax credit. This Statement does not change that requirement. Any tax effects included in unearned and deferred income as required by Interpretation 21 are not offset by the deferred tax consequences of other temporary differences or by the tax benefit of operating loss or tax credit carryforwards. However, deferred tax credits that arise after the date of a business combination are accounted for in the same manner as described above for leveraged leases that were not acquired in a purchase business combination.

**258.** The following example illustrates integration of the results of income tax accounting for leveraged leases with the other results of accounting for income taxes as required by this Statement.

**a.** At the end of year 1, the current year, an enterprise has two temporary differences. One temporary difference is for a leveraged lease that was entered into in a prior year. During year 1, the enacted tax rate for year 2 and thereafter changed from 40 percent to 35 percent. After adjusting for the change in estimated total net income from the lease as a result of the change in tax rates as required by Statement 13, the components of the investment in the leveraged lease at the end of year 1 are as follows:

| | | |
|---|---|---|
| Net rentals receivable plus residual value less unearned pretax income | | $150,000 |
| Reduced by: | | |
| Deferred ITC | $ 9,000 | |
| Deferred tax credits | 39,000 | 48,000 |
| Net investment in leveraged lease for financial reporting | | $102,000 |

**b.** The other temporary difference is for a $120,000 estimated liability for warranty expense that will result in a tax deduction in year 5 when the liability is expected to be paid. Absent consideration of the deferred tax credits attributable to the leveraged lease, the weight of available evidence indicates that a valuation allowance is needed for the entire amount of the deferred tax asset related to that $120,000 deductible temporary difference.

**c.** The tax basis of the investment in the leveraged lease at the end of year 1 is $41,000. The amount of the deferred tax liability for that leveraged lease that would otherwise result from the requirements of this Statement is determined as follows:

| | |
|---|---|
| Net rentals receivable plus residual value less unearned pretax income | $150,000 |
| Temporary difference for deferred ITC | 9,000 |
| | 141,000 |
| Tax basis of leveraged lease | 41,000 |
| Temporary difference | $100,000 |
| Deferred tax liability (35 percent) | $ 35,000 |

**d.** Loss carryback (to year 2) and loss carryforward (to year 20) of the $120,000 tax deduction for warranty expense in year 5 would offset the $100,000 of taxable amounts resulting from future recovery of the net investment in the leveraged lease over the remainder of the lease term.

**e.** At the end of year 1, the enterprise recognizes a $42,000 ($120,000 at 35 percent) deferred tax asset and a related $7,000 valuation allowance. The effect is to recognize a $35,000 net deferred tax benefit for the reduction in deferred tax credits attributable to the leveraged lease. Deferred tax credits attributable to the leveraged lease determined under the requirements of Statement 13 are $39,000. However, the deferred tax liability determined under the requirements of this Statement is only $35,000. The $4,000 difference is not available for offsetting.

**Business Combinations**

**259.** This Statement requires recognition of deferred tax liabilities and deferred tax assets (and related valuation allowances, if necessary) for the deferred tax consequences of differences between the assigned values and the tax bases of the assets and liabilities recognized in a business combination accounted for as a purchase under Opinion 16. A deferred tax liability or asset is not recognized for a difference between the reported amount and the tax basis of goodwill or the portion thereof for which amortization is not deductible for tax purposes (paragraphs 262 and 263), unallocated "negative" goodwill, and leveraged leases (paragraphs 256-258). Acquired Opinion 23 differences are accounted for in accordance with the requirements of Opinion 23, as amended by this Statement (paragraphs 31-34).

**Nontaxable Business Combinations**

**260.** The following example illustrates recognition and measurement of a deferred tax liability and asset in a nontaxable business combination. The assumptions are as follows:

**a.** The enacted tax rate is 40 percent for all future years, and amortization of goodwill is not deductible for tax purposes.
**b.** An enterprise is acquired for $20,000, and the enterprise has no leveraged leases.
**c.** The tax basis of the net assets acquired is $5,000, and the assigned value (other than goodwill) is $12,000. Future recovery of the assets and settlement of the liabilities at their assigned values will result in $20,000 of taxable amounts and $13,000 of deductible amounts that can be offset against each other. Therefore, no valuation allowance is necessary.
The amounts recorded to account for the purchase transaction are as follows:

| | |
|---|---|
| Assigned value of the net assets (other than goodwill) acquired | $12,000 |
| Deferred tax liability for $20,000 of taxable temporary differences | (8,000) |
| Deferred tax asset for $13,000 of deductible temporary differences | 5,200 |
| Goodwill | 10,800 |
| Purchase price of the acquired enterprise | $20,000 |

**Taxable Business Combinations**

**261.** In a taxable business combination, the purchase price is assigned to the assets and liabilities recognized for tax purposes as well as for financial reporting. However, the amounts assigned to particular assets and liabilities may differ for financial reporting and tax purposes. A deferred tax liability and asset are recognized for the deferred tax consequences of those temporary differences in accordance with the recognition and measurement requirements of this Statement. For example, a portion of the amount of goodwill for financial reporting may be allocated to some other asset for tax purposes, and amortization of that other asset may be deductible for tax purposes. If a valuation allowance is recognized for that deferred tax asset at the acquisition date, recognized benefits for those tax deductions after the acquisition date should be applied (a) first to reduce to zero any goodwill related to that acquisition, (b) second to reduce to zero other noncurrent intangible assets related to that acquisition, and (c) third to reduce income tax expense.

**262.** Amortization of goodwill is deductible for tax purposes in some tax jurisdictions. In those tax jurisdictions, the reported amount of goodwill and the tax basis of goodwill are each separated into two components as of the combination date for purposes of deferred tax calculations. The first component of each equals the lesser of (a) goodwill for financial reporting or (b) tax-deductible goodwill. The second component of each equals the remainder of each, that is, (1) the remainder, if any, of goodwill for financial reporting or (2) the remainder, if any, of tax-deductible goodwill. Any difference that arises between the book and tax basis of that first component of goodwill in future years is a temporary difference for which a deferred tax liability or asset is recognized based on the requirements of this Statement. No deferred taxes are recognized for the second component of goodwill. If that second component is an excess of tax-deductible goodwill over the reported amount of goodwill, the tax benefit for that excess is recognized when realized on the tax return, and that tax benefit is applied first to reduce to zero the goodwill related to that acquisition, second to reduce to zero other noncurrent intangible assets related to that acquisition, and third to reduce income tax expense.

**263.** The following example illustrates accounting for the tax consequences of goodwill when amortization of goodwill is deductible for tax purposes. The assumptions are as follows:
**a.** At the combination date, the reported amount and tax basis of goodwill are $600 and $800, respectively.
**b.** For tax purposes, amortization of goodwill will result in tax deductions of $400 in each of years 1 and 2. Those deductions result in a current tax benefit in years 1 and 2.
**c.** For financial reporting, amortization of goodwill is straight-line over years 1-4.
**d.** For purposes of simplification, the consequences of other temporary differences are ignored for years 1-4.
**e.** Income before amortization of goodwill and income taxes in each of years 1-4 is $1,000.
**f.** The tax rate is 40 percent for all years.

Income taxes payable for years 1-4 are:

| | Year 1 | Year 2 | Year 3 | Year 4 |
|---|---|---|---|---|
| Income before amortization of goodwill | $1,000 | $1,000 | $1,000 | $1,000 |
| Amortization of goodwill | 400 | 400 | — | — |
| Taxable income | $ 600 | $ 600 | $1,000 | $1,000 |
| Income taxes payable (40 percent) | $ 240 | $ 240 | $ 400 | $ 400 |

At the combination date, goodwill is separated into two components as follows:

| | Reported Amount | Tax Basis |
|---|---|---|
| First component | $600 | $600 |
| Second component | — | 200 |
| Total goodwill | $600 | $800 |

A deferred tax liability is recognized at the end of years 1-3 for the excess of the reported amount over the tax basis of the first component of goodwill. A deferred tax asset is not recognized for the second component of goodwill; the tax benefit is allocated to reduce goodwill when realized on the tax returns for years 1 and 2.

The second component of goodwill is deductible $100 per year in years 1 and 2. Those tax deductions provide $40 (100 at 40 percent) of tax benefits that are realized in years 1 and 2. Allocation of those realized tax benefits to reduce the first component of goodwill produces a deferred tax benefit by reducing the taxable temporary difference related to that component of goodwill. Thus, the total tax benefit allocated to reduce the first component of goodwill in each of years 1 and 2 is the sum of (a) the $40 realized tax benefit allocated to reduce goodwill and (b) the deferred tax benefit from reducing the deferred tax liability related to goodwill. That total tax benefit (TTB) is determined as follows:

TTB = realized tax benefit plus (tax rate times TTB)
TTB = $40 + (.40 × TTB)
TTB = $67

Goodwill for financial reporting for years 1-4 is:

| | Year 1 | Year 2 | Year 3 | Year 4 |
|---|---|---|---|---|
| Balance at beginning of year | $600 | $383 | $188 | $94 |
| Amortization: | | | | |
| $600 ÷ 4 years | 150 | | | |
| $383 ÷ 3 years | | 128 | | |
| $188 ÷ 2 years | | | 94 | 94 |
| Total tax benefit allocated to reduce goodwill | 67 | 67 | — | — |
| Balance at end of year | $383 | $188 | $ 94 | $— |

The deferred tax liability for the first component of goodwill and the related amount of deferred tax expense (benefit) for years 1-4 are:

| | Year 1 | Year 2 | Year 3 | Year 4 |
|---|---|---|---|---|
| Reported amount of goodwill at end of year | $383 | $188 | $ 94 | $— |
| Tax basis of goodwill (first component) | 300 | — | — | — |
| Taxable temporary difference | $ 83 | $188 | $ 94 | $— |
| Deferred tax liability: | | | | |
| At end of year (40 percent) | $ 33 | $ 75 | $ 38 | $— |
| At beginning of year | — | 33 | 75 | $ 38 |
| Deferred tax expense (benefit) for the year | $ 33 | $ 42 | $(37) | $(38) |

Income for financial reporting for years 1-4 is:

| | Year 1 | Year 2 | Year 3 | Year 4 |
|---|---|---|---|---|
| Income before amortization of goodwill and income taxes | $1,000 | $1,000 | $1,000 | $1,000 |
| Amortization of goodwill | 150 | 128 | 94 | 94 |
| Pretax income | 850 | 872 | 906 | 906 |
| Income tax expense (benefit): | | | | |
| Current | 240 | 240 | 400 | 400 |
| Deferred | 33 | 42 | (37) | (38) |
| Benefit applied to reduce goodwill | 67 | 67 | — | — |
| Income tax expense | 340 | 349 | 363 | 362 |
| Net income | $ 510 | $ 523 | $ 543 | $ 544 |

**Carryforwards—Purchase Method**

**264.** Accounting for a business combination should reflect any provisions in the tax law that restrict the future use of either of the combining enterprises' deductible temporary differences or carryforwards to reduce taxable income or taxes payable attributable to the other enterprise subsequent to the business combination. For example, the tax law may limit the use of the acquired enterprise's deductible temporary differences and carryforwards to subsequent taxable income of the acquired enterprise in a consolidated tax return for the combined enterprise. In that circumstance, or if the acquired enterprise will file a separate tax return, the need for a valuation allowance for some portion or all of the acquired enterprise's deferred tax assets for deductible temporary differences and carryforwards is assessed based on the acquired enterprise's *separate* past and expected future results of operations.

**265.** The following example illustrates (a) recognition of a deferred tax asset and the related valuation allowance for acquired deductible temporary differences at the date of a nontaxable business combination and in subsequent periods when (b) the tax law limits the use of an acquired enterprise's deductible temporary differences and carryforwards to subsequent taxable income of the acquired enterprise in a consolidated tax return. The assumptions are as follows:

**a.** The enacted tax rate is 40 percent for all future years.

**b.** The purchase price is $20,000, and the assigned value of the net assets acquired is also $20,000.

**c.** The tax basis of the net assets acquired is $60,000. The $40,000 ($60,000 − $20,000) of deductible temporary differences at the combination date is primarily attributable to an allowance for loan losses. Provisions in the tax law limit the use of those future tax deductions to subsequent taxable income of the acquired enterprise.

**d.** The acquired enterprise's actual pretax results for the two preceding years and the expected results for the year of the business combination are as follows:

| | |
|---|---|
| Year 1 | $(15,000) |
| Year 2 | (10,000) |
| Year 3 to the combination date | (5,000) |
| Expected results for the remainder of year 3 | (5,000) |

**e.** Based on assessments of all evidence available at the date of the business combination in year 3 and at the end of year 3, management concludes that a valuation allowance is needed at both dates for the entire amount of the deferred tax asset related to the acquired deductible temporary differences.

The acquired enterprise's pretax financial income and taxable income for year 3 (after the business combination) and year 4 are as follows:

| | Year 3 | Year 4 |
|---|---|---|
| Pretax financial income | $15,000 | $10,000 |
| Reversals of acquired deductible temporary differences | (15,000) | (10,000) |
| Taxable income | $ — | $ — |

At the end of year 4, the remaining balance of acquired deductible temporary differences is $15,000 ($40,000 − $25,000). The deferred tax asset is $6,000 ($15,000 at 40 percent). Based on an assessment of all available evidence at the end of year 4, management concludes that no valuation allowance is needed for that $6,000 deferred tax asset. Elimination of the $6,000 valuation allowance results in a $6,000 deferred tax benefit that is reported as a reduction of deferred income tax expense because there is no goodwill or other noncurrent intangible assets related to the acquisition. For the same reason, tax benefits realized in years 3 and 4 attributable to reversals of acquired deductible temporary differences are reported as a zero current income tax expense. The consolidated statement of earnings would include the following amounts attributable to the acquired enterprise for year 3 (after the business combination) and year 4:

| | Year 3 | Year 4 |
|---|---|---|
| Pretax financial income | $15,000 | $10,000 |
| Income tax expense (benefit): | | |
| Current | — | — |
| Deferred | — | (6,000) |
| Net income | $15,000 | $16,000 |

**266.** The tax law in some tax jurisdictions may permit the future use of either of the combining enterprises' deductible temporary differences or carryforwards to reduce taxable income or taxes payable attributable to the other enterprise subsequent to the business combination. If the combined enterprise expects to file a consolidated tax return, a deferred tax asset (net of a valuation allowance, if necessary) is recognized for deductible temporary differences or carryforwards of either combining enterprise based on an assessment of the *combined* enterprise's past and expected future results of operations as of the acquisition date. This either reduces goodwill or noncurrent assets (except long-term investments in marketable securities) of the acquired enterprise or creates or increases negative goodwill.

**267.** The following example illustrates (a) elimination of the need for a valuation allowance for the deferred tax asset for an acquired loss carryforward based on offset against taxable temporary differences of the acquiring enterprise in a nontaxable business combination when (b) the tax law permits use of an acquired enterprise's deductible temporary differences and carryforwards to reduce taxable income or taxes payable attributable to the acquiring enterprise in a consolidated tax return. The assumptions are as follows:

**a.** The enacted tax rate is 40 percent for all future years.

**b.** The purchase price is $20,000. The tax basis of the identified net assets acquired is $5,000, and the assigned value is $12,000, that is, there are $7,000 of taxable temporary differences. The acquired enterprise also has a $16,000 operating loss carryforward, which, under the tax law, may be used by the acquiring enterprise in the consolidated tax return.

**c.** The acquiring enterprise has temporary differences that will result in $30,000 of net taxable amounts in future years.

**d.** All temporary differences of the acquired and acquiring enterprises will result in taxable amounts before the end of the acquired enterprise's loss carryforward period.

In assessing the need for a valuation allowance, future taxable income exclusive of reversing temporary differences and carryforwards (paragraph 21(b)) need not be considered because the $16,000 operating loss carryforward will offset (a) the *acquired* enterprise's $7,000 of taxable temporary differences and (b) another $9,000 of the *acquiring* enterprise's taxable temporary differences. The amounts recorded to account for the purchase transaction are as follows:

| | |
|---|---|
| Assigned value of the identified net assets acquired | $12,000 |
| Deferred tax liability recognized for the acquired company's taxable temporary differences ($7,000 at 40 percent) | (2,800) |
| Deferred tax asset recognized for the acquired loss carryforward based on offset against the acquired company's taxable temporary differences ($7,000 at 40 percent) | 2,800 |
| Deferred tax asset recognized for the acquired loss carryforward based on offset against the acquiring company's taxable temporary differences ($9,000 at 40 percent) | 3,600 |
| Goodwill | 4,400 |
| Purchase price of the acquired enterprise | $20,000 |

### Subsequent Recognition of Carryforward Benefits—Purchase Method

**268.** If a valuation allowance is recognized for some portion or all of an acquired enterprise's deferred tax asset for deductible temporary differences and operating loss or tax credit carryforwards at the acquisition date, tax benefits for those items recognized in financial statements for a subsequent year(s) are:

**a.** First applied to reduce to zero any goodwill related to the acquisition

**b.** Second applied to reduce to zero other noncurrent intangible assets related to the acquisition

**c.** Third applied to reduce income tax expense.

Additional amounts of deductible temporary differences and operating loss or tax credit carryforwards may arise after the acquisition date and before recognition of the tax benefit of amounts existing at the acquisition date. Tax benefits are recognized in later years as follows:

**a.** The tax benefit of amounts existing at the acquisition date is first applied to reduce goodwill and other noncurrent intangible assets to zero. Any additional tax benefit reduces income tax expense.

**b.** The tax benefit of amounts arising after the acquisition date is recognized as a reduction of income tax expense.

Whether a tax benefit recognized in later years is attributable to an amount (for example, an operating loss carryforward) existing at or arising after the acquisition date is determined for financial reporting by provisions in the tax law that identify the sequence in which those amounts are utilized for tax purposes. If not determinable by provisions in the tax law, a tax benefit recognized for financial reporting is prorated between a reduction of (a) goodwill and other noncurrent intangible assets and (b) income tax expense.

**269.** The following example illustrates recognition of tax benefits subsequent to a business combination. The assumptions are as follows:

**a.** A nontaxable business combination occurs on the first day of year 1. Before considering any acquired deferred tax assets, the purchase transaction is summarized as follows:

| | Assigned Value | Tax Basis |
|---|---|---|
| Net assets acquired | $5,000 | $6,000 |
| Excess of purchase price over the fair value of the net assets acquired* | 1,500 | |
| Purchase price | $6,500 | |

*There are no other noncurrent intangible assets.

**b.** The only difference between pretax financial income and taxable income (amortization of goodwill is disregarded for this example) for years 1-3 is a $1,000 loss for tax purposes in year 1 from disposal of the acquired identified net assets at amounts equal to their $5,000 assigned value on the acquisition date.

| | Year 1 | Year 2 | Year 3 |
|---|---|---|---|
| Pretax financial income (loss) | $(3,000) | $2,500 | $1,500 |
| Disposal of acquired identified net assets | (1,000) | — | — |
| Taxable income (loss) before loss carryforward | (4,000) | 2,500 | 1,500 |
| Loss carryforward (loss carryback not permitted) | 4,000 | (2,500) | (1,500) |
| Taxable income after loss carryforward | $ — | $ — | $ — |

**c.** The tax rate is 40 percent for all years.

**d.** Based on an assessment of all available evidence, management reaches the following conclusions at the acquisition date and at the end of years 1 and 2:

**(1)** At the acquisition date, the portion of the $1,000 of deductible temporary differences ($6,000 − $5,000) for which it is more likely than not that a tax benefit will not be realized is $500.

**(2)** At the end of year 1, the portion of the $4,000 loss carryforward for which it is more likely than not that a tax benefit will not be realized is $1,750.
**(3)** At the end of year 2, it is more likely than not that a tax benefit will be realized for all of the remaining $1,500 of loss carryforward.

At the acquisition date, a $400 ($1,000 at 40 percent) deferred tax asset and a $200 ($500 at 40 percent) valuation allowance are recognized. The $200 net tax benefit reduces the excess of purchase price over the fair value of the net assets acquired from $1,500 to $1,300. Thus, the amount of goodwill recognized at the acquisition date is $1,300.

