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COMMONWEALTH OF KENTUCKY

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BEFORE THE PUBLIC SERVICE COMMISSION PUBLIC SERVICE
COMMISSION

IN THE MATTER OF AN ADJUSTMENT)
OF GAS RATES OF THE UNION, LIGHT,) CASE NO. 2005-00042
HEAT AND POWER COMPANY)

REBUTTAL TESTIMONY OF

JOHN J. SPANOS

ON BEHALF OF

THE UNION LIGHT, HEAT AND POWER COMPANY

TABLE OF CONTENTS

	PAGE
I. INTRODUCTION AND PURPOSE	- 1 -
II. ATTORNEY GENERAL'S NET SALVAGE POSITION.....	- 2 -
III. DEPRECIATION CONCEPTS	- 4 -
IV. EXCESSIVE DEPRECIATION	- 8 -
V. FINANCIAL ACCOUNTING AND RATEMAKING.....	- 9 -
VI. DEREGULATION.....	- 12 -
VII. ESTIMATION OF NET SALVAGE.....	- 15 -
VIII. THE MAJOROS ALTERNATIVES	- 21 -
IX. DEPRECIATION TEXTS AND REGULATORY PRECEDENTS	- 23 -
X. SPECIFIC SERVICE LIFE AND NET SALVAGE ESTIMATES	- 29 -
XI. CALCULATION OF ANNUAL DEPRECIATION RATES	- 37 -
XII. SUMMARY AND CONCLUSION.....	- 38 -

I. INTRODUCTION AND PURPOSE

1 **Q. PLEASE STATE YOUR NAME.**

2 A. My name is John J. Spanos.

3 **Q. ARE YOU THE SAME JOHN J. SPANOS WHO PREVIOUSLY FILED**
4 **TESTIMONY IN THIS PROCEEDING?**

5 A. Yes.

6 **Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY IN**
7 **THIS PROCEEDING?**

8 A. The purpose of my testimony in this statement is to rebut the Direct Testimony of
9 Michael J. Majoros, Jr., submitted on behalf of the Attorney General.

10 **Q. WHAT ARE THE SUBJECTS OF YOUR REBUTTAL TESTIMONY?**

11 A. The primary subject of my rebuttal testimony is net salvage. Within the overall topic
12 of net salvage, I will discuss depreciation concepts, "excessive depreciation," the
13 differences between financial/regulatory reporting and ratemaking, deregulation, the
14 estimation of future net salvage, the alternatives to accrual accounting proposed by
15 Mr. Majoros, and the treatment of net salvage used in other jurisdictions and
16 recommended in authoritative texts. I also will discuss the changes to my estimates
17 of service life and net salvage proposed by Mr. Majoros.

II. ATTORNEY GENERAL'S NET SALVAGE POSITION

1 **Q. PLEASE SUMMARIZE THE POSITION OF ATTORNEY GENERAL**
2 **WITNESS MR. MAJOROS REGARDING THE RATEMAKING**
3 **TREATMENT OF NET SALVAGE FOR ULH&P.**

4 A. Although it appears that Mr. Majoros has returned to the mainstream by
5 proposing estimates of future net salvage, his estimates are so unreasonable
6 that they represent an effort to effect proposals previously rejected by this
7 Commission through the back door. I base this conclusion on the end result
8 of his net salvage estimates and the extent to which he discusses: (1) the
9 factors that he relied on for his previous proposal to expense net salvage, i.e.,
10 Financial Accounting Standard No. 143 and Federal Energy Regulatory
11 Commission Order No. 631, the Supreme Court's Lindheimer decision, etc.;
12 and (2) his alternative proposals for the treatment of net salvage.

13 **Q. WHAT IS THE END RESULT OF HIS NET SALVAGE ESTIMATES?**

14 A. The end result of Mr. Majoros' net salvage estimates, as shown on page 8 of
15 Exhibit ___(MJM-12), is an accrual of negative \$298,457 for future net
16 salvage. That is, Mr. Majoros has estimated future negative net salvage that
17 is \$2,951,156 less than the amount accrued by ULH&P through the end of
18 2004 toward such negative net salvage. He then proposes to reduce
19 depreciation expense going forward by \$298,457, in furtherance of his oft-
20 stated goal of returning such monies to customers. His accrual is \$1,453,553
21 less than the accrual for net salvage that I have determined to be appropriate.

1 **Q. WHAT IS THE END RESULT OF HIS REVISIONS TO YOUR**
2 **ESTIMATES OF SERVICE LIFE?**

3 A. The end result of Mr. Majoros' revisions to the service life estimates for
4 several accounts is a reduction in annual accrual of \$231,312, or about 3.6%
5 of the accrual that I have determined.

6 **Q. WHAT ARE THE BASES FOR HIS PROPOSALS?**

7 A. The bases for the proposals of Mr. Majoros as stated on pages 4 and 5 of his
8 direct testimony are his view that my proposal results in "excessive
9 depreciation," his depreciation study, ULH&P's responses to certain Staff
10 data requests, and ULH&P's actions as a result of recent accounting
11 pronouncements.