During year 1, the $1,000 of net deductible temporary differences at the acquisition date reverse and are part of the $4,000 loss carryforward for tax purposes at the end of year 1. An analysis of the components of that $4,000 loss carryforward follows:

| | Acquired Deductions | Loss in Year 1 | Total |
|---|---|---|---|
| Total loss carryforward | $1,000 | $3,000 | $4,000 |
| Portion for which a tax benefit was recognized at the acquisition date | 500 | — | 500 |
| Remainder available for recognition of a tax benefit at the end of year 1 | $ 500 | $3,000 | $3,500 |

Provisions in the tax law do not distinguish between those two components of the $3,500, and the component that is used first for tax purposes is indeterminable. However, the $500 of acquired deductions for which a tax benefit has not been recognized is one-seventh of the $3,500 total, and the $3,000 loss in year 1 is six-sevenths of the $3,500 total. The tax benefit of that $3,500 is prorated one-seventh to reduce goodwill and six-sevenths to reduce income tax expense when recognized in years 1 and 2.

At the end of year 1, a $1,600 ($4,000 at 40 percent) deferred tax asset and a $700 ($1,750 at 40 percent) valuation allowance are recognized. The tax benefit for the $700 increase in the net deferred tax asset (from $200 at the acquisition date to $900 at the end of year 1) is prorated as follows:
a. One-seventh or $100 to reduce goodwill
b. Six-sevenths or $600 to reduce tax expense.

During year 2, $1,000 ($2,500 at 40 percent) of the deferred tax asset recognized at the end of year 1 is realized. In addition, a tax benefit is recognized for the remaining $1,750 of future tax deductions by eliminating the $700 valuation allowance. That tax benefit is prorated $100 to reduce goodwill and $600 to reduce tax expense. The combined effect of the changes in the deferred tax asset and the related valuation allowance during year 2 is illustrated below:

| | Deferred Tax Asset Year 1 | Deferred Tax Asset Year 2 | Tax Expense or (Benefit) |
|---|---|---|---|
| Deferred tax asset | $1,600 | $600 | $1,000 |
| Valuation allowance | (700) | — | (700) |
| | $ 900 | $600 | 300 |
| Portion of $700 tax benefit allocated to reduce goodwill | | | 100 |
| Deferred tax expense for year 2 | | | $ 400 |

The $600 deferred tax asset at the end of year 2 is realized in year 3, resulting in $600 of deferred tax expense for year 3. The consolidated statement of earnings would include the following amounts attributable to the acquired enterprise:

| | Year 1 | Year 2 | Year 3 |
|---|---|---|---|
| Pretax financial income (loss) | $(3,000) | $2,500 | $1,500 |
| Net deferred tax expense (benefit) | (600) | 400 | 600 |
| Net income (loss) | $(2,400) | $2,100 | $ 900 |

Carryforwards—Pooling-of-Interests Method

**270.** The separate financial statements of combining enterprises for prior periods are restated on a combined basis when a business combination is accounted for by the pooling-of-interests method. For restatement of periods prior to the combination date, a combining enterprise's operating loss carryforward does not offset the other enterprise's taxable income because consolidated tax returns cannot be filed for those periods. However, provisions in the tax law may permit an operating loss carryforward of either of the combining enterprises to offset combined taxable income subsequent to the combination date.

**271.** If the combined enterprise expects to file consolidated tax returns, a deferred tax asset is recognized for either combining enterprise's operating loss carryforward in a prior period. A valuation allowance is necessary to the extent it is more likely than not that a tax benefit will not be realized for that loss carryforward through offset of either (a) the other enterprise's deferred tax liability for taxable temporary differences that will reverse subsequent to the combination date or (b) combined taxable income subsequent to the combination date. Determined in that manner, the valuation allowance may be less than the sum of the valuation allowances in the separate financial statements of the combining enterprises prior to the combination date. That tax benefit is recognized as part of the adjustment to restate financial statements on a combined basis for prior periods. The same requirements apply to deductible temporary differences and tax credit carryforwards.

**272.** A taxable business combination may sometimes be accounted for by the pooling-of-interests method. The increase in the tax basis of the net assets acquired results in temporary differences. The deferred tax consequences of those temporary differences are recognized and measured the same as for other temporary differences. As of the combination date, recognizable tax benefits attributable to the increase in tax basis are allocated to contributed capital. Tax benefits attributable to the increase in tax basis that become recognizable after the combination date (that is, by elimination of a valuation allowance) are reported as a reduction of income tax expense.

## Intraperiod Tax Allocation

**273.** If there is only one item other than continuing operations, the portion of income tax expense or benefit for the year that remains after the allocation to continuing operations is allocated to that item. If there are two or more items other than continuing operations, the amount that remains after the allocation to continuing operations is allocated among those other items in proportion to their individual effects on income tax expense or benefit for the year.

**274.** The following example illustrates allocation of income tax expense if there is only one item other than income from continuing operations. The assumptions are as follows:

**a.** The enterprise's pretax financial income and taxable income are the same.

**b.** The enterprise's ordinary loss from continuing operations is $500.

**c.** The enterprise also has an extraordinary gain of $900 that is a capital gain for tax purposes.

**d.** The tax rate is 40 percent on ordinary income and 30 percent on capital gains. Income taxes currently payable are $120 ($400 at 30 percent).

Income tax expense is allocated between the pretax loss from operations and the extraordinary gain as follows:

| | |
|---|---|
| Total income tax expense | $120 |
| Tax benefit allocated to the loss from operations | (150) |
| Incremental tax expense allocated to the extraordinary gain | $270 |

The effect of the $500 loss from continuing operations was to offset an equal amount of capital gains that otherwise would be taxed at a 30 percent tax rate. Thus, $150 ($500 at 30 percent) of tax benefit is allocated to continuing operations. The $270 incremental effect of the extraordinary gain is the difference between $120 of total tax expense and the $150 tax benefit from continuing operations.

**275.** The following example illustrates allocation of the tax benefit of a tax credit carryforward that is recognized as a deferred tax asset in the current year. The assumptions are as follows:

**a.** The enterprise's pretax financial income and taxable income are the same.

**b.** Pretax financial income for the year comprises $300 from continuing operations and $400 from an extraordinary gain.

**c.** The tax rate is 40 percent. Taxes payable for the year are zero because $330 of tax credits that arose in the current year more than offset the $280 of tax otherwise payable on $700 of taxable income.

**d.** A $50 deferred tax asset is recognized for the $50 ($330 –$280) tax credit carryforward. Based on the weight of available evidence, management concludes that no valuation allowance is necessary.

Income tax expense or benefit is allocated between pretax income from continuing operations and the extraordinary gain as follows:

| | | |
|---|---|---|
| Total income tax benefit | | $ (50) |
| Tax expense (benefit) allocated to income from continuing operations: | | |
| Tax (before tax credits) on $300 of taxable income at 40 percent | $120 | |
| Tax credits | (330) | (210) |
| Tax expense allocated to the extraordinary gain | | $160 |

APPENDIX E

## GLOSSARY

**289.** This appendix contains definitions of certain terms or phrases used in this Statement.

**Carrybacks**
Deductions or credits that cannot be utilized on the tax return during a year that may be carried back to reduce taxable income or taxes payable in a prior year. An operating loss carryback is an excess of tax deductions over gross income in a year; a tax credit carryback is the amount by which tax credits available for utilization exceed statutory limitations. Different tax jurisdictions have different rules about whether excess deductions or credits may be carried back and the length of the carryback period.

**Carryforwards**
Deductions or credits that cannot be utilized on the tax return during a year that may be carried forward to reduce taxable income or taxes payable in a future year. An operating loss carryforward is an excess of tax deductions over gross income in a year; a tax credit carryforward is the amount by which tax credits available for utilization exceed statutory limitations. Different tax jurisdictions have different rules about whether excess deductions or credits may be carried forward and the length of the carryforward period. The terms *carryforward*, *operating loss carryforward*, and *tax credit carryforward* refer to the amounts of those items, if any, reported in the tax return for the current year.

**Current tax expense or benefit**
The amount of income taxes paid or payable (or refundable) for a year as determined by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues for that year.

**Deductible temporary difference**
Temporary differences that result in deductible amounts in future years when the related asset or liability is recovered or settled, respectively. Also refer to **Temporary difference.**

**Deferred tax asset**
The deferred tax consequences attributable to deductible temporary differences and carryforwards. A deferred tax asset is measured using the applicable enacted tax rate and provisions of the enacted tax law. A deferred tax asset is reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

**Deferred tax consequences**
The future effects on income taxes as measured by the applicable enacted tax rate and provisions of the enacted tax law resulting from temporary differences and carryforwards at the end of the current year.

**Deferred tax expense or benefit**
The change during the year in an enterprise's deferred tax liabilities and assets. For deferred tax liabilities and assets acquired in a purchase business combination during the year, it is the change since the combination date. Income tax expense or benefit for the year is allocated among continuing operations, discontinued operations, extraordinary items, and items charged or credited directly to shareholders' equity.

**Deferred tax liability**
The deferred tax consequences attributable to taxable temporary differences. A deferred tax liability is measured using the applicable enacted tax rate and provisions of the enacted tax law.

**Event**
A happening of consequence to an enterprise. The term encompasses both transactions and other events affecting an enterprise.

**Gains and losses included in comprehensive income but excluded from net income**
Under present practice, gains and losses included in comprehensive income but

Absent the extraordinary gain and assuming it was not the deciding factor in reaching a conclusion that a valuation allowance is not needed, the entire tax benefit of the $330 of tax credits would be allocated to continuing operations. The presence of the extraordinary gain does not change that allocation.

**276.** Income taxes are sometimes allocated directly to shareholders' equity. The following example illustrates the allocation of income taxes for translation adjustments under Statement 52 directly to shareholders' equity.

**a.** A foreign subsidiary has earnings of FC600 for year 2. Its net assets (and unremitted earnings) are FC1,000 and FC1,600 at the end of years 1 and 2, respectively.

**b.** The foreign currency is the functional currency. For year 2, translated amounts are as follows:

| | Foreign Currency | Exchange Rate | Dollars |
|---|---|---|---|
| Unremitted earnings, beginning of year | 1,000 | FC1 = $1.20 | 1,200 |
| Earnings for the year | 600 | FC1 = $1.10 | 660 |
| Unremitted earnings, end of year | 1,600 | FC1 = $1.00 | 1,600 |

**c.** A $260 translation adjustment ($1,200 + $660 – $1,600) is charged to the cumulative translation adjustment account in shareholders' equity for year 2.

**d.** The U.S. parent expects that all of the foreign subsidiary's unremitted earnings will be remitted in the foreseeable future, and under Opinion 23, a deferred U.S. tax liability is recognized for those unremitted earnings.

**e.** The U.S. parent accrues the deferred tax liability at a 20 percent tax rate (that is, net of foreign tax credits, foreign tax credit carryforwards, and so forth). An analysis of the net investment in the foreign subsidiary and the related deferred tax liability for year 2 is as follows:

| | Net Investment | Deferred Tax Liability |
|---|---|---|
| Balances, beginning of year | $1,200 | $240 |
| Earnings and related taxes | 660 | 132 |
| Translation adjustment and related taxes | (260) | (52) |
| Balances, end of year | $1,600 | $320 |

**f.** For year 2, $132 of deferred taxes are charged against earnings, and $52 of deferred taxes are credited directly to the cumulative translation adjustment account in shareholders' equity.

excluded from net income include certain changes in market values of investments in marketable equity securities classified as noncurrent assets, certain changes in market values of investments in industries having specialized accounting practices for marketable securities, adjustments from recognizing certain additional pension liabilities, and foreign currency translation adjustments. Future changes to generally accepted accounting principles may change what is included in this category.

**Income taxes**
Domestic and foreign federal (national), state, and local (including franchise) taxes based on income.

**Income taxes currently payable (refundable)**
Refer to **Current tax expense or benefit.**

**Income tax expense (benefit)**
The sum of current tax expense (benefit) and deferred tax expense (benefit).

**Nonpublic enterprise**
An enterprise other than one (a) whose debt or equity securities are traded in a public market, including those traded on a stock exchange or in the over-the-counter market (including securities quoted only locally or regionally), or (b) whose financial statements are filed with a regulatory agency in preparation for the sale of any class of securities.

**Public enterprise**
An enterprise (a) whose debt or equity securities are traded in a public market, including those traded on a stock exchange or in the over-the-counter market (including securities quoted only locally or regionally), or (b) whose financial statements are filed with a regulatory agency in preparation for the sale of any class of securities.

**Taxable income**
The excess of taxable revenues over tax deductible expenses and exemptions for the year as defined by the governmental taxing authority.

**Taxable temporary difference**
Temporary differences that result in taxable amounts in future years when the related asset or liability is recovered or settled, respectively. Also refer to **Temporary difference.**

**Tax consequences**
The effects on income taxes—current or deferred—of an event.

**Tax-planning strategy**
An action (including elections for tax purposes) that meets certain criteria (paragraph 22) and that would be implemented to realize a tax benefit for an operating loss or tax credit carryforward before it expires. Tax-planning strategies are considered when assessing the need for and amount of a valuation allowance for deferred tax assets.

**Temporary difference**
A difference between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. Paragraph 11 cites 8 examples of temporary differences. Some temporary differences cannot be identified with a particular asset or liability for financial reporting (paragraph 15), but those temporary differences (a) result from events that have been recognized in the financial statements and (b) will result in taxable or deductible amounts in future years based on provisions of the tax law. Some events recognized in financial statements do not have tax consequences. Certain revenues are exempt from taxation and certain expenses are not deductible. Events that do not have tax consequences do not give rise to temporary differences.

**Valuation allowance**
The portion of a deferred tax asset for which it is more likely than not that a tax benefit will not be realized. ■

# ACCOUNTING FOR PUBLIC UTILITIES

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the loss of eligibility to utilize accelerated tax depreciation and amortization. (See Chapter 17 for a detailed discussion.)

(2) *Generally accepted accounting principles*--In recognition of changes over time in effective tax rates, generally accepted accounting principles, as stated in Accounting Principles Board Opinion No. 11, called for the amortization of tax reserves over the lives of the assets creating the reserves at the rates utilized when the reserves were originally created.

The Federal Energy Regulatory Commission's (FERC) general position on this controversial issue was initially stated by the Federal Power Commission (FPC) in 1965 with the issuance of Accounting Release No. AR-2. The FPC's response to the question regarding the appropriate treatment was as follows:

"Amounts accumulated in Account 281, Accumulated Deferred Income Taxes--Accelerated Amortization, shall be credited to Account 411, Income Taxes Deferred In Prior Years--Credit, at the same rate that was originally used to defer the amounts in Account 281. Therefore, the amounts previously deferred will be fully restored to income over the appropriate estimated remaining useful life allowable for tax purposes of the related property."

The FERC readdressed this issue in an indirect manner in 1981 with the issuance of its Order No. 144, which requires tax normalization for the tax effects of certain timing differences in rate proceedings before the Commission. Here, the Commission's primary concern related to excessive or deficient tax reserves that were largely the result of prior flow-through treatment of tax benefits that would now turn around and be accounted for under tax normalization. While recognizing that amortization of excess reserves over the service lives of the assets was an appropriate method, the Commission stated that the most appropriate method of dealing with the 2-percent reserve excess was the subject of case-by-case determination, since other factors may also have contributed to an excessive or deficient reserve.

The Tax Reform Act of 1986 reduced the federal corporate tax rate from 46 percent to 34 percent effective July 1, 1987. In contrast to the previous 2-percent reduction, the 1986 Act specifically addressed regulatory accounting treatment of the so-called "excess" deferred tax reserves created by the tax rate reduction. Generally, the 1986 Act specifies that deferred tax reserves associated with timing differences between book and tax depreciation that result from different depreciation methods and lives are "protected" deferred tax reserves. The identified protected reserves must be reversed using an average tax rate assumption that effectively results in a reversal at the average tax rate at which the deferred income taxes were previously provided. (See Chapter 17 for a more detailed discussion of the 1986 Act and the regulatory implications of the corporate tax rate reduction.)

The Omnibus Budget Reconciliation Act (OBRA'93) increased the top corporate federal tax rate from 34 percent to 35 percent effective January 1, 1993. This creates shortfalls in deferred tax liabilities provided at 34 percent that now will have to be paid at 35 percent. OBRA'93 does not address how this shortfall is to be restored. Most regulatory commissions are addressing the issue on a case-by-case basis as rate filings are made by the utilities.

**[10]--Investment Tax Credits**

Accounting and ratemaking treatment for investment tax credits (ITC) has largely been dictated by the Internal Revenue Code with a limited number of options available to utilities and their regulatory commissions. In this sense, the Code has generally attempted to require a sharing of the benefits of ITC between utility investors and utility customers. This has basically been accomplished by providing for either rate base reduction for deferred ITC balances or amortization of deferred ITC balances above-the-line as a reduction of income tax expense--both of which reduce revenue requirements to the ratepayers' benefit. Only one or the other of these procedures, however, is generally allowed, thereby allowing the utility to share in the tax savings of investment tax credit. Only in limited circumstances have both procedures been permitted simultaneously.

The pertinent section of the Code regarding ratemaking treatment of ITC is *IRC Section 46(f)*. Two optional methods are described under this section that are commonly labeled Options 1 and 2. Utilities must follow one of these options to avoid recapture of ITC benefits by the Service.

(1) *Option 1*--Under this option, utilities are permitted to defer the investment tax credit utilized and amortize the deferred balance over the life of the assets giving rise to the credits. This amortization is below-the-line (to nonutility tax expense), thereby having no effect on utility cost of service. The utility, however, may reduce the rate base for the unamortized deferred ITC balance. These rate base reductions are in effect restored over the useful life of the tax credit property as the deferred balance is amortized. Option 1 is generally termed as the "ratable restoration" method, since, in essence, it allows the utility to keep the tax credit savings but does not require that the utility earn a return on those assets effectively financed by the U.S. Treasury.

(2) *Option 2*--Following this option, utilities again defer the investment tax credit utilized. Ratemaking treatment under this option is basically the reverse of Option 1. The deferred ITC balance may be amortized above-the-line, thereby reducing the income tax component of cost of service. No rate base reduction is permitted for the unamortized ITC balance. This option is generally referred to as the "ratable flow-through" method, since it allows the utility to earn a return on the entire cost of assets generating the tax credits (with no reduction for the tax savings) but at the same time permits a flow-through of the ITC benefits to customers over the life of the related assets.

At one time, a third option was available. This option provided that no restrictions applied and was commonly labeled the "immediate flow-through" method. The most common treatment under this option was to recognize the utilization of ITC as a current reduction of the income tax element of cost of service. Because there was immediate recognition of the entire benefit, no deferred investment tax credit balance existed for ratemaking or financial accounting purposes. Availability of this option was restricted before 1981 and was effectively eliminated for years after 1980 by the Economic Recovery Tax Act of 1981.

This discussion of investment tax credit has been purposely brief and devoted solely to a general discussion of the available rate base treatments. A detailed discussion of this highly controversial and complex subject is contained in Chapter 17, where the implications of the various options are explored in detail.

**[11]--Cancelled Plant Investment**

The Federal Energy Regulatory Commission (FERC) in Opinion No. 295 adopted a 50-50 sharing policy relating to the recovery of the costs of abandoned or cancelled construction projects by electric utilities.n25 The methodology adopted by the Commission provides that 50 percent of the incurred costs of a cancelled plant are to be amortized to cost of service over the expected life of the planned plant. The remaining incurred costs of the plant are to be written off as a loss to the utility. In the past, as specified in Order No. 49, the FERC allowed utilities to pass through abandonment costs but did not permit rate base treatment of the unrecovered investment. Under the new policy, rate base treatment is permitted on the portion of the costs recovered from ratepayers, less related deferred income taxes. According to the FERC, this ruling allows utility shareholders funding major facilities to recover a greater share of abandonment losses and reduces regulatory uncertainty.