12 **Q. DO YOU AGREE WITH MR. MAJOROS' PROPOSAL AND THE**
13 **CONSIDERATIONS ON WHICH IT IS BASED?**

14 A. No, I do not. Mr. Majoros' estimates of service life and net salvage are
15 unreasonable and do not properly consider the statistical analyses of
16 ULH&P's data or the typical range of estimates used in the industry. Mr.
17 Majoros' proposal is designed to reduce rates for today's customers, but does
18 so at the expense of tomorrow's customers. The Commission should reject
19 this proposal and continue with more reasonable and typical estimates of
20 service lives and net salvage. Before addressing the specific estimates, I will
21 address the concepts and theories put forth by Mr. Majoros and also his
22 criticisms of the traditional approach to accruing for net salvage. This is
23 necessary both because the record should reflect more than Mr. Majoros'

1 views on these subjects and because his end result indicates that he is still
2 attempting to deny the utility an appropriate level of future net salvage
3 recovery.

III. DEPRECIATION CONCEPTS

4 **Q. IN EXHIBIT ___(MJM-4), MR. MAJOROS HAS PROVIDED A**
5 **DISCUSSION OF DEPRECIATION CONCEPTS. DO YOU HAVE**
6 **ANY DISAGREEMENTS WITH THE STATEMENTS MADE IN THIS**
7 **DOCUMENT?**

8 A. Yes, I do. Mr. Majoros' concept of public utility depreciation is not the same
9 as the concept set forth in the Uniform System of Accounts and authoritative
10 texts on the subject. He states on page 1 of Exhibit ___(MJM-4) that "public
11 utility depreciation is straight line capital recovery" and "is accomplished by
12 allocating the original cost of assets to expense..." He repeats this concept
13 again at the bottom of page 2. Depreciation is not simply the allocation of
14 original cost to expense. The Uniform System of Accounts defines
15 depreciation as "the loss in service value not restored by current maintenance
16 incurred in connection with the consumption or prospective retirement of
17 property in the course of service from causes which are known to be in
18 current operation and against which the utility is not protected by insurance."
19 The operative words in this definition that differ markedly from Mr.
20 Majoros' definition are *service value*. The Uniform System of Accounts goes
21 on to define service value as "the difference between the original cost and the
22 net salvage value of the utility plant," not as just the original cost. The

1 service value rendered by an asset, i.e., depreciation, must reflect both its
2 original cost and its net salvage.

3 **Q. DOES THE UNIFORM SYSTEM OF ACCOUNTS ALSO ADDRESS**
4 **THE MANNER IN WHICH DEPRECIATION IS TO BE**
5 **RECOGNIZED?**

6 A. Yes, it does. The Uniform System of Accounts requires that depreciation be
7 recognized through accrual accounting. That is, the service value of an asset
8 must be accrued during the life of the asset. Since net salvage is a part of the
9 service value, it must be accrued during the life of the related asset in order to
10 comply with the Uniform System of Accounts.

11 **Q. PLEASE CONTINUE WITH YOUR REVIEW OF MR. MAJOROS'**
12 **DISCUSSION OF DEPRECIATION CONCEPTS AS PRESENTED IN**
13 **HIS EXHIBIT ___(MJM-4).**

14 A. Mr. Majoros makes several inaccurate or misleading statements throughout
15 this exhibit. On page 1, he states that "in certain jurisdictions public utility
16 depreciation rates incorporate net salvage factors." A more accurate
17 statement would be "in *nearly all* jurisdictions public utility depreciation
18 rates incorporate net salvage factors." I will discuss the policy of several
19 state commissions on this subject later in my testimony. At the top of page 5,
20 he states "Some utilities, such as SCE, include net salvage in the depreciation
21 rate calculation." This is the first of several instances in which Mr. Majoros
22 failed to change the name of the utility in his exhibit. That aside, the

1 accuracy of this statement would be improved by stating “*Nearly all* utilities,
2 including ULH&P, include net salvage in the depreciation rate calculation.”

3 On page 3, Mr. Majoros states “...but no cash flows out of the
4 company for depreciation expense.” This is a true statement, but also may
5 leave an incorrect impression. In order for the company to record
6 depreciation expense, it must have first experienced a cash outflow which is
7 represented by the original cost of the asset.

8 Mr. Majoros claims on page 5 that the net salvage adjustment in the
9 numerator of the equation for the annual depreciation accrual rate is
10 “equivalent to capitalizing or adding the estimated cost of removal to the
11 original cost of the asset.” This is only true mathematically with respect to
12 the formula for the annual depreciation accrual. It is not true conceptually
13 and such amounts are not capitalized for rate base or any other purpose. He
14 goes on to say in the concluding paragraph on page 5 that “when negative net
15 salvage is included in the depreciation rate there will not be an equality of
16 plant and reserve at the end of an asset’s life because the Company will have
17 charged more depreciation than it paid for the original cost of the asset.” Of
18 course they will have charged more than the original cost. The total
19 depreciation expense must equal the sum of the original cost and the negative
20 net salvage, not just the original cost. This is in accordance with the
21 definition of depreciation as set forth in the Uniform System of Accounts and
22 authoritative texts on the subject of public utility depreciation. Once the net

1 salvage costs are incurred, the equality of plant and reserve at the end of an
2 asset's life is restored.

3 Mr. Majoros continues his assault on net salvage at the top of page 6
4 by implying that the equality of depreciation expense with company
5 expenditures, original cost and negative net salvage, "will only be achieved if
6 the Company actually spends the additional money at the end of the asset's
7 life. However, unless the Company has a legal liability to remove the asset, it
8 is not required to spend the money." While ULH&P does not have a legal
9 obligation to remove plant, it does have an obligation to provide service. In
10 order to provide service, ULH&P must continually renew its plant by adding
11 new assets and retiring old assets. *ULH&P has been spending significant*
12 *sums to retire plant for many years. I see no reason to suspect that it will not*
13 *continue to do so for many more to come. Mr. Majoros then suggests that the*
14 *amounts recovered from ratepayers for negative net salvage could be used to*
15 *pay "salaries, dividends, etc."* While it is true that dollars paid by customers
16 are not earmarked, it is disingenuous to suggest that dollars recovered for
17 negative net salvage would be used for anything other than plant
18 expenditures. Each year ULH&P spends significantly more on plant, both its
19 installation and removal, than it recovers in depreciation expense.

20 On page 9, Mr. Majoros concludes his discussion of Depreciation
21 Concepts with an unsupported claim that "Many of SCE's proposed
22 depreciation rates contain negative net salvage factors which charge too much
23 for future cost of removal because they are too negative." Having established

1 this unsupported supposition, he concludes “The combination of these two
2 factors, i.e., understated lives and overstated cost of removal ratios,
3 compounds the excessive depreciation rate problem.” While that would be a
4 true statement if the supposition were correct, it does not comport with the
5 overwhelming evidence in this proceeding. In my opinion, many of
6 ULH&P’s existing depreciation rates contain negative net salvage factors
7 which charge too little for future cost of removal and compound the
8 *inadequate depreciation* rate problem.

IV. EXCESSIVE DEPRECIATION

9 **Q. AT THE BOTTOM OF PAGE 5 OF HIS DIRECT TESTIMONY AND**
10 **IN EXHIBIT ___ (MJM-3), MR. MAJOROS REFERS TO THE TERM**
11 **"EXCESSIVE DEPRECIATION." PLEASE COMMENT.**

12 **A.** Mr. Majoros expresses his concern over the possibility that the Company’s
13 depreciation rates will produce depreciation expense that is “more than
14 necessary to return ...capital investment over the life of an asset.” He cites
15 the 1934 decision of the U.S. Supreme Court in *Lindheimer v. Illinois Bell*
16 *Telephone Company* in support of his concern. In *Lindheimer*, the Court held
17 that the company’s depreciation was excessive and, therefore, represented a
18 contribution of capital. The court determined that the annual depreciation
19 allowances that resulted from the “studies of the ‘behavior of large groups’ of
20 items” must “meet the controlling test of experience.” Mr. Majoros failed to
21 include in his quote the very next sentence in which the controlling test used
22 by the court was described:

1 In this instance, the evidence of expert
2 computations of the amounts required for annual
3 allowances does not stand alone. In striking
4 contrast is the proof of the actual condition of
5 the plant as maintained...

6
7 The concept of physical depreciation referred to in this sentence is no longer
8 used in the determination of rate base in public utility regulation. Instead,
9 largely as a result of the 1944 decision of the U. S. Supreme Court in *Federal*
10 *Power Commission et al v. Hope Natural Gas Co.*, net investment has
11 become the primary, if not exclusive, means of determining rate base. In this
12 approach, the Accumulated Provision for Depreciation as recorded on the
13 company's books is deducted from original cost. The Accumulated Provision
14 for Depreciation reflects the past allowances for depreciation whether they
15 have been excessive or inadequate. Thus, these past allowances are used to
16 limit the amount on which the utility is permitted to earn a return and, in
17 jurisdictions such as the Kentucky Public Service Commission (KPSC) that
18 adjust the annual depreciation to reflect the level of the Accumulated
19 Provision for Depreciation as compared to the calculated or theoretical
20 reserve, they also are used to limit the amount that will be recovered through
21 future depreciation allowances.

V. FINANCIAL ACCOUNTING AND RATEMAKING

22 **Q. BEGINNING ON PAGE 21 OF HIS TESTIMONY, MR. MAJOROS**
23 **DISCUSSES FINANCIAL ACCOUNTING STANDARD (FAS) NO. 143,**
24 **FEDERAL ENERGY REGULATORY COMMISSION (FERC)**
25 **ORDER NO. 631, AND HIS VIEW OF THEIR APPLICABILITY TO**

1 **THIS PROCEEDING. DOES FAS NO. 143 HAVE ANYTHING TO DO**
2 **WITH RATEMAKING IN GENERAL AND THIS PROCEEDING IN**
3 **PARTICULAR?**

4 A. No, it does not. Although Mr. Majoros assures the Commission that none of
5 his specific recommendations has any impact on ULH&P's depreciation
6 rates, he spends the final 20 pages of his testimony discussing FAS No. 143
7 and his four "new issues." While the requirements of FAS No. 143 may
8 improve a potential investor's ability to ascertain a company's financial
9 condition, compliance with such standards for ratemaking purposes would
10 violate principles of customer equity and, thus, it has no place in ratemaking
11 or regulatory accounting.