By fixing amortization periods equal to the expected plant life--rather than allowing them to vary from case to case--the Commission hopes to avoid rate cases involving plant abandonments.

The Commission's prior policy under Opinion No. 49 permitted utilities to defer and amortize cancelled plant costs in order to recover their total investment in cancelled projects, including accrued AFUDC, up to the time of cancellation. However, utilities were not allowed to include the unamortized deferral in rate base (and thereby earn a return on the unrecovered cost during the recovery period). Electric utilities in the past have requested rate base

# REGULATED OPERATIONS

## SECTION Re6

**Sources:** FASB Statement 71; FASB Statement 87; FASB Statement 90; FASB Statement 92; FASB Statement 98; FASB Statement 101; FASB Statement 106; FASB Statement 109; FASB Statement 135; FASB Statement 142; FASB Statement 144; FASB Interpretation 40; FASB Technical Bulletin 87-2

[**Note:** A list of Issues discussed by the Emerging Issues Task Force (EITF) that provide supplemental guidance for this section is presented in paragraph .1000.]

### Summary

This section provides guidance in preparing general-purpose financial statements for most public utilities. Certain other enterprises with regulated operations that meet specified criteria are also covered.

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

For a number of reasons, revenues intended to cover some costs are provided either before or after the costs are incurred. If regulation provides assurance that incurred costs will be recovered in the future, this section requires enterprises to capitalize those costs. If current recovery is provided for costs that are expected to be incurred in the future, this section requires enterprises to recognize those current receipts as liabilities.

The cost of electric utilities' plants constructed in the 1980s has been much greater than the cost of those completed in earlier years, so that, for some utilities, conventional rate-making methods would result in significantly increased rates when a newly completed plant goes into service. In such cases, some regulators have adopted phase-in plans to moderate the initial rate increase. The objective of those plans is to increase rates more gradually than would be the case under conventional rate making, while providing the utility eventual recovery of all of its allowable costs and a return on investment. This section requires allowable costs deferred for future recovery under a phase-in plan related to plants completed before January 1, 1988 and plants on which substantial physical construction had been performed before that date to be capitalized if certain criteria are met.

This section requires the future revenue that is expected to result from the regulator's inclusion of the cost of an abandoned plant in allowable cost for rate-making purposes to be reported at its present value when the abandonment becomes probable. Any costs in excess of that present value of the abandoned plant shall be recognized as a loss. This section also requires loss recognition for any disallowed costs of a recently completed plant.

This section requires recognition, as costs of assets and increases in net income, of two types of allowable costs that include amounts not usually accepted as costs in the present accounting framework for unregulated enterprises, as follows:

- If rates are based on allowable costs that include an allowance for the cost of funds used during construction (consisting of an equity component and a debt component) and it is probable that the allowance for funds used during construction will be allowed for rate-making purposes, then the enterprise shall capitalize and increase net income by the amount used for rate-making purposes—instead of capitalizing interest in accordance with Section I67, "Interest: Capitalization of Interest Costs."
- If rates are based on allowable costs that include reasonable inter-company profits, the enterprise shall not eliminate those inter-company profits in its financial statements.

Regulated enterprises shall account for income taxes as required under Section I27, "Income Taxes." Specifically:

a Net-of-tax accounting and reporting is prohibited
b. Deferred taxes are to be recognized for temporary differences
c. Adjustments to deferred taxes are to be made for an enacted change in tax law or rates.

If it is probable that a future increase or decrease in taxes payable will result from the above and be recovered from or returned to customers then an asset or liability should be recognized for that amount.

This section may require that a cost be accounted for in a different manner from that required by another section. In that case, this section is to be followed because it reflects the economic effects of the rate-making process—effects not considered in other sections. All other provisions of that other section apply to the regulated enterprise.

An enterprise's operations can cease to meet the specified criteria mentioned above for various reasons, including deregulation, a change in the method of regulation, or a change in the competitive environment for the enterprise's regulated services or products. Regardless of the reason, an enterprise whose operations cease to meet those criteria should discontinue application of the accounting described above and report that discontinuation by eliminating from its statement of financial position the effects of any actions of regulators that had been recognized as assets and liabilities but would not have been recognized as assets and liabilities by enterprises in general. However, the carrying amounts of plant, equipment, and inventory measured and reported pursuant to this section should not be adjusted unless those assets are impaired, in which case the carrying amounts of those assets should be reduced to reflect that impairment. The net effect of the adjustments should be included in income of the period in which the discontinuation occurs and classified as an extraordinary item.

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## Introduction

.101-.110 [Deleted 12/82 because of FASB Statement 71, *Accounting for the Effects of Certain Types of Regulation.*]

.111 Regulation of an enterprise's prices (hereinafter referred to as *rates*) is sometimes based on the enterprise's costs. Regulators use a variety of mechanisms to estimate a regulated enterprise's **allowable costs,**[1] and they allow the enterprise to charge rates that are intended to produce revenue approximately equal to those allowable costs. Specific costs that are allowable for rate-making purposes result in revenue approximately equal to the costs. [FAS71, ¶1]

.112 In most cases, allowable costs are used as a means of estimating costs of the period during which the rates will be in effect, and there is no intent to permit recovery of specific prior costs. The process is a way of setting prices—the results of the process are reported in general-purpose financial statements in accordance with the same accounting principles that are used by unregulated enterprises. [FAS71, ¶2]

[1]The term *allowable costs* is used throughout this section to refer to all costs for which revenue is intended to provide recovery. Those costs can be actual or estimated. In that context, allowable costs include interest cost and [FAS71, ¶1, fn1] an allowance for earnings on shareholders' investment. [FAS92, ¶3, fn1]

.113 Regulators sometimes include costs in allowable costs in a period other than the period in which the costs would be charged to expense by an unregulated enterprise. That procedure can create assets (future cash inflows that will result from the rate-making process), reduce assets (reductions of future cash inflows that will result from the rate-making process), or create liabilities (future cash outflows that will result from the rate-making process) for the regulated enterprise. For general-purpose financial reporting, an **incurred cost** for which a regulator permits recovery in a future period is accounted for like an incurred cost that is reimbursable under a cost-reimbursement-type contract. [FAS71, ¶3]

.114 Accounting requirements that are not directly related to the economic effects of rate actions may be imposed on regulated businesses by orders of regulatory authorities and occasionally by court decisions or statutes. This does not necessarily mean that those accounting requirements conform with generally accepted accounting principles. For example, a regulatory authority may order an enterprise to **capitalize**[2] and amortize a cost that would be charged to income currently by an unregulated enterprise. Unless capitalization of that cost is appropriate under this section, generally accepted accounting principles require the regulated enterprise to charge the cost to income currently. [FAS71, ¶4] [Regulated] enterprises [are not precluded] from issuing financial statements prepared under statutory requirements but those financial statements shall not be described as prepared "in conformity with generally accepted accounting principles." [FIN40, ¶18] [Regulated operations,] like all other business enterprises, [shall disclose] significant accounting policies used to prepare financial statements intended to be in conformity with generally accepted accounting principles.[2a] [FIN40, ¶5]

.114A When a utility places a newly completed plant in service, traditional rate-making procedures establish rates to recover the allowable costs of that plant. [FAS92, ¶48] In

[2] *Capitalize* is used in this section to indicate that the cost would be recorded as the cost of an asset. That procedure is often referred to as "deferring a cost," and the resulting asset is sometimes described as a "deferred cost." [FAS71, ¶4, fn2]

[[2a]Editorial deletion, 7/97.]

recent years, a combination of circumstances caused traditional rate-making procedures to result in a phenomenon called *rate spike*—a major, one-time increase in rates that can result from the inclusion of the cost of new plants in rates under traditional rate-making procedures. [FAS92, ¶49]

.114B **Phase-in plans** were developed to alleviate the problem of rate spike. Those plans are intended to moderate the initial increase in rates that would otherwise result from placing newly completed plants in service by deferring some of that rate increase to future years and providing the utility with return on investment for those deferred amounts. Instead of the traditional pattern of an increase in allowable costs followed by decreasing allowable costs for utility plants after the plants are placed in service, phase-in plans create a pattern of gradually increasing allowable costs for the initial years of the plant's service life. [FAS92, ¶50]

## Scope

.115 This section, except for paragraphs .204 through .216, applies to general-purpose external financial statements of an enterprise that has regulated operations[3] that meet all of the following criteria:

a. The enterprise's rates for regulated services or products provided to its customers are established by or are subject to approval by an independent, third-party regulator or by its own governing board empowered by statute or contract to establish rates that bind customers.[4]

[3]This section does not address an enterprise's regulatory accounting. Regulators may require regulated enterprises to maintain their accounts in a form that permits the regulator to obtain the information needed for regulatory purposes. This section neither limits a regulator's actions nor endorses them. Regulators' actions are based on many considerations. Accounting addresses the effects of those actions. This section merely specifies how the effects of different types of rate actions are reported in general-purpose financial statements. [FAS71, ¶55]

[[4]GASB Statement 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting,* paragraph 9, provides that state and local proprietary activities that meet the criteria of paragraph .115 may apply [the provisions of] this section [from FASB Statements 71, *Accounting for the Effects of Certain Types of Regulation,* 90, *Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs,* 92, *Regulated Enterprises—Accounting for Phase-in Plans,* and 101, *Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71,*] that [were] issued on or before November 30, 1989. [Provisions] of this section related to regulated operations issued after that date are subject to the provisions of GASB Statement 20, paragraph 7. [FAS135, ¶4(o)]

b. The regulated rates[5] are designed to recover the specific enterprise's costs of providing the regulated services or products.[6]

c. In view of the demand for the regulated services or products and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover the enterprise's costs can be charged to and collected from customers. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs.[7]

[FAS71, ¶5] [Refer to paragraph .1001 for an EITF Issue that provides interpretive guidance on this paragraph.]

.116 If some of an enterprise's operations are regulated and meet the criteria of paragraph .115, this section shall be applied to only that portion of the enterprise's operations. [FAS71, ¶6]

.117 Sections that apply to enterprises in general also apply to regulated enterprises. However, enterprises subject to this section shall apply it instead of any conflicting provisions of other sections.[8] [FAS71, ¶7]

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[5]This criterion is intended to be applied to the substance of the regulation, rather than its form. If an enterprise's regulated rates are based on the costs of a group of enterprises and the enterprise is so large in relation to the group of enterprises that its costs are, in essence, the group's costs, the regulation would meet the second criterion for that enterprise. [FAS71, ¶65]

[6]This criterion is intended to exclude contractual arrangements in which the government, or another party that could be viewed as a "regulator," is a party to a contract and is the enterprise's principal customer. [FAS71, ¶62]

[[7]This criterion] must be evaluated in light of the circumstances. For example, if the enterprise has an exclusive franchise to provide regulated services or products in an area and competition from other services or products is minimal, there is usually a reasonable expectation that it will continue to meet the other criteria. Exclusive franchises can be revoked, but they seldom are. If the enterprise has no exclusive franchise but has made the very large capital investment required to provide either the regulated services or products or an acceptable substitute, future competition also may be unlikely. [FAS71, ¶68] [This] criterion [also is not intended] as a requirement that the enterprise earn a fair return on shareholders' investment under all conditions; an enterprise can earn less than a fair return for many reasons unrelated to the ability to bill and collect rates that will recover allowable costs. For example, mild weather might reduce demand for energy utility services. In that case, rates that were expected to recover an enterprise's allowable costs might not do so. The resulting decreased earnings do not demonstrate an inability to charge and collect rates that would recover the enterprise's costs; rather, they demonstrate the uncertainty inherent in estimating weather conditions. [FAS71, ¶67]

[8]For example, a regulator might authorize a regulated enterprise to incur a major research and development cost because the cost is expected to benefit future customers. The regulator might also direct that cost to be capitalized and amortized as an allowable cost over the period of expected benefit. If the criteria of paragraph .119 were met, the enterprise would capitalize that cost even though Section R50, "Research and Development," requires such costs to be charged to income currently. Section R50 would still apply to accounting for other research and development costs of the regulated enterprise, as would the disclosure requirements of Section R50. [FAS71, ¶7, fn4]

.117A Deregulation of certain industries and changes in the method of regulating others have caused several enterprises to discontinue, for some or all of their operations, [the specialized accounting described in this section for the effects of regulation. Paragraphs .204 through .216] address the accounting that should result when an enterprise's operations cease to meet [the criteria in paragraph .115.] [FAS101, ¶1]

.117B Failure of an enterprise's operations to continue to meet the criteria in paragraph .115 can result from different causes. Examples include the following:

a. Deregulation
b. A change in the regulator's approach to setting rates from cost-based rate making to another form of regulation
c. Increasing competition that limits the enterprise's ability to sell utility services or products at rates that will recover costs[8b]
d. Regulatory actions resulting from resistance to rate increases that limit the enterprise's ability to sell utility services or products at rates that will recover costs if the enterprise is unable to obtain (or chooses not to seek) relief from prior regulatory actions through appeals to the regulator or the courts.

[FAS101, ¶4]

.118 This section does not apply to accounting for price controls that are imposed by governmental action in times of emergency, high inflation, or other unusual conditions. Nor does it cover accounting for contracts in general. However, if the terms of a contract between an enterprise and its customer are subject to regulation and the criteria of paragraph .115 are met with respect to that contract, this section shall apply. [FAS71, ¶8]

.118A This section specifies the accounting for phase-in plans, [FAS92, ¶2] plant abandonments, and disallowances of costs of recently completed plants. It also provides guidance for the capitalization of an allowance for funds used during construction (AFUDC). [FAS90, ¶2]

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[8a][Deleted 1/89 and renumbered as footnote 8c.]

[8b]The term *costs* is used consistent with its usage in paragraph .115, [that is,] based on allowable costs [as opposed to incurred costs]. [FAS101, ¶36]

## General Standards of Accounting for the Effects of Regulation

.119 Rate actions of a regulator can provide reasonable assurance of the existence of an asset.[8c] An enterprise shall capitalize all or part of an incurred cost[9] that would otherwise be charged to expense if both of the following criteria are met:

a. It is **probable**[10] that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes.
b. Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs. If the revenue will be provided through an automatic rate-adjustment clause, this criterion requires that the regulator's intent clearly be to permit recovery of the previously incurred cost. [FAS71, ¶9]

If at any time the incurred cost no longer meets the above criteria, that cost shall be charged to earnings. [FAS144, ¶C32(a)] [Refer to paragraph .1001 for EITF Issues that provide interpretive guidance on this paragraph.]

.120 Rate actions of a regulator can reduce or eliminate the value of an asset. [FAS71, ¶10] If a regulator excludes all or part of a cost from allowable costs, the carrying amount of any asset recognized pursuant to paragraph .119 of this section shall be reduced to the extent of the excluded cost. [FAS144, ¶C32(b)] Whether [FAS71, ¶10] other assets have [FAS144, ¶C32(b)] been impaired shall be judged the same as for enterprises in general[10a] [FAS71, ¶10] and paragraphs .139 through .161 of Section I08, "Impairment," shall apply. [FAS144, ¶C32(b)]

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[8c]Costs of abandoned plants shall be accounted for in accordance with paragraphs .127A through .127D. [FAS90, ¶9(b)] Phase-in plans shall be accounted for in accordance with paragraphs 125A. through .125F. [FAS92, ¶13(a)]

[9]An *incurred cost* is "a cost arising from cash paid out or obligation to pay for an acquired asset or service a loss from any cause that has been sustained and has been or must be paid for" (Eric L. Kohler, *A Dictionary for Accountants,* 5th ed. [Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1975], p.253). [FAS71, ¶9, fn5]

[10]The term *probable* is used in this section consistent with its use in Section C59, "Contingencies." Section C59 defines *probable* as an area within a range of the likelihood that a future event or events will occur. That range is from probable to remote, as follows:

*Probable.* The future event or events are likely to occur.
*Reasonably possible.* The chance of the future event or events occurring is more than remote but less than likely.
*Remote.* The chance of the future event or events occurring is slight.

[FAS90, ¶9(a)]

[10a]Disallowances of costs of recently completed plants, whether direct or indirect, shall be accounted for in accordance with paragraph .127E. [FAS90, ¶9(c)]

.120A If a regulator allows recovery through rates of costs previously excluded from allowable costs, that action shall result in recognition of a new asset. The classification of that asset shall be consistent with the classification that would have resulted had those costs been initially included in allowable costs. [FAS144, ¶C32(c)]

.121 Rate actions of a regulator can impose a liability on a regulated enterprise. Such liabilities are usually obligations to the enterprise's customers. The following are the usual ways in which liabilities can be imposed and the resulting accounting:

a. A regulator may require refunds to customers.[11] Refunds that meet the criteria of Section C59, "Contingencies," paragraph .105 (accrual of loss contingencies) shall be recorded as liabilities and as reductions of revenue or as expenses of the regulated enterprise.
b. A regulator can provide current rates intended to recover costs that are expected to be incurred in the future with the understanding that if those costs are not incurred future rates will be reduced by corresponding amounts. If current rates are intended to recover such costs and the regulator requires the enterprise to remain accountable for any amounts charged pursuant to such rates and not yet expended for the intended purpose,[12] the enterprise shall not recognize as revenues amounts charged pursuant to such rates. Those amounts shall be recognized as liabilities and taken to income only when the associated costs are incurred.[13]
c. A regulator can require that a gain or other reduction of net allowable costs be given to customers over future periods. That would be accomplished, for rate-making purposes, by amortizing the gain or other reduction of net allowable costs over those future periods and reducing rates to reduce revenues in approximately the amount of the amortization. If a gain or other reduction of net allowable costs is to be amortized over future periods for rate-making purposes, the regulated enterprise shall not recognize that gain or other reduction of net allowable costs in income of the current period. Instead, it shall record it as a liability for future reductions of charges to customers that are expected to result.

[FAS71, ¶11] [Refer to paragraph .1001 for an EITF Issue that provides interpretive guidance on this paragraph.]

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[11]Refunds can be paid to the customers who paid the amounts being refunded; however, they are usually provided to current customers by reducing current charges. [FAS71, ¶11, fn7]

[12]The usual mechanism used by regulators for this purpose is to require the regulated enterprise to record the anticipated cost as a liability in its regulatory accounting records. [FAS71, ¶11, fn8]

[[13]This paragraph does not address nuclear plant decommissioning costs or other similar costs because they] are incurred costs in the current accounting framework. Those costs and the related liabilities are imposed by regulation or statute, similar to the liability to restore the land after strip mining, discussed in paragraph 210 of Concepts Statement 6. [FAS71, ¶80]

.122 Actions of a regulator can eliminate a liability only if the liability was imposed by actions of the regulator. [FAS71, ¶12]

.123 Paragraphs .132 through .203 illustrate the accounting for the effects of regulation. [FAS92, ¶13(b)]

## Specific Standards Derived from the General Standards

.124 The following specific standards are derived from the general standards in paragraphs .119 through .122. The specific standards shall not be used as guidance for other applications of [those] general standards. [FAS92, ¶13(c)]

### Allowance for Funds Used during Construction

.125 In some cases, a regulator requires an enterprise subject to its authority to capitalize, as part of the cost of plant and equipment, the cost of financing construction as financed partially by borrowings and partially by equity. A computed interest cost and a designated cost of equity funds, [FAS71, ¶15] [also referred to as] an allowance for earnings on shareholders' investment, [FAS92, ¶8, fn4] are capitalized, and net income for the current period is increased by a corresponding amount. After the construction is completed, the resulting capitalized cost is the basis for depreciation and unrecovered investment for rate-making purposes. In such cases, the amounts capitalized for rate-making purposes as part of the cost of acquiring the assets shall be capitalized for financial reporting purposes instead of the amount of interest that would be capitalized in accordance with Section I67, "Interest: Capitalization of Interest Costs."[14] [FAS71, ¶15] Those amounts shall be capitalized only if their subsequent inclusion in allowable costs for rate-making purposes is probable.[14a] [FAS90, ¶9(e)] The income statement shall include an

[14]Section I67 requires capitalization of interest cost on certain qualifying assets. The amount capitalized is the portion of the interest cost incurred during the period that theoretically could have been avoided if the expenditures had not been made. [FAS71, ¶15, fn9]

[14a]If the specific criteria in paragraph .125 are met but [an allowance for funds used during construction] is not capitalized because its inclusion in the cost that will become the basis for future rates is not probable, the regulated enterprise may not alternatively capitalize interest cost in accordance with Section I67. [FAS90, ¶66] [If] completion of a plant under construction is reasonably possible but no longer probable, and the regulator in the governing jurisdiction routinely disallows accumulated AFUDC on abandoned plants, the criteria required to write off previously recognized AFUDC are not met since disallowance is not probable; thus, previously capitalized AFUDC should not be written off. However, because inclusion of AFUDC in the cost allowed for future rates is no longer probable, further capitalization of AFUDC is not warranted. [FAS90, ¶67] [Assume that] a prudence investigation is in process or has taken place, and a disallowance of cost (including subsequent AFUDC on those costs) is reasonably possible, [and that] the range of such disallowance is from zero to some maximum amount, [with] no point within the range [being] more likely than any other. In that situation, because a disallowance of the maximum amount in the range is reasonably possible and thus inclusion of that amount in rates is no longer probable, subsequent capitalization of AFUDC should be discontinued for an amount of costs equal to the maximum amount that is within the range. [FAS90, ¶68]

item of other income, a reduction of interest expense, or both, in a manner that indicates the basis for the amount capitalized. [FAS71, ¶15]

### Accounting for Phase-in Plans

.125A The term *phase-in plan* is used in this section to refer to any method of recognition of allowable costs in rates that meets all of the following criteria:

a. The method was adopted by the regulator in connection with a major, newly completed plant of the regulated enterprise or of one of its suppliers or a major plant scheduled for completion in the near future (hereinafter referred to as "a plant").
b. The method defers the rates intended to recover allowable costs beyond the period in which those allowable costs would be charged to expense under generally accepted accounting principles applicable to enterprises in general. [Refer to paragraph .1001 for an EITF Issue that provides interpretive guidance on subparagraphs (b) and (c) of this paragraph.]
c. The method defers the rates intended to recover allowable costs beyond the period in which those rates would have been ordered under the rate-making methods routinely used prior to 1982 by that regulator for similar allowable costs of that regulated enterprise.

[FAS92, ¶3]

The definition of a phase-in plan is not intended to encompass actions of a regulator that are designed to protect a utility from the effects of **regulatory lag** in the absence of a rate order, nor is it intended to encompass the regulator's subsequent treatment of any allowable costs that result from those actions. [Refer to paragraphs .196 through .199.] [FAS92, ¶39]

.125B If a phase-in plan is ordered by a regulator in connection with a plant on which no substantial physical construction had been performed before January 1, 1988, none of the allowable costs that are deferred for future recovery by the regulator under the plan[14b] for rate-making purposes shall be capitalized for general-purpose financial reporting purposes (hereinafter referred to as "financial reporting"). [FAS92, ¶4]

.125C If a phase-in plan is ordered by a regulator in connection with a plant completed before January 1, 1988 or a plant on which substantial physical construction had been performed before January 1, 1988, the criteria specified below shall be applied to that plan. If the phase-in plan meets all of those criteria, all allowable costs that are deferred for future recovery by the regulator under the plan shall be capitalized for financial re-

[14b] "Allowable costs that are deferred for future recovery by the regulator under the plan" consist of all allowable costs deferred for rate-making purposes under the plan beyond the period in which those allowable costs would be charged to expense under generally accepted accounting principles applicable to enterprises in general. [FAS92, ¶4, fn2]

porting as a separate asset (a deferred charge). If any one of those criteria is not met, none of the allowable costs that are deferred for future recovery by the regulator under the plan[14c] shall be capitalized for financial reporting. The criteria to determine whether capitalization is appropriate are:

a. The allowable costs in question are deferred pursuant to a formal plan that has been agreed to by the regulator.
b. The plan specifies the timing of recovery of all allowable costs that will be deferred under the plan.
c. All allowable costs deferred under the plan are scheduled for recovery within 10 years of the date when deferrals begin.
d. The percentage increase in rates scheduled under the plan for each future year is no greater than the percentage increase in rates scheduled under the plan for each immediately preceding year. That is, the scheduled percentage increase in year two is no greater than the percentage increase granted in year one, the scheduled percentage increase in year three is no greater than the scheduled percentage increase in year two, and so forth.

[FAS92, ¶5]

### *Modifications of and Supplements to Phase-in Plans*

.125D When an existing phase-in plan is modified or a new plan is ordered to replace or supplement an existing plan, the above criteria[14d] shall be applied to the combination of the original plan and the new plan. The date when deferrals begin, used in applying the criterion in paragraph .125C(c), would be the date of the earliest deferral under either the new or the old plan, and the final recovery date would be the date of the last recovery of all amounts deferred under the plans. [FAS92, ¶6]

### *Interrelationship of Phase-in Plans and Disallowances*

.125E A phase-in plan, as defined in paragraph .125A, is a method of rate making intended to moderate a sudden increase in rates while providing the regulated enterprise with recovery of its investment and a return on that investment during the recovery period. A disallowance is a rate-making action that prevents the regulated enterprise from recovering either some amount of its investment or some amount of return on its investment. Paragraph .127E specifies the accounting for disallowances of plant costs. If a method of rate making that meets the criteria of paragraph .125A for a phase-in plan includes an indirect disallowance of plant costs, that disallowance shall be accounted for in accordance with paragraph .127E. [FAS92, ¶7]

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[14c]Refer to footnote 14b. [FAS92, ¶5, fn3]

[[14d]Editorial deletion, 3/95.]

### *Financial Statement Classification of Amounts Capitalized under Phase-in Plans*

.125F Cumulative amounts capitalized under phase-in plans shall be reported as a separate asset in the balance sheet. The net amount capitalized in each period or the net amount of previously capitalized allowable costs recovered during each period shall be reported as a separate item of other income or expense in the income statement. Allowable costs capitalized shall not be reported as reductions of other expenses. [FAS92, ¶10]

### Allowance for Earnings on Shareholders' Investment

.125G An allowance for earnings on shareholders' investment is not "an incurred cost that would otherwise be charged to expense." Accordingly, such an allowance shall not be capitalized pursuant to paragraph .119. [FAS92, ¶8] [However,] in specified circumstances, paragraph .125 requires capitalization of an allowance for earnings on shareholders' investment (a designated cost of equity funds) during construction and paragraph .125C requires capitalization of an allowance for earnings on shareholders' investment for qualifying phase-in plans. If an allowance for earnings on shareholders' investment is capitalized for rate-making purposes other than during construction or as part of a phase-in plan, the amount capitalized for rate-making purposes shall not be capitalized for financial reporting;[14e] [FAS92, ¶9] [in that event, certain disclosures are required by paragraph .131B].

### Accounting for Sale-Leaseback Transactions

.125H The provisions of paragraphs .130A through .130M of Section L10, "Leases," apply to sale-leaseback transactions of a regulated enterprise subject to this section. That accounting may result in a difference between the timing of income and expense recognition required by those paragraphs and the timing of income and expense recognition for rate-making purposes. That difference shall be accounted for as follows:

a. If the difference in timing of income and expense recognition constitutes all or a part of a phase-in plan, as defined in paragraph .125A, it shall be accounted for in accordance with paragraphs .125A through .125F of this section.
b. Otherwise, the timing of income and expense recognition related to the sale-leaseback transaction shall be modified as necessary to conform to this section. That modification required for a transaction that is accounted for by the deposit method or as a financing is further described in paragraphs .125I and .125J.

[FAS98, ¶14]

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[14e If such amounts had been] capitalized in fiscal years prior to the initial application of FASB Statement 92, [FAS92, ¶14] retroactive application is not permitted. [FAS92, ¶72]

.125I If a sale-leaseback transaction that is not part of a phase-in plan is accounted for by the deposit method but the sale is recognized for rate-making purposes, the amortization of the asset shall be modified to equal the total of the rental expense and the gain or loss allowable for rate-making purposes. Similarly, if the sale-leaseback transaction is accounted for as a financing and the sale is recognized for rate-making purposes, the total of interest imputed under the interest method for the financing and the amortization of the asset shall be modified to equal the total rental expense and the gain or loss allowable for rate-making purposes. [FAS98, ¶15]

.125J The difference between the amount of income or expense recognized for a transaction that is not part of a phase-in plan and that is accounted for by the deposit method or as a financing under paragraphs .130A through .130M of Section L10 and the amount of income or expense included in allowable costs for rate-making purposes shall be capitalized or accrued as a separate regulatory-created asset or liability, as appropriate, if that difference meets the criteria of this section. [FAS98, ¶16]

### Intercompany Profit

.126 [**Intercompany**] **profit**[15] on sales to regulated affiliates shall not be eliminated in general-purpose financial statements[16] if both of the following criteria are met:

a. The sales price is reasonable.
b. It is probable that, through the rate-making process, future revenue approximately equal to the sales price will result from the regulated affiliate's use of the products.

[FAS71, ¶16]

.127 The sales price usually shall be considered reasonable if the price is accepted or not challenged by the regulator that governs the regulated affiliate. Otherwise, reasonableness shall be considered in light of the circumstances. For example, reasonableness might be judged by the return on investment earned by the manufacturing or construction operations or by a comparison of the transfer prices with prices available from other sources. [FAS71, ¶17]

[15]The term *intercompany profit* is used in this section to include both profits on sales from one enterprise to another within a consolidated or affiliated group and profits on sales from one operation of an enterprise to another operation of the same enterprise. [FAS71, ¶16, fn10]

[16]Section C51, "Consolidation," requires that profit on sales of assets remaining in the consolidated group be eliminated in consolidated financial statements. Section I82, "Investments: Equity Method," effectively extends that requirement to affiliated entities reported on the equity method. [FAS71, ¶16, fn11]

### Accounting for Abandonments[16a]

.127A When it becomes probable[16b] that an operating asset or an asset under construction will be abandoned, the cost of that asset shall be removed from construction work-in-process or plant-in-service. The enterprise shall determine whether recovery of any allowed cost is likely to be provided with (a) full return on investment during the period from the time when abandonment becomes probable to the time when recovery is completed or (b) partial or no return on investment during that period. That determination should focus on the facts and circumstances related to the specific abandonment and should also consider the past practice and current policies of the applicable regulatory jurisdiction on abandonment situations. Based on that determination, the enterprise shall account for the cost of the abandoned plant as follows:

a. *Full return on investment is likely to be provided.* Any disallowance of all or part of the cost of the abandoned plant that is both *probable* and *reasonably estimable,* as those terms are used in Section C59, shall be recognized as a loss, and the carrying basis of the recorded asset shall be correspondingly reduced. The remainder of the cost of the abandoned plant shall be reported as a separate new asset.
b. *Partial or no return on investment is likely to be provided.* Any disallowance of all or part of the cost of the abandoned plant that is both *probable* and *reasonably estimable,* as those terms are used in Section C59, shall be recognized as a loss. The present value of the future revenues expected to be provided to recover the allowable cost of that abandoned plant and return on investment, if any, shall be reported as a separate new asset. Any excess of the remainder of the cost of the abandoned plant over that present value also shall be recognized as a loss. The discount rate used to compute the present value shall be the enterprise's incremental borrowing rate, that is, the rate that the enterprise would have to pay to borrow an equivalent amount for a period equal to the expected recovery period. In determining the present value of expected future revenues, the enterprise shall consider such matters as (1) the probable time period before such recovery is expected to begin and (2) the probable time period over which recovery is expected to be provided. If the estimate of either period is a range, the guidance of paragraphs .106 through .107 and .124 through .127 in Section C59 shall be applied to determine the loss to be recognized. Accordingly, the most likely period within that range shall be used to compute the present value. If no period within that range is a better estimate than any other, the present value shall be based on the minimum time period within that range.

[FAS90, ¶3]

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[[16a]Editorial deletion.]

[16b]The term *probable* is used in this section consistent with its use in Section C59 to mean that a transaction or event is likely to occur. [FAS90, ¶3, fn1]

.127B The recorded amount of the new asset shall be adjusted from time to time as necessary if new information indicates that the estimates used to record the separate new asset have changed.[16c] Those estimates include (a) the determination of whether full return on investment will be provided and, if not, the probable time period before recovery is expected to begin and the probable time period over which recovery is expected to be provided and (b) the amount of any probable and reasonably estimable disallowance of recorded costs of the abandoned plant. The amount of the adjustment shall be recognized in income as a loss or gain. Paragraphs .162, .163, and .165 illustrate how this paragraph applies to changes in the estimated time period before recovery begins and the time period over which recovery is expected to be provided. The recorded carrying amount of the new asset shall not be adjusted for changes in the enterprise's incremental borrowing rate. [FAS90, ¶4]

.127C During the period between the date on which the new asset is recognized and the date on which recovery begins, the carrying amount shall be increased by accruing a carrying charge. The rate used to accrue that carrying charge shall be as follows:

a. If full return on investment is likely to be provided, a rate equal to the allowed overall cost of capital in the jurisdiction in which recovery is expected to be provided shall be used.
b. If partial or no return on investment is likely to be provided, the rate that was used to compute the present value shall be used. Paragraphs .161 and .164 and Exhibits 161A and 164A illustrate that procedure.

[FAS90, ¶5]

.127D During the recovery period, the new asset shall be amortized as follows:

a. If full return on investment is likely to be provided, the asset shall be amortized in the same manner as that used for rate-making purposes.
b. If partial or no return on investment is likely to be provided, the asset shall be amortized in a manner that will produce a constant return on the unamortized investment in the new asset equal to the rate at which the expected revenues were discounted. Paragraph .166 and Exhibit 166A illustrate that procedure.

[FAS90, ¶6]

[16c]Usually the receipt of a rate order [is a] confirming event [that a loss has occurred], permitting an estimate of the loss to be refined at that time. However, [if it is not] probable that a loss has occurred [or] the amount [cannot] be reasonably estimated at the time of an initial rate order, the loss should not be recognized at that time. [FAS90, ¶52]

## Disallowances of Costs of Recently Completed Plants[16d]

.127E When it becomes probable that part of the cost of a recently completed plant will be disallowed for rate-making purposes and a reasonable estimate of the amount of the disallowance can be made,[16e] the estimated amount of the probable disallowance shall be deducted from the reported cost of the plant and recognized as a loss. If part of the cost is explicitly, but indirectly, disallowed (for example, by an explicit disallowance of return on investment on a portion of the plant), an equivalent amount of cost shall be deducted from the reported cost of the plant and recognized as a loss. [FAS90, ¶7]

## Other Specific Standards

### Accounting for Income Taxes

.128 A deferred tax liability or asset shall be recognized for the deferred tax consequences of temporary differences in accordance with Section I27, "Income Taxes." [FAS109, ¶288(v)]

.128A Regulated enterprises that meet the criteria for this section are not exempt from the requirements of Section I27. Specifically, Section I27:

a. Prohibits net-of-tax accounting and reporting
b. Requires recognition of a deferred tax liability (1) for tax benefits that are flowed through to customers when temporary differences originate and (2) for the equity component of the allowance for funds used during construction
c. Requires adjustment of a deferred tax liability or asset for an enacted change in tax laws or rates.

If, as a result of an action by a regulator, it is probable that the future increase or decrease in taxes payable for items (b) and (c) above will be recovered from or returned to customers through future rates, an asset or liability is recognized for that probable future revenue or reduction in future revenue pursuant to paragraphs .119 through .121. That asset or liability also is a temporary difference for which a deferred tax liability or asset shall be recognized. [(Refer to paragraphs .179 through .182 in Section I27 for further guidance.)] [FAS109, ¶29]

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[[16d]Editorial deletion.]

[16e]Paragraphs .106, .107, and .124 through .127 of Section C59 provide guidance for making a reasonable estimate of the amount of a loss. [FAS90, ¶7, fn2]

[17][Deleted 2/92 because of FASB Statement 109, *Accounting for Income Taxes*.]

.129 [Editorial deletion, 4/88.]

.129A-.129E [Deleted 8/87 and renumbered as paragraphs .127A through .127E.]

## Other Disclosure

### Refunds

.130 For refunds that are recognized in a period other than the period in which the related revenue was recognized and that have a material effect on net income, the enterprise shall disclose the effect on net income and indicate the years in which the related revenue was recognized. Such effect may be disclosed by including it, net of related income taxes, as a line item in the income statement. However, that item shall not be presented as an extraordinary item. [FAS71, ¶19]

### Recovery without Return on Investment

.131 In some cases, a regulator may permit an enterprise to include a cost that would be charged to expense by an unregulated enterprise as an allowable cost over a period of time by amortizing that cost for rate-making purposes, but the regulator does not include the unrecovered amount in the rate base. That procedure does not provide a return on investment during the recovery period. If recovery of such major costs is provided without a return on investment during the recovery period,[17f] the enterprise shall disclose the remaining amounts of such assets and the remaining recovery period applicable to them. [FAS71, ¶20]

### Phase-in Plans

.131A The terms of any phase-in plans in effect during the year or ordered for future years shall be disclosed. This section does not permit capitalization for financial reporting of allowable costs deferred for future recovery by the regulator pursuant to a phase-in plan that does not meet the criteria of paragraph .125C of this section or a phase-in plan related to a plant on which substantial physical construction was not completed before

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[17a-17e][Deleted 8/87 and renumbered as footnotes 16a through 16e.]

[[17f]Paragraph .127A(b) of this section requires that, if for certain of those costs a full return on investment is not provided by the regulator, the future revenues expected to be provided shall be reported at their present value. Paragraph .127C requires the enterprise to accrue a carrying charge on that present value.]