12 Further, the legal obligation standard of FAS No. 143 for recognizing
13 a liability to retire plant does not recognize the reality of ongoing utility
14 operations. Although the utility may not have a legal obligation to retire
15 plant, it nevertheless does so on a regular basis and will continue to do so in
16 the future. The Uniform System of Accounts states that depreciation
17 represents the loss in service value, where service value is the original cost
18 less net salvage. Thus, net salvage is a capital cost to be recovered through
19 depreciation accruals. It is appropriate that such recovery comes from the
20 customers served by the related plant.

21 **Q. DOES FERC ORDER NO. 631 HAVE ANY IMPACT ON THIS**
22 **PROCEEDING?**

1 A. In my opinion, it does not. FERC Order No. 631 modified the Uniform
2 System of Accounts to allow utilities to record the entries required for
3 financial reporting by FAS No. 143 on the books maintained for regulatory
4 accounting. FERC specifically stated that the order did not affect existing
5 tariffs. The order simply provides the accounting structure that enables the
6 identification of amounts for use in financial statements and those for use in
7 ratemaking proceedings.

8 **Q. ON PAGE 23, LINES 25 AND 26, MR. MAJOROS STATES THAT**
9 **THERE IS A “NEED FOR THE KENTUCKY PUBLIC SERVICE**
10 **COMMISSION TO SPECIFICALLY RECOGNIZE A REGULATORY**
11 **LIABILITY FOR REGULATORY AND RATE-MAKING**
12 **PURPOSES.” DO YOU AGREE?**

13 A. No, I do not. As I stated above, FAS No. 143 is a financial accounting
14 standard. There is no *need* to recognize a financial accounting entry for
15 ratemaking purposes, particularly when it is related to a treatment of the
16 related costs that is contrary to the cardinal ratemaking tenet of
17 intergenerational equity. The amount recorded as a regulatory liability for
18 these assets for financial reporting purposes represents the extent to which
19 past accruals have exceeded past costs of retiring. They do not represent an
20 indication of whether that amount, along with future accruals, will be
21 sufficient to offset future costs of removal. Past accruals need to have
22 exceeded past costs in order to recognize the cost of removal portion of the
23 service value rendered in the past by assets presently in service.

VI. DEREGULATION

1 **Q. ON PAGES 29 THROUGH 35, MR. MAJOROS, REFERRING TO**
2 **PAST ACCRUALS IN EXCESS OF COSTS, PUTS FORTH THE**
3 **PROPOSITION THAT “UNLESS THEY ARE EXPLICITLY**
4 **IDENTIFIED AS ‘SUBJECT TO REFUND’ THEY ARE MERELY**
5 **HIDDEN POTENTIAL INCOME TO ULH&P.” WHAT IS THE**
6 **GENESIS OF HIS CONCERN?**

7 A. Mr. Majoros concern is based on the financial accounting entries of Cinergy
8 and several other electric utilities related to their deregulated power plants
9 and the financial accounting entries of telecommunications companies also
10 related to deregulated property.

11 **Q. SHOULD THIS BE A CAUSE FOR CONCERN?**

12 A. No, it should not. These utilities made these entries for financial reporting
13 purposes pursuant to financial accounting standards. Further, they relate to
14 plant whose nature was more readily subject to deregulation. The delivery of
15 natural gas through a network of pipes is truly a natural monopoly and is not
16 likely to be deregulated.

17 **Q. IN THE EVENT THAT ULH&P’S GAS DISTRIBUTION BUSINESS**
18 **IS DEREGULATED, DO YOU BELIEVE THAT THE PAST**
19 **ACCRUALS FOR FUTURE NET SALVAGE WILL DISAPPEAR?**

20 A. No, I do not. I’m certain that such deregulation would be the subject of
21 proceedings before the KPSC and that the Commission, ULH&P, and groups

1 such as the AG would work together to develop an equitable transition from
2 regulation to deregulation.

3 **Q. ON PAGE 34, LINES 19 THROUGH 22, MR. MAJOROS MAKES**
4 **THE FOLLOWING STATEMENT: “THEREFORE, AT THE**
5 **MOMENT, THERE IS NO REGULATORY RECOGNITION OF SUCH A**
6 **LIABILITY AND THERE IS NO PROVISION FOR A REFUND TO**
7 **RATEPAYERS IF THE AMOUNTS THEY HAVE PAID ARE NOT**
8 **SPENT ON COST OF REMOVAL OR DISMANTLEMENT.” IS THIS**
9 **STATEMENT CORRECT?**

10 A. No, it is not. Although the amount which Mr. Majoros is referring to is
11 recorded as a regulatory liability for financial reporting purposes, for
12 ratemaking purposes it is reflected in the Accumulated Provision for
13 Depreciation. This amount is deducted from rate base and also is deducted
14 from the determination of future accruals when calculating annual
15 depreciation. If the past accruals recorded to this account for future cost of
16 removal are not so spent, there is a provision in remaining life depreciation
17 for the reduction of future accruals. There are regulatory mechanisms that
18 recognize this amount. They are called net investment rate base and
19 remaining life depreciation.

20 **Q. IS THERE A NEED FOR THE PAST ACCRUALS FOR FUTURE NET**
21 **SALVAGE TO BE SPECIFICALLY RECOGNIZED AS A**
22 **REGULATORY LIABILITY FOR RATEMAKING PURPOSES?**

1 A. No, there is not. These amounts are separately identified in ULH&P's books
2 and records for Account 108, Accumulated Provision for Depreciation, and
3 used in its determination of rate base and its calculations of remaining life
4 depreciation rates. This treatment has afforded protections to ratepayers for
5 many years and is adequate to do so for many more.

6 **Q. ON PAGE 36, MR. MAJOROS OFFERS THREE ALTERNATIVES**
7 **FOR DISPOSITION OF THE REGULATORY LIABILITY: (1) A**
8 **PERMANENT RATE BASE OFFSET; (2) AMORTIZATION BACK**
9 **TO RATEPAYERS; AND (3) ONGOING REMAINING LIFE COST**
10 **OF REMOVAL RATE. WHICH DO YOU RECOMMEND?**

11 A. I recommend that the past accruals for future costs of removal be reflected in
12 the calculation of an ongoing annual depreciation rate related to the recovery
13 of cost of removal from customers receiving the service provided by the plant
14 for which the removal costs will be incurred. Such accruals will offset rate
15 base until the amounts are expended for removal cost. There is no need for a
16 separate amortization to ratepayers and it would not be appropriate to do so.

17 **Q. WHY WOULD IT BE INAPPROPRIATE TO RETURN PAST**
18 **ACCRUALS TO RATEPAYERS?**

19 A. Past accruals were made pursuant to depreciation rates authorized by the
20 KPSC and represent amounts recorded on ULH&P's books. They are not
21 necessarily amounts collected from customers. Further, to the extent that
22 such amounts represent collections, the revenue was received in accordance

1 with the orders of this Commission and represents amounts paid for service
2 received.

VII. ESTIMATION OF NET SALVAGE

3 **Q. ON PAGE 19 OF HIS TESTIMONY AND IN EXHIBIT ___ (MJM-13),**
4 **MR. MAJOROS DESCRIBES WHAT HE REFERS TO AS THE**
5 **TRADITIONAL INFLATED FUTURE COST APPROACH OR**
6 **"TIFCA." ARE YOU FAMILIAR WITH THE APPROACH BEING**
7 **DESCRIBED BY MR. MAJOROS?**

8 A. Yes, I am.

9 **Q. HAVE YOU EVER HEARD OR READ OF IT REFERRED TO AS**
10 **"TIFCA?"**

11 A. No, I have not. The name and related acronym have been constructed by Mr.
12 Majoros.

13 **Q. ON PAGE 1 OF EXHIBIT ___(MJM-13), MR. MAJOROS STATES**
14 **THAT "TIFCA" NET SALVAGE STUDIES RELATE REMOVAL**
15 **COSTS IN CURRENT DOLLARS TO RETIREMENTS IN**
16 **HISTORICAL DOLLARS. IS THAT CORRECT?**

17 A. Yes, it is. Traditional studies of net salvage use as their statistical bases data
18 that relate the cost of retiring an asset or group of assets to its original cost.

19 **Q. WHAT WERE THE STATISTICAL BASES FOR YOUR NET**
20 **SALVAGE ESTIMATES?**

1 A. The statistical bases for my estimates of net salvage were the historical net
2 salvage costs as a percent of the original cost of the retired assets that
3 produced the gross salvage or required the costs to remove.

4 **Q. DOES THE USE OF THIS STATISTICAL BASIS RESULT IN THE**
5 **COLLECTION OF FUTURE INFLATED COSTS TO REMOVE**
6 **FROM CURRENT CUSTOMERS?**

7 A. Yes, to a certain extent. The reliance on historical indications of net salvage
8 as a percent of the original cost retired will result in the collection of net
9 salvage costs at a future price level. However, such reliance also assumes
10 that there will be substantial improvements in technology, comparable or
11 lesser environmental regulations and a significant reduction in inflation.

12 **Q. HOW DOES USE OF NET SALVAGE PERCENTS THAT ARE**
13 **COMPARABLE TO THE HISTORICAL INDICATIONS ASSUME**
14 **THESE EVENTS?**

15 A. The net salvage percents, that is the net salvage costs divided by the original
16 costs of the assets that have been retired and expressed as percents, are
17 related to the retirement of plant that on average is significantly younger than
18 the average service life of the plant in service, on an original cost dollar
19 weighted basis. For example, the average age of retirements of distribution
20 mains during the period 1980 through 2003 was 29 years. This amount is
21 less than three-fifths of the average life of 50 to 53 years estimated for the
22 majority of this account.