January 1, 1988. Nevertheless, the financial statements shall include disclosure of the net amount deferred at the balance sheet date for rate-making purposes and the net change in deferrals for rate-making purposes during the year for those plans. [FAS92, ¶11]

### Allowance for Earnings on Shareholders' Investment Capitalized for Rate-Making Purposes

.131B The nature and amounts of any allowance for earnings on shareholders' investment capitalized for rate-making purposes but not capitalized for financial reporting shall be disclosed. [FAS92, ¶12]

## Application of General Standards to Specific Situations

.132 Paragraphs .133 through .155 provide guidance for application of this section to some specific situations. The guidance does not address all possible applications of this section. All of the examples assume that the enterprise meets the criteria in paragraph .115; thus, recovery of any cost is probable if that cost is designated for future recovery by the regulator. The examples also assume that the items addressed are material. The provisions of this section need not be applied to immaterial items. [FAS71, ¶27]

.133 Specific situations discussed in paragraphs .134 through .155 are:

| | Paragraph Numbers |
|---|---|
| Intangible assets | .134–.135 |
| Accounting changes | .136–.137 |
| Recovery of costs without return on investment | .138–.139 |
| Early extinguishment of debt | .140–.142 |
| Accounting for contingencies | .143–.144 |
| Accounting for leases | .145–.148 |
| Revenue collected subject to refund | .149–.150 |
| Refunds to customers | .151–.152 |
| Accounting for compensated absences | .153–.154 |
| [Pension costs | .155] |

[FAS71, ¶28]

### Goodwill

.134 Section G40, "Goodwill and Other Intangible Assets," states that goodwill shall not be amortized and shall be tested for impairment in accordance with that section. For rate-making purposes, a regulator may permit an enterprise to amortize purchased goodwill over a specified period. In other cases, a regulator may direct an enterprise not to amortize goodwill or to write off goodwill. [FAS142, ¶D8(a)]

.135 If the regulator permits all or a portion of goodwill to be amortized over a specific time period as an allowable cost for rate-making purposes, the regulator's action provides reasonable assurance of the existence of a regulatory asset (refer to paragraph .119). That regulatory asset would then be amortized for financial reporting purposes over the period during which it will be allowed for rate-making purposes. Otherwise, goodwill shall not be amortized and shall be accounted for in accordance with Section G40. [FAS142, ¶D8(b)]

### Accounting Changes

.136 Section A06, "Accounting Changes," defines various types of accounting changes and establishes guidelines for reporting each type. Authoritative [accounting] pronouncements specify the manner of reporting initial application of those pronouncements. [FAS71, ¶31]

.137 If a regulated enterprise changes accounting methods and the change does not affect costs that are allowable for rate-making purposes, the regulated enterprise would apply the change in the same manner as would an unregulated enterprise. Capitalization of leases with no income statement effect (refer to paragraphs .145 through .148) is an example of that type of change. If a regulated enterprise changes accounting methods and the change affects allowable costs for rate-making purposes, the change generally would be implemented in the way that it is implemented for regulatory purposes. A change in the method of accounting for research and development costs, either from a policy of capitalization and amortization to one of charging those costs to expense as incurred or vice versa, is an example of that type of change. [FAS71, ¶32]

### Recovery of Costs without Return on Investment

.138 In some cases, a regulator may approve rates that are intended to recover an incurred cost over an extended period without a return on the unrecovered cost during the recovery period. [FAS71, ¶33]

.139 The regulator's action provides reasonable assurance of the existence of an asset (refer to paragraph .119). Accordingly, the regulated enterprise would capitalize the cost and amortize it over the period during which it will be allowed for rate-making purposes. That cost would not be recorded at discounted present value.[17g] If the amounts are material, the disclosures specified in paragraph .131 would be furnished. [FAS71, ¶34]

### Early Extinguishment of Debt

.140 Section L35, "Liabilities: Extinguishments," requires recognition in income of a gain or loss on an early extinguishment of debt in the period in which the debt is extinguished. For rate-making purposes, the difference between the enterprise's net carrying amount of the extinguished debt and the reacquisition price may be amortized as an adjustment of interest expense over some future period. [FAS71, ¶35]

.141 If the debt is reacquired for an amount in excess of the enterprise's net carrying amount, the regulator's decision to increase future rates by amortizing the difference for rate-making purposes provides reasonable assurance of the existence of an asset (refer to paragraph .119). Accordingly, the regulated enterprise would capitalize the excess cost and amortize it over the period during which it will be allowed for rate-making purposes. [FAS71, ¶36]

.142 If the debt is reacquired for an amount that is less than the enterprise's net carrying amount, the regulator's decision to reduce future rates by amortizing the difference for rate-making purposes imposes a liability on the regulated enterprise (refer to paragraph .121(c)). Accordingly, the enterprise would record the difference as a liability and amortize it over the period during which permitted rates will be reduced. [FAS71, ¶37]

### Accounting for Contingencies

.143 Section C59 specifies criteria for recording estimated losses from loss contingencies. A regulator may direct a regulated enterprise to include an amount for a contingency in allowable costs for rate-making purposes even though the amount does not meet

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[17g] An exception to this general rule is provided for costs of abandoned plants. Paragraphs .157 through .166 illustrate accounting for future revenues expected to result from the cost of an abandoned plant with partial return or no return on investment during the recovery period. [FAS90, ¶9(f)]

the criteria of that section for recording. For example, a regulator may direct a regulated enterprise to include an amount for repairs of expected future uninsured storm damage. [FAS71, ¶38]

.144 If the regulator requires the enterprise to remain accountable for any amounts charged pursuant to such rates and not yet expended for the intended purpose, the resulting increased charges to customers create a liability (refer to paragraph .121(b)). If a cost to repair storm damage is not subsequently incurred, the increased charges will have to be refunded to customers through future rate reductions. Accordingly, the regulated enterprise would recognize the amounts charged pursuant to such rates as liabilities rather than as revenues. If a cost to repair storm damage is subsequently incurred, the enterprise would charge that cost to expense and reduce the liabilities at that time by recognizing income in amounts equal to the cost. [FAS71, ¶39]

### Accounting for Leases

.145 Section L10 specifies criteria for classification of leases and the method of accounting for each type of lease. For rate-making purposes, a lease may be treated as an operating lease even though the lease would be classified as a capital lease under the criteria of that section. In effect, the amount of the lease payment is included in allowable costs as rental expense in the period it covers. [FAS71, ¶40]

.146 For financial reporting purposes, the classification of the lease is not affected by the regulator's actions. The regulator cannot eliminate an obligation that was not imposed by the regulator (refer to paragraph .122). Also, by including the lease payments as allowable costs, the regulator sets rates that will provide revenue approximately equal to the combined amount of the capitalized leased asset and interest on the lease obligation over the term of the lease and, thus, provides reasonable assurance of the existence of an asset (refer to paragraph .119). Accordingly, regulated enterprises would classify leases in accordance with Section L10. [FAS71, ¶41]

.147 The nature of the expense elements related to a capitalized lease (amortization of the leased asset and interest on the lease obligation) is not changed by the regulator's action; however, the timing of expense recognition related to the lease would be modified to conform to the rate treatment. Thus, amortization of the leased asset would be modified so that the total of interest on the lease obligation and amortization of the leased asset would equal the rental expense that was allowed for rate-making purposes. [FAS71, ¶42]

.148 [It is noted] that generally accepted accounting principles do not require interest expense or amortization of leased assets to be classified as separate items in an income statement. For example, the amounts of amortization of capitalized leased nuclear fuel and interest on the related lease obligation could be combined with other costs and displayed as "fuel cost." However, the disclosure of total interest cost incurred, required by Section I67, would include the interest on that lease obligation; and the disclosure of the total amortization charge, required by Section L10, would include amortization of that leased asset. [FAS71, ¶43]

### Revenue Collected Subject to Refund

.149 In some cases, a regulated enterprise is permitted to bill requested rate increases before the regulator has ruled on the request. [FAS71, ¶44]

.150 When the revenue is originally recorded, the criteria in Section C59, paragraph .105 would determine whether a provision for estimated refunds shall be accrued as a loss contingency. That provision would be adjusted subsequently if the estimate of the refund changes (refer to paragraph .121(a)).[18] [FAS71,¶45]

### Refunds to Customers

.151 Section A35, "Adjustments of Financial Statements for Prior Periods," limits prior period adjustments (other than those that result from reporting accounting changes) to corrections of errors and adjustments related to prior interim periods of the current fiscal year. [FAS71, ¶46]

.152 In accordance with Section A35, estimated refunds that were not previously accrued would be charged to income in the first period in which they meet the criteria for accrual (Section C59, paragraph .105). If the amounts are material, the disclosures specified in paragraph .130 of this section would be furnished. [FAS71, ¶47]

### Accounting for Compensated Absences

.153 Section C44, "Compensation to Employees: Paid Absences," specifies criteria for accrual of a liability for employees' compensation for future absences. For rate-making purposes, compensation for employees' absences may be included in allowable costs when the compensation is paid. [FAS71, ¶48]

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[18]Revenue collected subject to refund is similar to sales with warranty obligations. Section C59, paragraph .131 states that "inability to make a reasonable estimate of the amount of a warranty obligation at the time of sale because of significant uncertainty about possible claims . . . precludes accrual and, if the range of possible loss is wide, may raise a question about whether a sale should be recorded. . . ." Similarly, if the range of possible refund is wide and the amount of the refund cannot be reasonably estimated, there may be a question about whether it would be misleading to recognize the provisional revenue increase as income. [FAS71, ¶45, fn16]

.154 The liability, if any, would be accrued in accordance with Section C44 because rate actions of the regulator cannot eliminate obligations that were not imposed by the regulator (refer to paragraph .122). By including the accrued compensation in future allowable costs on an as-paid basis, the regulator provides reasonable assurance of the existence of an asset. The asset is the probable future benefit (increased revenue) that will result from the regulatory treatment of the subsequent payment of the liability (refer to paragraph .119). Accordingly, the enterprise also would record the asset that results from the regulator's actions. [FAS71, ¶49]

### Pension Costs and Postretirement Benefits Other Than Pensions

.155 [This section requires that] the difference [(a)] between net periodic pension cost as defined in Section P16, "Pension Costs," and amounts of pension cost considered for rate-making purposes [FAS87, ¶210] [or (b)] between net periodic postretirement benefit cost as defined in Section P40, "Postretirement Benefits Other Than Pensions," and amounts of postretirement benefit cost considered for rate-making purposes be recognized as an asset or a liability created by the actions of the regulator. [FAS106, ¶364] Those actions of the regulator change the timing of recognition of net pension cost [FAS87, ¶210] [and] of net periodic postretirement benefit cost [FAS106, ¶364] as an expense; they do not otherwise affect the requirements of Section P16 [FAS87, ¶210] [or] of Section P40. [FAS106, ¶364]

## Examples of Application of Certain Specific Standards to Specific Situations

.155A Paragraphs .157 through .203 provide guidance for application of paragraphs .125A through .125E and .127A through .127E to some specific situations. The guidance does not address all possible applications of those paragraphs. All the examples assume that the enterprise meets the criteria in paragraph .115. Cases similar to those illustrated in this section may involve income tax effects that could accrue to the utility in question. [FAS90, ¶14] [In] Section I27, the tax effects of temporary differences are measured based on enacted tax laws and rates and are recognized based on specified criteria. [FAS109, ¶288(x)] For simplicity, the examples base the income tax effects on a 34 percent tax rate and assume that those effects may be recognized. [FAS90, ¶14]

.156 Specific situations discussed in paragraphs .167 through .203 and .508 through .521 are:



[FAS92, ¶20]

### Accounting for an Abandonment

.157-.166 [Deleted 12/87 because of FASB Technical Bulletin 87-2, *Computation of a Loss on an Abandonment*. (Refer to paragraphs .501 through .521 for guidance on accounting for a loss on an abandonment.)]

### Accounting for a Disallowance of Plant Cost

.167 Assume that Utility B operates in two state jurisdictions. After an extensive "prudence investigation," the regulator in one of those state jurisdictions disallows $865 million of the $3.6 billion total cost of Utility B's recently completed nuclear generating plant. That state jurisdiction represents approximately 50 percent of Utility B's operations, and approximately 50 percent of the output of the recently completed plant is expected to be used in that state. The tax basis of the plant is $2.4 billion. The regulator indicates that the tax benefit from a ratable portion of depreciation will be given to the shareholders as a result of the disallowance. After consultation with counsel, Utility B decides that it should not appeal the regulator's disallowance. The regulator in Utility B's other state jurisdiction has not participated in the "prudence investigation," and there is no indication that a similar disallowance is likely in that jurisdiction. [FAS90, ¶26]

.168 Utility B should recognize the effective disallowance as a loss. Because only 50 percent of the plant's cost will be recoverable from customers in the state, the effective disallowance is 50 percent of the amount disallowed, or $432.5 million. The disallowance should be recognized when the disallowance is probable and the amount of the disallowance can be reasonably estimated, and those conditions are met in this case. The tax benefit of the loss will be realized as future depreciation is taken for income tax purposes. Since the tax benefit of the plant is based on $2.4 billion and the cost of the plant prior to the disallowance is $3.6 billion, only two-thirds of the loss is available for tax benefit. A deferred tax benefit, based on two-thirds of the loss, can be recognized when the loss is recognized providing that benefit meets the criteria of [FAS90, ¶27] Section I27 [FAS109, ¶287] for recognition. [FAS90, ¶27]

### Accounting for a Disallowance of Plant Cost Resulting from a "Cost Cap"

.169 Assume that Utility C, which operates solely in one state jurisdiction, is constructing a new electric generating plant. Completion is expected to take approximately one year. The cost of the plant, which was originally expected to be $1.25 billion, is now estimated to be as follows:

| | |
|---|---|
| Costs capitalized to date | $2,700,000,000 |
| AFUDC on above for 1 year at 11.25% | 303,750,000 |
| Remaining labor, materials, etc., to complete, expected to be spent ratably over the year | 469,822,500 |
| AFUDC on above for ½ year at 11.25% | 26,427,500 |
| Total estimated cost at completion | $3,500,000,000 |

Various parties have charged that certain cost increases were a result of imprudent management of the construction. [FAS90, ¶28]

.170 To avoid the cost and time delay that would be involved in a full-scale "prudence investigation" of the construction of the plant, Utility C and its regulator agree that the total cost of the plant that will be allowable in determining depreciation and that will be allowed in Utility C's rate base will be $3.4 billion. If the eventual cost of the plant exceeds that "cap," a ratable portion of the tax benefit of depreciation will accrue to the benefit of the shareholders. For tax purposes, the plant is expected to have a net depreciable basis of $2.0 billion. [FAS90, ¶29]

.171 The loss that results from the disallowance inherent in the "cost cap" would be computed as follows:

| | |
|---|---|
| Total estimated cost at completion | $3,500,000,000 |
| Maximum allowable cost | 3,400,000,000 |
| Difference | $ 100,000,000 |
| Loss to be recognized (present value of difference at 11.25% AFUDC rate, based on 1 year to complete) | $ 89,887,600 |
| Deferred tax benefit of loss (2.0/3.5 × $100,000,000 × 34%) | 19,428,600 |
| Net loss to be recognized when "cost cap" is agreed to | $ 70,459,000 |

After the loss is recognized, AFUDC would continue to be recorded based on the remaining recorded costs. Subsequently, if additional increases in the cost of the plant become probable and those costs are not allowable under the agreed "cost cap," those increases would also be recognized as losses from disallowances when they become probable. [FAS90, ¶30]

.172 If the regulator ordered a "cost cap" that Utility C did *not* agree to, Utility C would have to assess whether the criteria of Section C59 for loss recognition are met. If those criteria are met, the accounting would be as indicated above. Otherwise, no loss would be recognized until that loss was probable and could be reasonably estimated. Because of the possible disallowance inherent in the "cost cap," it may no longer be probable that some amount of AFUDC will be included in allowable costs in the future, and that amount may be reasonably estimable. In that case, that amount of AFUDC would not be capitalized. [FAS90, ¶31]

**Accounting for an Explicit, but Indirect, Disallowance**

.173 Assume that Utility D operates solely in a single-state jurisdiction. On January 1, 19X1, Utility D's new electric generating plant becomes operational. The cost of that plant is $1 billion. [FAS90, ¶32]

.174 Utility D's regulator concludes that part of the cost of the recently completed plant was imprudently incurred. However, rather than disallow the specific costs that were imprudent, the regulator instead excludes 10 percent ($100 million) of the plant from the rate base, thereby providing no return on investment on that portion of the plant. The regulator does not intend any part of the tax benefit of depreciation to accrue to the benefit of Utility D's shareholders. The regulator indicates that the exclusion of 10 percent of the plant's cost from the rate base is intended to be permanent. The utility concludes that it will not appeal the disallowance after considering the likely outcome of an appeal. [FAS90, ¶33]

.175 Utility D should record the indirect disallowance as a loss and should estimate the amount of that loss using the best available information. If the regulator specifies the amount of cost that was imprudent, that amount may be the best estimate of the loss. Otherwise, Utility D would have to estimate the future cash flows that have been disallowed as a result of the order and determine the effective disallowance by computing the present value of those disallowed future cash flows. Since both the disallowed future cash flows and the appropriate discount rate to compute the present value would be estimates, those estimates should be calculated on a consistent basis. Accordingly, if the future cash flows are estimated based on the current weighted-average overall cost of Utility D's capital, that weighted-average overall cost of capital should also be used as the discount rate. The loss has no tax benefit to Utility D. [FAS90, ¶34]

### Accounting for an "Excess Capacity" Disallowance

.176 "Excess capacity" disallowances relate to part of the cost of service of a recently completed plant and are based on a finding that the utility's reserve capacity exceeds an amount deemed to be reasonable. If an "excess capacity" disallowance is ordered by a regulator *without* a specific finding that the enterprise should not have constructed that capacity or should have delayed the construction of that capacity, the rate order raises questions about whether the enterprise meets the criteria in paragraph .115 in that it is not being regulated based on its own cost of service. However, because such a rate order itself is neither a direct disallowance nor an explicit, but indirect, disallowance of part of the cost of the plant, this section does not specify the accounting for it. If an "excess capacity" disallowance is ordered by a regulator *with* a specific finding that the enterprise should not have constructed that capacity or should have delayed the construction of that capacity, the rate order may be an explicit, but indirect, disallowance of part of the cost of the plant, and the enterprise should account for the substance of that order as set forth in paragraph .127E of this section. [FAS90, ¶60]

### Accounting for Value-Based Ratemaking

.177 If a regulator has included a recently completed plant in rates based on the assumed cost of another plant rather than based on the cost of the plant that exists, then the enterprise is not being regulated based on its own cost, and the criteria in paragraph .115 do not appear to be met. If the rate order is based on a finding that, based on factors that were known during the construction, the utility should not have constructed the plant that it did construct, the order may be an explicit, but indirect, disallowance, and it should be accounted for as set forth in paragraph .127E of this section. Otherwise, unless the order is being appealed, the enterprise should consider discontinuing application of section. [FAS90, ¶61]

### Accounting for a Hidden, Indirect Disallowance

.178 Regulators have considerable discretion in selecting a rate that represents a fair return on equity investment, and specific matters included in a settlement agreement might not be apparent. Explicit, but indirect, disallowances [shall] be reported as disallowances; however, an enterprise [is not required to] determine whether the terms of a settlement agreement or rate order contained a hidden, indirect disallowance. [FAS90, ¶62]

### Accounting for a Phase-in Plan That Includes an Indirect Disallowance

.179 Utility E is an electric utility that operates solely in a single-state jurisdiction. On January 1, 19X1, Utility E's new electric generating plant becomes operational. The cost of that plant is $1 billion. [FAS92, ¶21]

.180 Utility E's regulator orders that the costs of the newly completed plant be phased in over a three-year period, as follows:

19X1—A portion of the return (interest and an allowance for earnings on shareholders' investment) on unrecovered investment is deferred by excluding 25 percent of the cost of the plant from the rate base.

19X2—All of the remaining cost of the plant is to be included in the rate base with no recovery of previously deferred amounts.

19X3—All of the remaining cost of the plant is to be included in the rate base. Also, additional revenue is to be provided equal to the return on unrecovered investment excluded from rates in year 1.