1 The average cost of removal percent related to these retirements,
2 made on average at age 29, was negative 34 percent. That is, after 29 years in
3 service, the plant was retired and the cost to remove the plant, as a result of
4 inflation, technological changes and other factors, was 34 percent of the cost
5 to install the same plant.

6 The future retirements of the total current distribution mains in
7 service will have an average age that actually exceeds the average life. Thus,
8 future retirements will be of plant that has been in service nearly twice as
9 long as the plant retired during the period 1980-2003. For retirements at such
10 ages to experience net salvage that is 20 % of the cost to install, which is my
11 estimate, there will have to be a reduction in the rate of inflation adjusted for
12 technological improvements. If the rate of inflation adjusted for
13 technological improvements that occurred between the installation and
14 retirement of plant retired during the period 1980-2003 occurred over a
15 period that is nearly twice as long, the removal cost would be much greater as
16 a percent of the original cost of the plant retired.

17 **Q. WILL THE GROSS SALVAGE RECEIVED FOR RETIRED**
18 **DISTRIBUTION MAINS ALSO INCREASE AS A PERCENT OF THE**
19 **ORIGINAL COST AS THE AGE OF RETIREMENTS INCREASES?**

20 **A.** No, it will not. The gross salvage recorded for distribution mains through the
21 mid-1990's represents a reuse salvage credit for mains that were used to
22 insert new mains through them. It does not represent scrap metal proceeds
23 which might be expected to increase as a percent of original cost with age.

1 The reuse salvage credits have decreased significantly in recent years as the
2 Company's contractors have found it more economic to use horizontal
3 directional drilling rather than pipe insertions. Therefore, future amounts of
4 gross salvage for mains will be minimal, consistent with the experience
5 during the past three to five years.

6 **Q. WHAT IS THE IMPLICATION OF THE ASSUMPTION THAT THE**
7 **FUTURE RATE OF INFLATION ADJUSTED FOR**
8 **TECHNOLOGICAL IMPROVEMENTS WILL BE LESS THAN THE**
9 **HISTORICAL RATE?**

10 A. The implication of this assumption as reflected in my estimates of net salvage
11 percents is that the resultant net salvage accruals are most likely inadequate to
12 recover the total net salvage costs over the entire life cycle of the plant
13 currently in service.

14 **Q. DO YOU HAVE ANY CONCERN THAT THE LEVEL OF NET**
15 **SALVAGE COSTS INCURRED WILL BE LESS THAN THE**
16 **AMOUNTS THAT YOU HAVE ESTIMATED?**

17 A. No, I do not. Net salvage costs will be incurred. My estimates will almost
18 certainly result in the recovery of less, not more, net salvage than the actual
19 costs incurred.

20 **Q. IS IT APPROPRIATE TO ASK CURRENT CUSTOMERS TO PAY**
21 **FOR FUTURE COSTS OF REMOVAL AT A PRICE LEVEL THAT IS**
22 **GREATER THAN TODAY'S PRICE LEVEL?**

1 A. Yes, it is. The future cost to remove an item of plant is part of the service
2 value that it renders to current customers and a ratable portion of such costs
3 should be recovered from these customers. That is the definition of
4 depreciation, i.e., the loss in service value during a specific period. As these
5 future costs are recovered from current customers, they are deducted from
6 rate base. This deduction in the amount on which the utility is entitled to earn
7 a fair return, in effect, represents an amount on which the customer earns a
8 return. That is, as customers provide for the future cost of removal, they
9 receive a return on such amounts. This is fair compensation for making
10 payment prior to the cost incurrence by the utility. Further, as already noted,
11 by charging customers for these costs during the life of the plant; the
12 customers that benefit from the plant, or consume its service value, are the
13 ones that pay for such service. Customers paying today for future costs of
14 removal and receiving a return on such payments is no different than the
15 utility recovering today amounts that it invested many years ago, but on
16 which it earned a return until the amount was recovered from customers.

17 **Q. WHY ARE THE CURRENT NET SALVAGE ACCRUALS SO MUCH**
18 **GREATER THAN THE CURRENT EXPERIENCE?**

19 A. The difference in price level as described above is part of the difference.
20 Another significant difference is that the current experience is related to plant
21 retirements that largely come from an older plant base that was constructed to
22 serve fewer customers, whereas the current net salvage accruals relate to the
23 plant presently in service that serves a much larger customer base.

1 Q. IS IT APPROPRIATE FOR ULH&P TO COLLECT AMOUNTS FOR
2 FUTURE NET SALVAGE COSTS THAT ARE GREATER THAN
3 THE AMOUNTS CURRENTLY EXPENDED FOR SUCH COSTS?