The order does not provide for recovery in any year of a return on Utility E's investment in the deferred amounts. Utility E's weighted-average cost of capital in its latest rate case was 11 percent. [FAS92, ¶22]

.181 The phase-in plan is partially a disallowance of plant costs because no return on investment is provided for the deferred amounts. That disallowance should be recognized in accordance with paragraph .127E when it became probable. The amount of equivalent cost disallowed should be determined as shown in Exhibit 181A. The recorded cost of the plant should be reduced by that amount, and a corresponding loss should be reported in 19X1. [FAS92, ¶23]

**Exhibit 181A**

**Utility E**
**Determination of Effective Disallowance Return on Investment Disallowed for Amounts Deferred under Phase-in Plan**
(in thousands)

| Month | (1) Cost Deferral (Recovery) | (2) Cumulative Amount Deferred | (3) R.O.I. on Cumulative Deferral | (4) Effective Disallowance |
|---|---|---|---|---|
| 1 | $ 2,292 | $ 2,292 | $ 21 | $ 0 |
| 2 | 2,291 | 4,583 | 42 | 21 |
| 3 | 2,292 | 6,875 | 63 | 41 |
| 4 | 2,292 | 9,167 | 84 | 61 |
| 5 | 2,291 | 11,458 | 105 | 80 |
| 6 | 2,292 | 13,750 | 126 | 99 |
| 7 | 2,292 | 16,042 | 147 | 118 |
| 8 | 2,291 | 18,333 | 168 | 137 |
| 9 | 2,292 | 20,625 | 189 | 155 |
| 10 | 2,292 | 22,917 | 210 | 173 |
| 11 | 2,291 | 25,208 | 231 | 190 |
| 12 | 2,292 | 27,500 | 252 | 207 |
| 13 | 0 | 27,500 | 252 | 224 |
| 14 | 0 | 27,500 | 252 | 222 |
| 15 | 0 | 27,500 | 252 | 220 |
| 16 | 0 | 27,500 | 252 | 218 |
| 17 | 0 | 27,500 | 252 | 216 |
| 18 | 0 | 27,500 | 252 | 214 |
| 19 | 0 | 27,500 | 252 | 212 |
| 20 | 0 | 27,500 | 252 | 210 |
| 21 | 0 | 27,500 | 252 | 208 |
| 22 | 0 | 27,500 | 252 | 206 |
| 23 | 0 | 27,500 | 252 | 204 |
| 24 | 0 | 27,500 | 252 | 202 |
| 25 | (2,292) | 25,208 | 231 | 201 |
| 26 | (2,291) | 22,917 | 210 | 182 |
| 27 | (2,292) | 20,625 | 189 | 164 |
| 28 | (2,292) | 18,333 | 168 | 146 |
| 29 | (2,291) | 16,042 | 147 | 129 |
| 30 | (2,292) | 13,750 | 126 | 112 |
| 31 | (2,292) | 11,458 | 105 | 95 |
| 32 | (2,291) | 9,167 | 84 | 78 |
| 33 | (2,292) | 6,875 | 63 | 62 |
| 34 | (2,292) | 4,583 | 42 | 46 |
| 35 | (2,291) | 2,292 | 21 | 31 |
| 36 | (2,292) | 0 | 0 | 15 |
| Total loss to be recognized in 19X1 | | | | $5,099 |

Computations:
Column (1)—Cost of plant ($1 billion) × .25 × 11% ÷ 12
Column (2)—Column (2) for prior month + Column (1) for current month
Column (3)—Column (2) × 11% ÷ 12
Column (4)—Present value (at beginning of month 1) at 11% (.9167 per month) of amount in Column (3) for prior month

.182 The disallowance will reduce revenues only in years 1 through 3, so the depreciation charge that would otherwise be recognized for that plant in years 1 through 3 should be reduced by the amount of the effective disallowance attributable to those years (the amount in column 4 of Exhibit 181A). Amounts deferred under the plan (the amount for months 1-12 in column 1 of Exhibit 181A) should be capitalized as a separate asset, and that asset should be amortized as recovery occurs (in months 25-36), using the amounts in column 1 of Exhibit 181A. [FAS92, ¶24]

### Applications of the Definition of a Phase-in Plan

#### *"Mirror CWIP"*

.183 "Mirror CWIP" is one means of moderating the sudden, one-time increase in rates that would otherwise result from placing a newly completed utility plant in service. Under "mirror CWIP," increasing amounts of construction work in progress (CWIP) are included in the current rate base in the periods before the plant goes into service, providing the utility with a current return on a portion of its investment in construction while the construction proceeds. After the plant is placed in service, a decreasing amount of plant-in-service is excluded from the rate base each year, "mirroring" the pattern in which the construction was included in the rate base. The result of this procedure is to increase rates while the plant is under construction and to reduce the increase in rates in the initial years of the plant's service life. [FAS92, ¶25]

.184 For rate-making purposes, no allowance for funds used during construction is recognized on the portion of the construction that is included in the rate base while the asset is under construction, and an allowance for funds used during construction is recognized on the portion of the plant-in-service that is subsequently excluded from the rate base after the plant is placed in service. The same total amount is capitalized as if no construction had been included in the current rate base. Is "mirror CWIP" a phase-in plan under the definition in this section? What financial reporting is appropriate for a "mirror CWIP" plan? [FAS92, ¶26]

.185 The "mirror CWIP" arrangement described above is not a phase-in plan under the definition used in this section because it does not defer recovery of costs that would not have been deferred under the methods of rate making used prior to 1982. Rather, it effectively provides a temporary loan from customers to the utility during construction and requires repayment of that loan after the plant is placed in service. [FAS92, ¶27]

.186 If the arrangement is known to be a "mirror CWIP" arrangement at the time of the construction (for example, if that arrangement is required by law or has been specifically ordered by the regulator), an allowance for funds used during construction should be accrued on the total cumulative construction cost in each period for financial reporting.

The revenue collected as a result of inclusion of construction in the current rate base should be recorded as a liability to customers, with disclosure of the approximate timing of the repayment that will be required under the "mirror CWIP" arrangement. [FAS92, ¶28]

.187 If the arrangement is not known to be a "mirror CWIP" arrangement when the construction is included in the rate base but the regulator later orders a "mirror CWIP" arrangement, the accounting described in paragraph .186 should be implemented as soon as the nature of the arrangement becomes known. That will require an adjustment for the cumulative effect of the arrangement to date. An amount should be capitalized, with a corresponding accrual of an allowance for funds used during construction, when the "mirror CWIP" arrangement becomes known. Current revenues should be reduced by an equal amount, and a corresponding liability to customers should be recognized. That amount should be the amount that would have been capitalized if the arrangement had been known to be a "mirror CWIP" arrangement when the revenue was collected during construction. That capitalized amount should be reported in the year in which the "mirror CWIP" arrangement becomes known in the same manner as if it had been capitalized during construction. [FAS92, ¶29]

### *Sale with Leaseback—Capital Lease*

.188 Utility F sells its interest in a newly completed electric generating plant for an amount equal to its cost and leases that interest back under a lease that requires equal annual payments. The sale meets the criteria of [Section L10, paragraph .130C, and] Section R10, "Real Estate," for recognition as a sale, and the leaseback meets the criteria of Section L10 for a capital lease. Utility F's regulator includes the lease rentals in allowable cost as they accrue. In the past, Utility F's regulator has treated other leases entered into by Utility F in the same manner, but those leases were for much less significant items of equipment—not for an interest in an electric generating plant. Is this rate-making method a phase-in plan under the definition in this section? [FAS92, ¶30]

.189 The rate-making method described is a phase-in plan under the definition in this section. Generally accepted accounting principles applicable to enterprises in general require a capital lease to be accounted for much like a purchase of the leased property. The resulting expense related to the lease consists of interest on the remaining lease obligation and depreciation based on the method used for similar owned property. In the early years of a lease, the lease rentals included in allowable cost as they accrue are significantly less than the sum of interest on the lease obligation and depreciation on the leased asset. Thus, significant deferrals will result. The method also defers recognition of expenses compared with the methods of expense recognition used by Utility F's regulator for similar assets of Utility F prior to 1982 because Utility F's interests in electric generating plants were included in allowable costs in the past based on current provisions for depreciation and for the cost of capital invested in the plants. The use of this rate-making method in the past for leases of equipment does not change this conclusion. The definition is based on the method of rate making used prior to 1982 for similar allowable costs. Similar allowable costs would be those resulting from electric generating plants. [FAS92, ¶31]

#### *Sale with Leaseback—Operating Lease*

.190 Utility G sells its interest in a newly completed electric generating plant for an amount equal to its cost and leases that interest back under a lease that requires equal annual payments. The sale meets the criteria of [Section L10, paragraph .130C, and] Section R10 for recognition as a sale, and the leaseback meets the criteria of Section L10 for an operating lease. Utility G's regulator includes the lease rentals in allowable cost as they accrue. In the past, Utility G's regulator has treated other leases entered into by Utility G in the same manner, but those leases were not for an interest in an electric generating plant. Is this rate-making method a phase-in plan under the definition in this section? [FAS92, ¶32]

.191 The rate-making method applied to Utility G is not a phase-in plan under the definition in this section because it recognizes rent expense for rate-making purposes in the same way as that expense would be recognized for enterprises in general for this type of lease. [FAS92, ¶33]

#### *Sale with Leaseback—Profit Recognition Accelerated*

.192 Utility H sells its interest in a 5-year-old electric generating plant for an amount that exceeds its undepreciated cost by $500,000 and leases that interest back. The leaseback term is 20 years, and there are no renewal options. The sale meets the criteria of [Section L10, paragraph .130C, and] Section R10 for recognition as a sale with full profit recognition, and the leaseback meets the criteria of Section L10 for an operating lease. Utility H's regulator includes the lease rentals in allowable cost as they accrue and orders Utility H to amortize the profit, for rate-making purposes, over 10 years. The sale occurred at a time when Utility H was about to place a newly completed plant in service. Utility H has not had any similar transactions in the past. Is this rate-making method a phase-in plan under the definition in this section? [FAS92, ¶34]

.193 The rate-making method described is a phase-in plan under the definition in this section. Generally accepted accounting principles applicable to enterprises in general require a profit on a sale-leaseback transaction to be amortized over the term of the leaseback. Amortization of that profit, for rate-making purposes, over 10 years when generally accepted accounting principles applicable to enterprises in general require amortization over the 20-year leaseback term is equivalent to a deferral of allowable costs. In view of the timing of the rate order on the sale-leaseback transaction, the presumption is that the order was issued in connection with the newly completed plant. The method cannot be compared with methods in use prior to 1982 because Utility H has had no previous transactions of this type. [FAS92, ¶35]

### *Modified Depreciation Method*

.194 Utility I's regulator orders it to depreciate its new electric generating plant, for rate-making purposes, by using an annuity method. Under the method ordered, depreciation increases each year so that the total of depreciation and return on investment stays approximately level over the life of the plant. In the past, Utility I's regulator required the use of straight-line depreciation for electric generating plants. Is this rate-making method a phase-in plan under the definition in this section? [FAS92, ¶36]

.195 The rate-making method applied to Utility I is a phase-in plan under the definition in this section because (a) it defers depreciation expense compared with the depreciation methods that are acceptable under generally accepted accounting principles applicable to enterprises in general (annuity methods of depreciation are not acceptable under generally accepted accounting principles applicable to enterprises in general) and (b) it defers depreciation expense compared with the method of depreciation used by Utility I's regulator for Utility I's electric generating plants prior to 1982. [FAS92, ¶37]

### *Deferral of Costs Before a Rate Order Is Issued*

.196 Utility J completes construction of a nuclear generating plant and places that plant in service. Utility J's regulator decides that it will complete its examination of the prudence of Utility J's construction cost before rates are adjusted to reflect the cost of operating the plant. During the examination and until rates are adjusted, the regulator orders Utility J to capitalize its net cost of operating the plant (operating costs, depreciation, allocable interest cost, and an allowance for earnings on shareholders' investment, all net of savings that result from operation of the new plant). Is the resulting deferral for rate-making purposes a phase-in plan? What accounting is required for financial reporting? [FAS92, ¶38]

.197 The resulting deferral is not a phase-in plan. The regulator's order to capitalize an amount pending completion of a rate hearing is designed to protect the utility from the effects of regulatory lag in the absence of a rate order—a routine procedure on the part of regulators. The definition of a phase-in plan in this section is not intended to encompass actions of a regulator that are designed to protect a utility from the effects of regulatory lag in the absence of a rate order, nor is it intended to encompass the regulator's subsequent treatment of any allowable costs that result from those actions. [FAS92, ¶39]

.198 Under paragraph .119, Utility J should capitalize that portion of the amount capitalized for rate-making purposes that represents incurred costs that would otherwise be charged to expense, provided that it is probable that future revenue in an amount at least equal to the capitalized cost will result from inclusion of those costs in allowable costs for rate-making purposes. Otherwise, Utility J should not capitalize those costs. [FAS92, ¶40]

.199 Since the situation in this example is neither during construction nor a phase-in plan, paragraph .125G does not permit capitalization of an allowance for earnings on shareholders' investment. Accordingly, Utility J should not capitalize, for financial reporting, the portion of the amount capitalized for rate-making purposes that represents an allowance for earnings on shareholders' investment. If recovery of that allowance subsequently occurs, increased earnings during the recovery period will result. [FAS92, ¶41]

### Interaction of Disallowance with Deferral of Costs Before a Rate Order Is Issued

.200 Six months after the accounting order referred to in the previous example, Utility J's regulator approves part of the cost of the new plant but disallows $600,000,000—consisting of construction expenditures of $570,000,000 and amounts capitalized for rate-making purposes during this 6-month operating period prior to the rate order of $30,000,000. The recorded cost of the plant before consideration of the disallowance is $4,500,000,000. During this 6-month period, Utility J has capitalized $500,000,000 of net cost for rate-making purposes. This $500,000,000 consists of an allowance for earnings on shareholders' investment of $200,000,000 and incurred costs that would otherwise be charged to expense of $300,000,000. For rate-making purposes, the balance sheet accounts, before and after the disallowance, are as follows:

| | Balance before Disallowance | Disallowance (in thousands) | Balance after Disallowance |
|---|---|---|---|
| Plant in Service | $4,500,000 | $(570,000) | $3,930,000 |
| Amounts Capitalized Pending Rate Order | 500,000 | (30,000) | 470,000 |
| Combined totals | $5,000,000 | $(600,000) | $4,400,000 |

For financial reporting, how should the disallowance be recognized? [FAS92, ¶42]

.201 Paragraph .127E requires a disallowance of plant costs to be recognized as a loss. Utility J should perform the following analysis to determine the loss that should be recognized and how it will be allocated:

a. Assuming that $300,000,000 of the $500,000,000 capitalized for rate-making purposes during the 6-month period was also capitalized for financial reporting (the $200,000,000 allowance for earnings on shareholders' investment would not be capitalized), the total loss recognized by Utility J for financial reporting should be the amount that reduces the combined total of Plant in Service and Amounts Capitalized Pending Rate Order ($4,800,000,000) to the combined total that will be honored for rate-making purposes ($4,400,000,000). The recognizable loss is $400,000,000.
b. Utility J should allocate to Plant in Service the lesser of the amount of the disallowance that was allocated to Plant in Service by the regulator ($570,000,000) or the total disallowance recognized for financial reporting ($400,000,000), or $400,000,000.
c. Utility J should allocate the rest of the disallowance recognized for financial reporting, if any, to Amounts Capitalized Pending Rate Order. In this case, no amount is allocated to that asset.

The recognition of the disallowance and the effect of that recognition on the financial reporting balance sheet accounts are as follows:

| | Balance before Disallowance | Recognition of Disallowance (in thousands) | Balance after Disallowance |
|---|---|---|---|
| Plant in Service | $4,500,000 | $(400,000) | $4,100,000 |
| Amounts Capitalized Pending Rate Order | 300,000 | | 300,000 |
| Combined totals | $4,800,000 | $(400,000) | $4,400,000 |

[FAS92, ¶43]

#### Interaction of Deferral of Costs Before a Rate Order Is Issued with a Subsequent Phase-in Plan

.202 Utility K's fact situation is identical to that of Utility J, described in the above examples, except that Utility K's regulator approves all of the costs related to the newly completed plant. Utility K's regulator adopts a formal phase-in plan intended to provide recovery of amounts deferred under the plan and amounts capitalized, for rate-making purposes, during the six-month period from the plant's in-service date to the date of the rate order. How does the phase-in plan affect the financial reporting of the costs deferred during the six-month period? [FAS92, ¶44]

.203 The phase-in plan does not affect the financial reporting of those previously deferred costs described in paragraphs .198 and .199, nor does the existence of those previously deferred costs affect the financial reporting of the phase-in plan. Accordingly, the allowance for earnings on shareholders' investment that was not capitalized previously during the period preceding issuance of the rate order may not be capitalized upon adoption of the phase-in plan. [FAS92, ¶45]

## Accounting and Reporting When the Criteria in Paragraph .115 Are No Longer Met

.204 When an enterprise determines that its operations in a regulatory jurisdiction no longer meet the criteria [in paragraph .115] for application of the specialized accounting in this section, except for paragraphs .204 through .216, that enterprise shall discontinue application of that accounting to its operations in that jurisdiction. If a separable portion[19] of the enterprise's operations within a regulatory jurisdiction ceases to meet the criteria in paragraph .115, application of the specialized accounting as described above to that separable portion shall be discontinued. That situation creates a presumption that application of that specialized accounting shall be discontinued for all of the enterprise's operations within that regulatory jurisdiction. That presumption can be overcome by establishing that the enterprise's other operations within that jurisdiction continue to meet the criteria for application of that specialized accounting. [FAS101, ¶5]

### Accounting to Reflect the Discontinuation of Accounting for the Effects of Certain Types of Regulation

.205 When an enterprise discontinues application of the specialized accounting in this section to all or part of its operations, that enterprise shall eliminate from its statement of financial position prepared for general-purpose external financial reporting the effects of any actions of regulators that had been recognized as assets and liabilities pursuant to that specialized accounting but would not have been recognized as assets and liabilities by enterprises in general. However, the carrying amounts of plant, equipment, and

[19]The separable portion may be an enterprise's operations within a regulatory jurisdiction or a smaller portion (such as a customer class within a regulatory jurisdiction), either of which could require the allocation of system-wide assets and liabilities. [FAS101, ¶40]

inventory measured and reported pursuant to that specialized accounting[20] shall not be adjusted unless those assets are impaired, in which case the carrying amounts of those assets shall be reduced to reflect that impairment. Whether those assets have been impaired shall be judged in the same manner as for enterprises in general [FAS101, ¶6] and paragraphs .139 through .161 of Section I08 shall apply, except for the provisions for income statement reporting in paragraphs .160 and .161 of that section. [FAS144, ¶C33] The net effect of the adjustments required by this paragraph shall be included in income of the period in which the discontinuation occurs and shall be classified as an extraordinary item. [FAS101, ¶6] That classification shall be made without regard to the criteria in Section I17, "Income Statement Presentation: Extraordinary Items," paragraph .107. [FAS101, ¶10] [Refer to paragraph .1001 for an EITF Issue that provides interpretive guidance on paragraphs .205 and .206.]

.206 An enterprise that discontinues application of the specialized accounting in this section shall no longer recognize the effects of actions of a regulator as assets or liabilities unless the right to receive payment or the obligation to pay exists as a result of past events or transactions and regardless of future transactions. [FAS101, ¶7]

#### Disclosures

.207 For the period in which an enterprise reflects the discontinuation of application of the specialized accounting in this section for all or a separable portion of its operations, the enterprise shall disclose the reasons for the discontinuation and identify the portion of its operations to which the application of that accounting is being discontinued. [FAS101, ¶8]

.208 The disclosure requirements of Section I17 for extraordinary items apply to the net adjustment reported in the statement of operations as a result of applying paragraph .205. [FAS101, ¶9]

#### Examples of the Application of Paragraphs .204 through .208

.209 Paragraphs .210 through .216 provide examples of the application of paragraphs .204 through .208 to some specific situations. The examples do not address all possible applications of those paragraphs. [FAS101, ¶13]

---

[20]The carrying amounts of plant, equipment, and inventory for enterprises applying paragraphs .119 through .122 differ from those for enterprises in general only because of the allowance for funds used during construction, intercompany profit, and disallowances of costs of recently completed plants. If any other amounts that would not be includable in the carrying amounts of plant, equipment, or inventory by enterprises in general (such as postconstruction operating costs capitalized pursuant to paragraph .119) are included in or netted against the carrying amounts of plant, equipment, or inventory, those amounts shall be accounted for as this paragraph prescribes for the effects of actions of a regulator. [FAS101, ¶6, fn1] Another example of the effect of actions of a regulator that would require adjustment is the cumulative difference, if any, between recorded depreciation and depreciation computed using a generally accepted method of depreciation. [FAS101, ¶42]

### *Assets Recorded Based Solely on Expected Future Revenue to Be Provided by the Regulator*

.210 Utility L operates solely in one regulatory jurisdiction. At December 31, 19X1, Utility L concludes, based on current market conditions, that it no longer meets the criteria in paragraph .115. Utility L's statement of financial position at December 31, 19X1 includes the following items:

a. Deferred purchased power costs (costs of power used for operations in prior periods that were expected to be recovered from customers as a result of an automatic adjustment clause)
b. Deferred costs of abandoned plant (costs for which recovery was being provided through rates)
c. Deferred costs of repairing storm damage.

How should those items be reported at December 31, 19X1? [FAS101, ¶14]

.211 All of those items should be eliminated from the enterprise's statement of financial position when it ceases to apply the specialized accounting in this section. The resulting charge to income, net of any related tax effects, should be reported as an extraordinary item in the period that includes December 31, 19X1. The enterprise should no longer defer those costs and report them as assets because they could not be reported as assets by enterprises in general. Enterprises in general would report a receivable for those items only if a right to receive payment exists as a result of past events or transactions and regardless of future transactions (such as future sales). [FAS101, ¶15]

.212 For example, a contract between a supplier and a customer for the sale of fuel oil may specify that next year's sales price will be adjusted based on the supplier's current-year cost of fuel oil. Even though it is probable that a future economic benefit (the ability to charge a higher price in the future) will result from the supplier's current-year cost of fuel oil, no asset exists at the end of the current year because the transactions (sales to the customer) that give the supplier control of the benefit are in the future. However, if the contract provides that the customer is obligated to pay additional amounts related to past purchases and regardless of future purchases, the supplier has an asset and it does not matter whether that payment is made in a single amount or when the customer will pay for next year's purchases. [FAS101, ¶16]

### *Liabilities Recorded Based Solely on Actions of the Regulator*

.213 Utility M operates in two regulatory jurisdictions, State 1 and State 2. Forty percent of Utility M's operations are located in State 1 and 60 percent in State 2; system-wide assets, liabilities, and certain gains and losses are allocated 40 percent to State 1 and 60 percent to State 2. At December 31, 19X2, Utility M concludes, based on current and expected future market conditions in State 1, that it no longer meets the criteria in paragraph .115 for its operations in State 1. No similar conditions exist in State 2, and actions of State 1's regulators are not expected to influence the decisions of regulators in State 2. Utility M's statement of financial position at December 31, 19X2 includes the following items:

| | |
|---|---|
| Deferred gain on restructuring debt, being amortized for rate-making purposes on an allocated basis by both states | $50,000 |
| Revenues collected subject to refund in prior years in State 1, expected to be refunded through future rates | $75,000 |

How should those items be reported at December 31, 19X2? [FAS101, ¶17]

.214 The portion of the deferred gain allocable to State 1 (determined in the example to be 40 percent of $50,000, or $20,000), net of any related tax effects, should be eliminated from the enterprise's statement of financial position when it ceases to apply the specialized accounting in this section to its operations in State 1. No adjustment should be made for the deferred gain applicable to State 2. The regulatory-created accrual for revenues subject to refund in State 1, net of any related tax effects, should be eliminated. Whether any liability related thereto exists should be determined under generally accepted accounting principles for enterprises in general. For example, amounts that were collected in the current or prior periods for which refunds will be made *regardless of future sales* should continue to be reported as liabilities after application of paragraphs .204 through .206. The credit to income resulting from the above adjustments, net of any related tax effects, should be reported as an extraordinary item in the period that includes December 31, 19X2. [FAS101,¶18]

### *Regulatory-Created Assets Resulting from the Recording of Deferred Income Taxes Not Recognized for Rate Making*

.215 Utility N operates solely in one regulatory jurisdiction. At June 30, 19X3, Utility N concludes, based on new legislation, that it no longer meets the criteria in paragraph .115. Utility N had applied [FAS101, ¶19] Section I27 [FAS109, ¶287] in 19X2 and because of applying the specialized accounting in this section had recorded a regulatory-created asset of $650,000 for deferred taxes resulting from temporary differences that had not been recognized in the rate-making process but that were expected to be recovered in the future. What reporting is required for that regulatory-created asset? [FAS101, ¶19]

.216 Utility N should eliminate that regulatory-created asset from its statement of financial position when the enterprise ceases to apply the specialized accounting in this section. The charge to income, net of any related tax effects, should be reported as an extraordinary item in the period that includes June 30, 19X3. [FAS101, ¶20]

## Glossary

.401 **Allowable costs.** All costs for which revenue is intended to provide recovery. Those costs can be actual or estimated. In that context, allowable costs include interest cost and [FAS71, ¶1, fn1] an allowance for earnings on shareholders' investment. [FAS92, ¶3, fn1]

.402 **Capitalize.** Capitalize is used to indicate that the cost would be recorded as the cost of an asset. Often referred to as "deferring a cost," and the resulting asset is sometimes described as a "deferred cost." [FAS71, ¶4, fn2]

.403 **Incurred cost.** A cost arising from cash paid out or obligation to pay for an acquired asset or service, a loss from any cause that has been sustained and has been or must be paid for. [FAS71, ¶9, fn5]

.404 **Intercompany profit.** Includes both profits on sales from one enterprise to another within a consolidated or affiliated group and profits on sales from one operation of an enterprise to another operation of the same enterprise. [FAS71, ¶16, fn10]

.404A **Phase-in plan.** [Refer to paragraph .125A.]

.405 **Probable.** Probable is an area within a range of the likelihood that a future event or events will occur. That range is from probable to remote, as follows:

*Probable.* The future event or events are likely to occur.
*Reasonably possible.* The chance of the future event or events occuring is more than remote but less than likely.
*Remote.* The chance of the future event or events occurring is slight.

[FAS90, ¶9(a)]

.406 **Regulatory lag.** The delay between a change in a regulated enterprise's costs and a change in rates ordered by a regulator as a result of that change in costs. A shortfall in a utility's net income can occur when regulators set rates prospectively and the estimated or test-period costs on which those rates were based are less than the actual costs that are incurred during the period covered by those rates. Regulators' actions that are designed to protect a utility from the effects of regulatory lag can occur during a rate case but before a rate order is issued and when no rate case is under active consideration. An accounting order to a utility to capitalize the cost of repairing storm damage would be an example of the latter situation. Those actions can also be a part of a rate order. An example of that type of action would be a fuel adjustment clause that is intended to protect the utility from the effects of unanticipated changes in fuel costs. [FAS92, ¶39, fn6]

## Supplemental Guidance

### Computation of a Loss on an Abandonment

.501 *Question*—When a loss on abandonment is recognized, how should the amount of deferred income taxes related to the remaining asset be determined? [FTB87-2, ¶5]

.502 *Response*—Under [FTB87-2, ¶14] Section I27 [FAS109, ¶287] the deferred income tax liabilities related to the remaining asset will be (a) the amount of income taxes that will be payable in future years, based on the enacted tax law for those years at the measurement date, as a result of the recovery of the recorded amount of that remaining asset and (b) any additional income taxes that will result from recovery of a separate asset recognized to reflect the future revenue that is expected to be provided in rates by the regulator when the income taxes described both in (a) and (b) of this paragraph become payable. [FTB87-2, ¶14]

.503 *Question*—How should a regulated enterprise that meets the criteria in paragraph .115[501] compute a loss on an abandonment, accrue a return on investment, and amortize the recorded asset when the regulator allows recovery of cost without return on investment? [FTB87-2, ¶15]

.504 *Background*—The rate-making process generally allows a return on a utility's net investment in property (the recorded investment reduced by allocable deferred income tax amounts). In that situation, the computation in the example in paragraphs .508 through .521 should result in pretax earnings of 14 percent (the assumed incremental borrowing rate) times the net investment. The present value of a net investment cannot be computed directly on a pretax basis because any write-off of the investment will also result in a write-off of an allocable amount of recorded deferred income taxes. [FTB87-2, ¶16]

.505 *Response*—Usually, the net loss on an abandonment should be computed by discounting the after-tax future revenues expected to be allowed by the regulator at an after-tax incremental borrowing rate and comparing the result to the recorded net investment in the abandoned plant. If that discounted present value is less than the recorded net investment, a net loss should be recognized. However, the present accounting model generally does not permit display of losses on a net-of-tax basis. As a result, the net loss on an abandonment is grossed up for display purposes. [FTB87-2, ¶17] Paragraphs .508 through .521 illustrate how those computations should be done under [FTB87-2, ¶18] Section I27. [FAS109, ¶287]

[501]The response to this question is based on both the guidance in this section and the nature of rate making in the regulatory process. Whether this approach would be appropriate in other circumstances is beyond the scope of this question. [FTB87-2, ¶15, fn5]

.506 The computation of a loss on an abandonment is intended to approximate the economic effects of the regulator's rate actions. The response in paragraph .505 and the example in paragraphs .508 through .521 is based on the following general assumptions about the rate-making methods used for income taxes:

a. Deferred income taxes are allocated to the assets that resulted in those deferred income taxes. Under that assumption, if certain assets are included in the rate base (that is, a return is allowed on those assets), the deferred income taxes allocated to those assets are deducted from the rate base in computing the investment on which a return will be allowed. Similarly, if certain assets are excluded from the rate base (that is, a return is not allowed on those assets), the deferred income taxes allocated to those assets are not deducted from the rate base in computing the investment on which a return will be allowed.[502]
b. Income taxes that result from recovery of the recorded cost of the abandoned plant will be treated as allowable costs when those income taxes become payable to the extent those income taxes do not represent repayment of an income tax benefit that has already accrued to the enterprise's shareholders.

[FTB87-2, ¶19]

.507 If the rate-making methods used for an enterprise differ from the assumptions stated in paragraph .506, the computation used to compute the loss on the abandonment should be different from that described in paragraph .505 and illustrated in paragraphs .508 through .521. The computation should be changed to reflect the different economics of those different rate-making methods. For example, if the regulator deducts *all* existing deferred income taxes from the rate base in determining the investment on which a return will be provided (instead of allocating deferred income taxes between items included in the rate base and items excluded from the rate base), the procedure effectively disallows a return on the gross investment in the abandoned plant instead of disallowing a return on the net investment, and the recognized loss should reflect a disallowance of a return on the gross investment in the abandoned plant. [FTB87-2, ¶20]

#### Example of the Computation of a Loss on an Abandonment

.508 The following paragraphs illustrate how a loss on an abandonment should be computed under this section by an enterprise. The example is based on specific rate actions

[502] In some jurisdictions, certain deferred income taxes are considered cost-free capital in computing the weighted-average cost of capital. That procedure has approximately the same effect as basing return on investment on the net investment. Accordingly, the example in paragraphs .508 through .521 would also be appropriate in those jurisdictions. [FTB87-2, ¶3, fn3]

related to the abandonment and on the other assumptions stated in the example. The computations may need to be changed to reflect the economic effects of different fact situations. [FTB87-2, ¶34]

.509 Upon initial application of [FTB87-2, ¶35] Section I27, [FAS109, ¶287] an enterprise that meets the criteria in paragraph .115 will adjust its deferred income tax liabilities as required by [FTB87-2, ¶35] Section I27. [FAS109, ¶287] The details of initial application are covered in that section. The following example is presented as though the enterprise has already applied [FTB87-2, ¶35] Section I27 [FAS109, ¶287] prior to the date of the abandonment. [FTB87-2, ¶35]

.510 If an enterprise initially applies [FTB87-2, ¶36] Section I27 [FAS109, ¶287] after a loss has been recognized on an abandonment and before the end of the recovery period for any recoverable costs, the amount of the previously recognized loss may change. Once [FTB87-2, ¶36] Section I27 [FAS109, ¶287] is initially applied, the accounting for the abandonment should follow the approach described in this example. [FTB87-2, ¶36]

.511 The principal assumptions on which the example is based are as follows:

a. Utility A decides to abandon a plant that has been under construction for some time. Although the possibility of abandoning the plant has been under consideration, abandonment was not considered probable before the actual decision was made.
b. Immediately before the abandonment, the recorded assets for the plant and related deferred income tax liabilities are as follows:

| | Assets | Deferred Income Tax Liabilities |
|---|---|---|
| Recorded plant and related deferred income tax liabilities | $750,500,000 | $ 85,170,000 |
| Asset representing revenue that will be provided for payment of income taxes and related deferred income tax liabilities | 76,015,152 | 25,845,152 |
| Total | $826,515,152 | $111,015,152 |

c. For income tax purposes, the abandoned plant has a basis of $500 million at the date of the abandonment.
d. Utility A will deduct the remaining tax basis of the abandoned plant ($500,000,000) as an abandonment loss on its income tax return in the year of the abandonment and will receive a tax benefit of 34 percent of the tax basis of the plant ($170,000,000). Utility A operates in a state that has no state income taxes. The federal income tax rate is 34 percent.

e. Accounting pretax income before the loss on the abandonment and taxable income before any deduction for the loss on the abandonment are both $1,500,000,000. Utility A has no other temporary differences or tax credits.
f. Utility A operates solely in a single-state jurisdiction.
g. In the past, Utility A's regulator has permitted recovery of amounts prudently invested in abandoned plants over an extended period of time without a return on unrecovered investment during the recovery period.
h. The normal practice of Utility A's regulator is to allocate deferred income taxes to assets on which return on investment is disallowed. Deferred taxes allocated to assets excluded from the rate base are not deducted from the rate base for purposes of computing allowable return on investment.
i. Utility A's regulator normally treats income taxes that were not previously provided as allowable costs if they result from recovery of other allowable costs.
j. Utility A's incremental borrowing rate at the date of the decision to abandon the plant is 14 percent, interest payable monthly.
k. Utility A believes that it is probable that recovery of cost without return on investment during the recovery period will be granted over a period that will not be less than 5 years nor more than 10 years, but it has no basis for estimating the exact time period that the regulator will select.
l. At the date of the abandonment, Utility A believes that it will take approximately 18 months to obtain a rate order covering the abandoned plant.
m. No disallowance of recorded cost is expected.
n. A rate order covering the abandoned plant is received in the 18th month following the abandonment. There is no disallowance of recorded costs of the abandoned plant. Those recorded costs are to be recovered over 60 months commencing in the 19th month after abandonment.

[FTB87-2, ¶37]

.512 Because the amount of deferred taxes related to the remaining investment is both (a) a component of the net investment on which return would be based in the regulatory process and (b) based on the amount of the accounting loss on the abandonment (which is based on the present value of the net investment), the present value of the net investment cannot be derived through a simple present value calculation using a pretax rate. That present value could be derived through a series of iterative calculations, starting with an assumed loss and the resulting deferred tax amounts, then computing the accrual of return on investment and amortization by applying the pretax rate to the resulting net investment, and then computing the income tax effects of the resulting pretax income. Using the remaining asset at the end of the recovery period, the estimate of the loss could be refined until the accrual of a return, amortization, recovery of recorded costs, and the related tax effects resulted in a zero net asset at the end of the recovery period. Alternatively, the net loss can be initially computed based on a present value calculation using an after-tax rate. While that approach is used in this example, either approach will provide the same result. The following paragraphs illustrate how that approach can be used and the resulting computations of loss recognition, return to be accrued, and amortization. [FTB87-2, ¶38]

.513 When the abandonment becomes probable (in this case, at the date of the decision to abandon), Utility A should remove the recorded cost of the plant from the construction work-in-process accounts. Any disallowance of the recorded cost that is probable and can be reasonably estimated should also be recorded as a loss. There is none in this example. Utility A should record a separate new asset, representing the future revenues expected to result from the regulator's treatment of the cost of the abandoned plant, at the present value of those expected future revenues. [FTB87-2, ¶39]

.514 The next step is to compute the deferred income tax liabilities that would be recorded if the tax consequences of the abandonment were recognized before any loss related to the disallowance of return on investment were recognized. When the tax basis of the abandoned plant is deducted as an abandonment loss on the current year's tax return, an additional $500,000,000 of the recorded cost of the asset will be without tax basis. Recovery of that additional amount will result in $500,000,000 of taxable income. The deferred income tax liability on that amount should be computed in accordance with [FTB87-2, ¶40] Section I27. [FAS109, ¶287] This example assumes that the rate is the statutory rate of 34 percent and that Utility A should recognize additional deferred income tax liabilities of $170,000,000. [FTB87-2, ¶40]

.515 The amount of tax benefit that resulted from the current deduction of the abandonment loss is also $170,000,000, so no additional asset representing revenue that will be provided for the payment of income taxes should be recognized. Thus, the recorded balance sheet items related to the plant after the abandonment, but before any loss for disallowance of return on investment is recognized, and the resulting net investment should be as follows:

| | **Assets** | **Deferred Income Tax Liabilities** |
|---|---|---|
| Recorded plant and related deferred income tax liabilities | $750,500,000 | $255,170,000 |
| Asset representing revenue that will be provided for payment of income taxes and related deferred income tax liabilities | 76,015,152 | 25,845,152 |
| Total | $826,515,152(1) | $281,015,152(2) |
| Net investment (1) – (2) | $545,500,000 | |

[FTB87-2, ¶41]

.516 If the computed additional deferred income tax liabilities did not equal the tax benefit that resulted from the abandonment loss, the difference should be recorded as an adjustment of the asset representing revenue that will be provided for the payment of income taxes. [FTB87-2, ¶42]

.517 The cash flows provided to recover the asset should be estimated to begin in 19 months. For purposes of computing the present value of the net investment, the probable future after-tax revenues should be estimated at $9,091,667 per month for 5 years (based on an assumed straight-line recovery of the net investment over the 5-year minimum period within the range—$545,500,000/60). The discount rate used should be 9.24 percent (14 percent net of tax at the rate computed in paragraph .514). The computation of the amount to be recorded for the new asset and of the loss resulting from the abandonment should be as follows:

| | |
|---|---|
| Present value of $9,091,667 per month at 9.24% for 60 months, starting at the end of the 19th month (amount of new asset net of related deferred income taxes) (components computed in paragraph .518) | $379,361,954 |
| Less net investment in abandoned plant (computed in paragraph .515) | 545,500,000 |
| Loss (net of related income taxes) to be recognized at time of decision to abandon the plant | $166,138,046 |

[FTB87-2, ¶43]

.518 The net loss should be allocated between the new asset resulting from the abandonment and the existing deferred taxes based on the relationship between the investment (100 percent), deferred taxes (34 percent, computed as $281,015,152/$826,515,152), and the net investment (66 percent). The computation should be as follows:

| | Gross Investment | Deferred Taxes | Net Investment |
|---|---|---|---|
| Balances before loss recognition | $ 826,515,152 | $281,015,152 | $ 545,500,000 |
| Loss to be recognized | (251,724,312)* | (85,586,266)† | (166,138,046) |
| Balances after loss recognition | $ 574,790,840 | $195,428,886 | $ 379,361,954 |

*Computed as $166,138,046/0.66.

†Computed as $251,724,312 × 34%.