4 A. Yes, it is. Although the amount that I propose to collect from customers for
5 future net salvage costs is greater than the amount currently expended for
6 such costs, the amount that ULH&P spends for plant additions is far greater
7 than the amount that it proposes for the recovery of original cost. If net
8 salvage accruals should be limited to current net salvage expenditures, why
9 shouldn't the portion of depreciation expense related to the recovery of
10 original cost be increased to the current level of plant additions? For
11 example, in the year 2003, ULH&P's total plant additions were \$25.3 million.
12 Adding the net salvage costs of \$0.4 million for that year to this amount
13 results in total expenditures of \$25.7 million in 2003. This total expenditure
14 is approximately three times the level of depreciation expense that includes
15 the recovery of past original costs and future net salvage costs. When both
16 sides of the coin are considered, the amount for recovery of costs is far less
17 than actual expenditures. Equity considerations require that customers pay
18 for the service value, original cost less net salvage, of the plant from which
19 they receive service. The fact that this results in accruals for net salvage that
20 are greater than they currently experience is not unfair.

VIII. THE MAJOROS ALTERNATIVES

1 Q. ON PAGES 5 THROUGH 7 OF EXHIBIT___(MJM-13), MR.
2 MAJOROS PROVIDES THE COMMISSION WITH FOUR
3 ALTERNATIVES TO THE TRADITIONAL ESTIMATION AND
4 ACCRUAL FOR NET SALVAGE. PLEASE COMMENT ON HIS
5 FIRST APPROACH: "EXPENSING."

6 A. The first alternative offered by Mr. Majoros is the cash basis or expensing
7 approach. Expensing does not charge the appropriate customers for the cost
8 of retiring an asset and should be rejected. It defers the recovery of cost to
9 customers that are no longer, or never were, served by the asset. Mr. Majoros
10 also suggests that a portion of the cost of retiring assets be charged to the cost
11 of the replacement asset. This is worse, as it further defers the recovery of a
12 cost properly attributable to the customers served by the asset. Mr. Majoros
13 states that the allocation of costs between installation and removal is
14 "somewhat arbitrary." This is not the case. The allocations are based on
15 analyses of the effort required to do the several tasks required to install and
16 remove the asset. The resultant allocations are reasonable for both
17 accounting and ratemaking purposes.

18 Q. PLEASE COMMENT ON HIS SECOND APPROACH:
19 "NORMALIZED NET SALVAGE ALLOWANCE."

20 A. Mr. Majoros characterizes his normalized net salvage approach as
21 representing an accrual basis. This is not true. The addition to depreciation
22 expenses of an amount based on historical average net salvage amounts does

1 not represent an accrual for the future cost of retiring assets. He states it is
2 similar to the cash basis. It is the cash basis. The only difference is that he
3 has called it depreciation expense and charged it the Accumulated Provision
4 for Depreciation rather than calling it an operating expense. For ratemaking
5 purposes, this is the same approach and should be rejected for all the reasons
6 that I discussed above for expensing.

7 **Q. PLEASE COMMENT ON HIS THIRD APPROACH: "SFAS NO. 143**
8 **FAIR VALUE ACCRUAL."**

9 A. The pattern of recovery using this approach would not be appropriate. The
10 pattern of recovery would be a sinking fund, not a straight line. Such a
11 pattern suggests that the service value is being rendered in ever increasing
12 amounts as the asset ages. This is certainly not the case and it also should be
13 rejected.

14 **Q. PLEASE COMMENT ON HIS FOURTH APPROACH: "NET**
15 **PRESENT VALUE ACCRUAL."**

16 A. The net present value accrual simply removes inflation from the estimated
17 future net salvage. The sum of the accruals based on the present value will be
18 significantly less than the amount required to retire assets at the end of their
19 lives. Mr. Majoros makes no provision for this shortfall. Thus, there is an
20 inherent flaw in this approach. Further, if the service value of the asset is to
21 be adjusted to current price levels, then the future net salvage and the
22 historical original cost should both be adjusted. I suspect Mr. Majoros would

1 reject this modification to his net present value approach. I recommend that
2 the Commission reject this alternative as well.

3 **Q. DOES THE USE OF THE NET PRESENT VALUE APPROACH**
4 **ADDRESS THE CONCERNS EXPRESSED BY THE KPSC IN CASE**
5 **NO. 2003-00434?**

6 A. No, it does not. The issue discussed by the Commission in Case No. 2003-
7 00434 involving Kentucky Utilities Company related to an inflation
8 adjustment that was made to the historical removal cost percents. The
9 Commission in its order stated:

10 Depreciation methods inherently recognize
11 inflationary effects, since the depreciation rates are
12 based upon comparisons of the original cost of the
13 asset to the current cost of removal. This recognition
14 assumes that future inflation rates will be similar to
15 historical inflation rates. If it can be adequately
16 demonstrated that future inflation rates will be
17 different from the historical inflation rates, an
18 inflation adjustment would be reasonable.
19

20 The concern related to making inflationary adjustments beyond those
21 recognized in the historical data, not completely eliminating inflation as Mr.
22 Majoros would do with the net present value approach. I have not made any
23 inflationary adjustments to the historical data that I analyzed for ULH&P and
24 the suggestion of Mr. Majoros is without merit.