[FTB87-2, ¶44]

.519 Pending receipt of a rate order, Utility A should accrue carrying charges on the net recorded asset at a monthly rate of 1/12 of 14 percent. Taxes should be provided on those accrued carrying charges based on the rate required to adjust the accumulated deferred income tax liabilities to the amounts required by [FTB87-2, ¶45] Section I27. [FAS109, ¶287] Usually, that rate will be the statutory rate. Exhibit 519A illustrates those computations based on the statutory rate. [FTB87-2, ¶45]

## Exhibit 519A

### Computation of Carrying Charges and Related Deferred Taxes

| | (1) | (2) | (3) | (4) | (5) | (6) |
|---|---|---|---|---|---|---|
| | Beginning of Month | | | | | |
| Mo. | Gross Investment | Deferred Charge | Related Deferred Taxes | Net Investment | Carrying Charges Accrued | Inc. Tax Liability Accrued |
| Comp. | * | | † | [(1) + (2) - (3)] | [14%/12 × (4)] | [34% × (5)] |
| 1 | $498,775,688 | $76,015,152 | $195,428,886 | $379,361,954 | $4,425,889 | $1,504,802 |
| 2 | 503,201,577 | 76,015,152 | 196,933,688 | 382,283,041 | 4,459,969 | 1,516,390 |
| 3 | 507,661,546 | 76,015,152 | 198,450,078 | 385,226,620 | 4,494,310 | 1,528,065 |
| 4 | 512,155,856 | 76,015,152 | 199,978,143 | 388,192,865 | 4,528,917 | 1,539,832 |
| 5 | 516,684,773 | 76,015,152 | 201,517,975 | 391,181,950 | 4,563,789 | 1,551,688 |
| 6 | 521,248,562 | 76,015,152 | 203,069,663 | 394,194,051 | 4,598,931 | 1,563,636 |
| 7 | 525,847,493 | 76,015,152 | 204,633,299 | 397,229,346 | 4,634,342 | 1,575,677 |
| 8 | 530,481,835 | 76,015,152 | 206,208,976 | 400,288,011 | 4,670,027 | 1,587,809 |
| 9 | 535,151,862 | 76,015,152 | 207,796,785 | 403,370,229 | 4,705,986 | 1,600,035 |
| 10 | 539,857,848 | 76,015,152 | 209,396,820 | 406,476,180 | 4,742,222 | 1,612,356 |
| 11 | 544,600,070 | 76,015,152 | 211,009,176 | 409,606,046 | 4,778,737 | 1,624,770 |
| 12 | 549,378,807 | 76,015,152 | 212,633,946 | 412,760,013 | 4,815,534 | 1,637,282 |
| 13 | 554,194,341 | 76,015,152 | 214,271,228 | 415,938,265 | 4,852,613 | 1,649,888 |
| 14 | 559,046,954 | 76,015,152 | 215,921,116 | 419,140,990 | 4,889,978 | 1,662,593 |
| 15 | 563,936,932 | 76,015,152 | 217,583,709 | 422,368,375 | 4,927,631 | 1,675,394 |
| 16 | 568,864,563 | 76,015,152 | 219,259,103 | 425,620,612 | 4,965,574 | 1,688,295 |
| 17 | 573,830,137 | 76,015,152 | 220,947,398 | 428,897,891 | 5,003,809 | 1,701,296 |
| 18 | 578,833,946 | 76,015,152 | 222,648,694 | 432,200,404 | 5,042,338 | 1,714,395 |
| 19 | 583,876,284 | 76,015,152 | 224,363,089 | 435,528,347 | | |

Computations:

*Prior month (1) + prior month (5).

†Prior month (3) + prior month (6).

[FTB87-2, ¶45]

.520 Based on the rate order (refer to paragraph .511(n)), revenues actually allowed will be $13,775,253 per month ($826,515,152/60). Earnings should continue to be recognized each month equal to 1/12 of 14 percent of the remaining net investment, and taxes should continue to be provided on those earnings at the rate required to adjust the recorded deferred income tax liabilities to the amount required by [FTB87-2, ¶46] Section I27. [FAS109, ¶287] Usually that rate would be the statutory rate. Exhibit 520A illustrates those computations using the 34 percent statutory rate. [FTB87-2, ¶46]

.521 In the event of a change in tax rates, the accumulated deferred income tax liabilities should be adjusted to the computed liability at the new rates. If the change in tax rates causes a reduction of the recorded deferred income tax liability, that reduction would usually result in a reduction of the recorded asset representing revenue that will be provided for payment of income taxes. If the change in tax rates causes an increase of the recorded deferred income tax liability, that increase would usually result in an increase of the recorded asset representing revenue that will be provided for payment of income taxes. However, the regulator's expected rate actions could change that result. [FTB87-2, ¶47]

Exhibit 520A

## Computation of Earnings on Investment and Related Income Taxes

| | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) |
|---|---|---|---|---|---|---|---|---|---|
| | Beginning of Month | | | | | | | | |
| Mo. | Gross Investment | Deferred Charge | Income Tax Liability | Net Investment | Return on Net Investment | Amortization of Gross Investment | Amortization of Deferred Charge | Income Tax Expense | Payment of Previously Recorded Income Tax Liability |
| Comp. | * | † | ‡ | [(1) + (2) − (3)] | [14%/12 × (4)] | § | | [34% × (5)] | ‖ |
| 19 | $583,876,284 | $76,015,152 | $224,363,089 | $435,528,347 | $5,081,164 | $7,427,169 | $1,266,919 | $1,727,596 | $2,955,990 |
| 20 | 576,449,115 | 74,748,233 | 221,407,099 | 429,790,249 | 5,014,219 | 7,494,114 | 1,266,919 | 1,704,835 | 2,978,751 |
| 21 | 568,955,001 | 73,481,314 | 218,428,348 | 424,007,967 | 4,946,759 | 7,561,574 | 1,266,919 | 1,681,898 | 3,001,688 |
| 22 | 561,393,427 | 72,214,395 | 215,426,660 | 418,181,162 | 4,878,780 | 7,629,553 | 1,266,920 | 1,658,786 | 3,024,801 |
| 23 | 553,763,874 | 70,947,475 | 212,401,859 | 412,309,490 | 4,810,277 | 7,698,056 | 1,266,919 | 1,635,494 | 3,048,092 |
| 24 | 546,065,818 | 69,680,556 | 209,353,767 | 406,392,607 | 4,741,247 | 7,767,086 | 1,266,919 | 1,612,024 | 3,071,561 |
| 25 | 538,298,732 | 68,413,637 | 206,282,206 | 400,430,163 | 4,671,685 | 7,836,648 | 1,266,919 | 1,588,373 | 3,095,213 |
| 26 | 530,462,084 | 67,146,718 | 203,186,993 | 394,421,809 | 4,601,587 | 7,906,746 | 1,266,919 | 1,564,540 | 3,119,046 |
| 27 | 522,555,338 | 65,879,799 | 200,067,947 | 388,367,190 | 4,530,951 | 7,977,382 | 1,266,920 | 1,540,524 | 3,143,063 |
| 28 | 514,577,956 | 64,612,879 | 196,924,884 | 382,265,951 | 4,459,769 | 8,048,564 | 1,266,919 | 1,516,322 | 3,167,264 |
| 29 | 506,529,392 | 63,345,960 | 193,757,620 | 376,117,732 | 4,388,040 | 8,120,293 | 1,266,919 | 1,491,934 | 3,191,652 |
| 30 | 498,409,099 | 62,079,041 | 190,565,968 | 369,922,172 | 4,315,758 | 8,192,575 | 1,266,919 | 1,467,358 | 3,216,228 |
| 31 | 490,216,524 | 60,812,122 | 187,349,740 | 363,678,906 | 4,242,920 | 8,265,413 | 1,266,919 | 1,442,593 | 3,240,993 |
| 32 | 481,951,111 | 59,545,203 | 184,108,747 | 357,387,567 | 4,169,521 | 8,338,812 | 1,266,920 | 1,417,638 | 3,265,949 |
| 33 | 473,612,299 | 58,278,283 | 180,842,798 | 351,047,784 | 4,095,558 | 8,412,775 | 1,266,919 | 1,392,490 | 3,291,096 |
| 34 | 465,199,524 | 57,011,364 | 177,551,702 | 344,659,186 | 4,021,023 | 8,487,310 | 1,266,919 | 1,367,148 | 3,316,438 |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| 35 | 456,712,214 | 55,744,445 | 174,235,264 | 338,221,395 | 3,945,916 | 8,562,417 | 1,266,919 | 1,341,612 | 3,341,975 |
| . | . | . | . | . | . | . | . | . | . |
| . | . | . | . | . | . | . | . | . | . |
| . | . | . | . | . | . | . | . | . | . |
| 73 | 72,867,498 | 7,601,515 | 27,359,464 | 53,109,549 | 619,612 | 11,888,721 | 1,266,919 | 210,669 | 4,472,917 |
| 74 | 60,978,777 | 6,334,596 | 22,886,547 | 44,426,826 | 518,312 | 11,990,021 | 1,266,919 | 176,226 | 4,507,360 |
| 75 | 48,988,756 | 5,067,677 | 18,379,187 | 35,677,246 | 416,234 | 12,092,099 | 1,266,919 | 141,520 | 4,542,066 |
| 76 | 36,896,657 | 3,800,758 | 13,837,121 | 26,860,294 | 313,370 | 12,194,963 | 1,266,919 | 106,546 | 4,577,039 |
| 77 | 24,701,694 | 2,533,839 | 9,260,082 | 17,975,451 | 209,714 | 12,298,619 | 1,266,920 | 71,304 | 4,612,284 |
| 78 | 12,403,075 | 1,266,919 | 4,647,798 | 9,022,196 | 105,258 | 12,403,075 | 1,266,919 | 35,788 | 4,647,798 |

Computations:

* Prior month (1) – prior month (6).

† Prior month (2) – prior month (7).

‡ Prior month (3) – prior month (9).

§ $13,775,253 – (5) – (7).

‖ $4,683,586 – (8).

[FTB87-2, ¶46]

## Supplemental Guidance: Emerging Issues Task Force (EITF) Issues

.1000 [Listed below are EITF Issues that provide supplemental guidance for this section. These Issues are grouped by subject matter and may be either interpretive of or related by topic to the guidance in this section.

### Regulatory Assets Related to Statement 106 Costs

EITF Issue No. 92-12, "Accounting for OPEB Costs by Rate-Regulated Enterprises"
EITF Issue No. 93-4, "Accounting for Regulatory Assets"

### Other

EITF Issue No. 88-21, "Accounting for the Sale of Property Subject to the Seller's Preexisting Lease"
EITF Issue No. 92-7, "Accounting by Rate-Regulated Utilities for the Effects of Certain Alternative Revenue Programs"
EITF Issue No. 97-4, "Deregulation of the Pricing of Electricity—Issues Related to the Application of FASB Statements No. 71 and 101"
EITF Topic No. D-5, "Extraordinary Treatment Related to Abandoned Nuclear Power Plants"
EITF Topic No. D-21, "Phase-in Plans When Two Plants Are Completed at Different Times but Share Common Facilities"]

.1001 [Listed below are those EITF Issues that provide interpretive guidance on specific material in this section.

Paragraph .115 (FAS 71, ¶5)—EITF Issue No. 97-4
Paragraph .119 (FAS 71, ¶9)—EITF Issues No. 92-12 and 93-4
Paragraph .121 (FAS 71, ¶11)—EITF Issue No. 92-7
Paragraph .125A (b) and (c) (FAS 92, ¶3(b) and (c))—EITF Topic No. D-21
Paragraphs .205 and .206 (FAS 101, ¶6-7)—EITF Issue No. 97-4]

(The next page is 75151.)

**Sources:** FASB Statement 61; FASB Statement 144

## Summary

This section applies to enterprises, such as title insurance enterprises, title abstract enterprises, and title agents, that use a title plant in their operations. Costs directly incurred to construct a title plant are capitalized until the enterprise can use the title plant to do title searches. Capitalized costs of a title plant are not depreciated and costs of maintaining a title plant and doing title searches are expensed as incurred.

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## Introduction

.101 A **title plant** consists of (a) indexed and catalogued information for a period concerning the ownership of, and encumbrances on, parcels of land in a particular geographic area; (b) information relating to persons having an interest in real estate; (c) maps and plats; (d) copies of prior title insurance contracts and reports; and (e) other documents and records. In summary, a title plant constitutes a historical record of all matters affecting title to parcels of land in a particular geographic area. The number of years covered by a title plant varies, depending on regulatory requirements and the minimum information period considered necessary to issue title insurance policies efficiently. Title plants are updated on a daily or other frequent basis by adding copies of documents on the current status of title to specific parcels of real estate. [FAS61, ¶1]

## Applicability and Scope

.102 This section applies to enterprises that use a title plant in their operations. Those enterprises include, but are not limited to, title insurance enterprises (underwriters), title abstract enterprises, and title agents. [FAS61, ¶2]

## Capitalization of Title Plant

.103 Costs incurred to construct a title plant, including the costs incurred to obtain, organize, and summarize historical information in an efficient and useful manner, shall be capitalized until the title plant can be used by the enterprise to do title searches. To qualify for capitalization, costs need to be directly related to, and properly identified with, the activities necessary to construct the title plant. [FAS61, ¶3]

.104 Purchased title plant, including a purchased undivided interest in title plant, shall be recorded at cost at the date of acquisition. For title plant acquired separately, cost shall be measured by the fair value of the consideration given. [FAS61, ¶4]

.105 An enterprise may decide to construct or purchase a title plant that antedates the period covered by its existing title plant (backplant). Costs to construct a backplant need to be identifiable to qualify for capitalization. [FAS61, ¶5]

.106 Capitalized costs of title plant shall not be depreciated or charged to income unless circumstances indicate that the [FAS61, ¶6] carrying amount [FAS144, ¶C29(a)] of the title plant has been impaired. The following circumstances may indicate that the [FAS61, ¶6] carrying amount [FAS144, ¶C29(a)] of title plant has been impaired:

a. Changes in legal requirements or statutory practices
b. Effects of obsolescence, demand, and other economic factors
c. Actions of competitors and others that may affect competitive advantages
d. Failure to maintain the title plant properly on a current basis
e. Abandonment of title plant or other circumstances that indicate obsolescence. [FAS61, ¶6]

Those events or changes in circumstances, in addition to the examples in paragraph .143 of Section I08, "Impairment," indicate that the carrying amount of the capitalized costs may not be recoverable. Accordingly, the provisions of paragraphs .139 through .161 of Section I08 apply. [FAS144, ¶C29(b)]

## Title Plant Maintenance and Title Searches

.107 Costs incurred to maintain a title plant and to do title searches shall be expensed as incurred. Title plant maintenance involves the updating of the title plant on a daily or other frequent basis by adding (a) reports on the current status of title to specific parcels of real estate and (b) other documents, such as records relating to security or other ownership interests. Title searches involve the process of searching through records for all recorded documents or updating information summarized in the most recently issued title report. [FAS61, ¶7]

## Storage and Retrieval

.108 Costs incurred after a title plant is operational (a) to convert the information from one storage and retrieval system to another or (b) to modify or modernize the storage and retrieval system shall not be capitalized as title plant. Those costs, however, may be capitalized separately and charged to expense in a systematic and rational manner. [FAS61, ¶8]

## Sale of Title Plant

.109 The sale of a title plant shall be reported separately as follows:

a. If the enterprise sells its title plant and relinquishes all rights to its future use, the reported amount shall be the amount received net of the adjusted cost of the title plant.
b. If the enterprise sells an undivided ownership interest in its title plant (that is, the right to its joint use), the reported amount shall be the amount received net of a pro rata portion of the adjusted cost of the title plant.
c. If the enterprise sells a copy of its title plant or the right to use it, the reported amount shall be the amount received. Ordinarily, no cost shall be allocated to the sale of a copy of or the right to use a title plant unless the value of the title plant decreases below its adjusted cost as a result of the sale (refer to paragraph .106). [FAS61, ¶9]

## Glossary

.401 **Title plant.** Consists of (a) indexed and catalogued information for a period concerning the ownership of, and encumbrances on, parcels of land in a particular geographic area; (b) information relating to persons having an interest in real estate; (c) maps and plats; (d) copies of prior title insurance contracts and reports; and (e) other documents and records. In summary, a title plant constitutes a historical record of all matters affecting title to parcels of land in a particular geographic area. [FAS61, ¶1]

(The next page is A-1.)

No. OUCC 01-001

DATA INFORMATION REQUEST
Indiana American Water Company
Cause No. 43187

Requested From: Gary VerDouw
Date Requested: 1-9-07
Information Requested:

In how many state jurisdictions is American Water Works currently proposing rate increases?

For each state jurisdiction where a rate increase is being proposed:

1) Please provide the proposed increase over current rates in both dollars and percentage

2) Please provide the proposed cost of equity.

3) Please provide the proposed cost of debt.

4) Please provide the proposed cost of capital.

5) Describe any proposed trackers.

6) Please provide the amount of American Water Works' (or any other parent Indiana-American parent company) allocated costs charged to each state jurisdiction (in both total dollars and as a percentage of total state jurisdiction costs) and how it is determined.

7) Please provide the amount of costs for E-CIS allocated to each state jurisdiction and how that amount was determined.

Requested By: Jeffrey M. Reed, OUCC – 317-232-2494 – jreed@oucc.in.gov

Information Provided:

The Company objects to the request on the grounds and to the extent that such request is irrelevant and is not reasonably calculated to lead to the discovery and admissible evidence

Notwithstanding the Company's objections, the following information is provided. Please see attached spreadsheet for the requested detail for items 1 through 4 and 6. Please see the response to Data Request No. OUCC 01-002 for the answer to item 5. Regarding item 6, the dollar amounts requested cannot be compared as requested in the question. This is due to the fact that the amounts requested are for differing time periods as represented by differing rate case filing timing and differing test year periods in effect for the states involved. Regarding item 7, costs of the ECIS system were allocated to each state on a month by month basis over the period during which the call center and ECIS system were being installed. The amounts are shown in Exhibit AJV-1 filed as part of the Company's case-in-chief on December 5, 2006. The basis for allocations is the relative customer counts of the American Water subsidiaries involved in the ECIS system installation. In addition, costs for development of any special software routines required by a specific state were billed directly to that state and not billed through an allocation process.

Hyperlink. OUCC 01-001-R1.PDF

Date Response Provided:

Signed By: ______________________

Prepared By: Tom McKitrick

OUCC 01-001-R1

Indiana-American Water Company
**Cause no. 43187**
**OUCC Data Request No 001**
**Attachment to Response**

| Company Name | Proposed Increase $(000) | Proposed Increase (%) | Proposed ROE (%) | Proposed Debt Cost (%) | Proposed Cost of Capital (%) | Proposed AWWSCo Charges $(000) | ECIS Investment $(000) |
|---|---|---|---|---|---|---|---|
| Arizona - see note regarding ORCOM costs | | | | | | | |
| Mohave Water/Wastewater (WW) | $ 1,025 | 22.45% | 11.50% | 5.55% | 7.93% | $ 608 | $ 1,192 |
| Anthem Water Anthem/Agua Fria WW | $ 7,048 | 74.78% | 11.75% | 6.05% | 8.33% | $ 1,864 | $ 1,192 |
| Sun City Wastewater | $ 1,606 | 35.84% | 11.75% | 6.05% | 8.33% | $ 805 | $ 1,192 |
| Sun City West Wastewater | $ 1,435 | 51.50% | 11.75% | 6.05% | 8.33% | $ 435 | $ 1,192 |
| California - see note regarding ORCOM costs | | | | | | | |
| California-American LA District | $ 2,009 | 1.74% | 11.50% | 6.20% | 8.41% | $ 1,887 | $ 3,299 |
| California-American Coronado | $ (73) | -0.46% | 11.50% | 6.20% | 8.41% | $ 1,422 | $ 3,299 |
| California-American Village | $ 1,537 | 7.43% | 11.50% | 6.20% | 8.41% | $ 1,446 | $ 3,299 |
| California-American Sacramento | $ 8,967 | 33.89% | 11.50% | 6.20% | 8.41% | $ 3,991 | $ 3,299 |
| California-American Larkfield | $ 1,272 | 61.91% | 11.50% | 6.20% | 8.41% | $ 167 | $ 3,299 |
| Missouri-American Water Company | $ 41,462 | 24.85% | 11.30% | 6.04% | 8.52% | $ 26,097 | $ 11,135 |
| New Jersey-American Water Company | $ 98,993 | 22.30% | 11.23% | 6.00% | 8.61% | $ 32,163 | $ 11,124 |
| New Mexico-American Water Company | $ 2,121 | 24.88% | 11.40% | 6.02% | 8.43% | $ 1,153 | $ 376 |
| Ohio-American Water Company | $ 5,131 | 17.01% | 11.00% | 5.92% | 8.03% | $ 3,041 | $ 1,492 |
| Tennessee-American Water Company | $ 6,380 | 19.08% | 11.00% | 6.67% | 8.46% | $ 4,064 | $ 3,272 |

note - ECIS costs for Arizona and California have not been allocated among districts.

**Tennessee American Water Company**
**Operations and Maintenance ("O&M" )Expense Comparative**
**For the years Ended December 31, 2003-2006**

| | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|
| Total O&M Expenses | $ 15,266,425 | $ 16,583,284 | $ 17,872,992 | $ 19,992,392 |
| Annual Percentage Increase | | 8.63% | 7.78% | 11.86% |
| Three Year Percentage Increase | | | | 30.96% |

Source: TRA 3.06 Surveillance Reports, Sum of Lines 6-11.