IX. DEPRECIATION TEXTS AND REGULATORY PRECEDENTS

25 **Q. DO AUTHORITATIVE TEXTS ON DEPRECIATION SUPPORT MR.**
26 **MAJOROS' PROPOSALS RELATED TO NET SALVAGE?**

1 A. I am not aware of any authoritative texts on the subject of depreciation that
2 support these alternative proposals related to net salvage costs. The two
3 depreciation texts most often cited by depreciation experts as being
4 authoritative support the traditional approach that I have proposed. *Public*
5 *Utility Depreciation Practices*, published in 1996 by the National Association
6 of Regulatory Utility Commissioners states:

7 Closely associated with this reasoning are the accounting
8 principles that revenues be matched with costs and the
9 regulatory principle that utility customers who benefit from
10 the consumption of plant pay for the cost of that plant, no
11 more, no less. The application of the latter principle also
12 requires that the estimated cost of removal of plant be
13 recovered over its life.¹

14 *Depreciation Systems*, another widely accepted text, states the concept
15 in this manner:
16

17 The matching principle specifies that all costs incurred to
18 produce a service should be matched against the revenue
19 produced. Estimated future costs of retiring of an asset
20 currently in service must be accrued and allocated as part of
21 the current expenses²
22

23 **Q. WHAT OTHER STATE COMMISSIONS HAVE ALLOWED HIS**
24 **FIVE-YEAR NET SALVAGE APPROACH?**

25 A. The Pennsylvania Public Utility Commission uses the five-year net salvage
26 amortization pursuant to a 1962 court order interpreting and applying unique
27 Pennsylvania law. This Commission used it for two small electric

¹ Public Utility Depreciation Practices. Page 157. National Association of
Regulatory Utility Commissioners. 1996.

² Depreciation Systems, Wolf, Frank K. and W. Chester Fitch. Page 7. Iowa State
University Press. 1994.

1 cooperatives that did not maintain detailed records of cost of removal and
2 gross salvage by account. In other Kentucky cases, where the utility
3 maintains detailed records of net salvage as ULH&P does, the traditional
4 methodology that I have used is adopted. The Board of Public Utilities of the
5 State of New Jersey and the Georgia Public Service Commission have also
6 used the expensing or five-year amortization approach.

7 **Q. WHAT IS THE TREATMENT GIVEN TO NEGATIVE NET**
8 **SALVAGE IN THE DETERMINATION OF THE ANNUAL**
9 **DEPRECIATION RATES IN THE VAST MAJORITY OF STATE**
10 **COMMISSIONS?**

11 A. To the best of my knowledge, the 46 state utility commissions not mentioned
12 above each use the traditional treatment of incorporating negative net salvage
13 in the determination of an appropriate depreciation rate, which is consistent
14 with my approach in this case.

15 **Q. HAVE ANY OF THESE COMMISSIONS RECENTLY DEALT WITH**
16 **THIS ISSUE?**

17 A. Yes, the Missouri Public Service Commission and the Indiana Utility
18 Regulatory Commission both recently affirmed the use of the traditional
19 straight line accrual of net salvage during the life of the related property.

20 **Q. PLEASE DESCRIBE THE MANNER IN WHICH THE MISSOURI**
21 **COMMISSION DEALT WITH THE ISSUE OF NET SALVAGE?**

1 A. The Missouri Public Service Commission has been dealing with the issue of
2 net salvage for a number of years. It had originally adopted the expensing
3 approach in a few cases while continuing to adopt the traditional straight line
4 accrual method in another case. Laclede Gas Company appealed its case in
5 which the Commission effectively adopted the expensing approach. The
6 order was remanded to the Commission by the courts. During the remand
7 proceeding the Commission accepted additional evidence on the subject of
8 net salvage. In its final order, the Commission concluded:

9 The Commission finds that the fundamental goal of
10 depreciation accounting is to allocate the full cost of an asset,
11 including its net salvage cost, over its economic or service life
12 so that utility customers will be charged for the cost of the
13 asset in proportion to the benefit they receive from its
14 consumption. The Commission further finds that the method
15 utilized by Laclede is consistent with that fundamental goal.
16

17 **Q. WHAT CONCLUSIONS DID THE INDIANA COMMISSION REACH**
18 **IN ITS RECENT RULINGS ON THIS SUBJECT?**

19 A. The Indiana Utility Regulatory Commission considered the net salvage issue
20 in its 2004 order involving PSI Energy. It dealt with net salvage related both
21 to production plant and to delivery assets, i.e., transmission and distribution
22 plant. The Commission's conclusions regarding the appropriate recognition
23 of net salvage for both types of facilities are as follows:

24 The next issue is the timing of the collection of such costs.
25 The parties did not disagree that dismantling costs are a part
26 of the cost of current facilities providing current service. They
27 disagreed as to the timing of the collection of such costs and
28 their amount. This Commission can either find that current
29 customers should pay a share of dismantling costs, which will
30 not be incurred for a number of years, or, in the alternative,

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conclude that these costs should be passed on to a future generation of customers. This Commission does not believe that the latter alternative constitutes sound regulatory policy, or is based on sound ratemaking principles. Current customers are receiving service from PSI's generation facilities. A part of the costs of those facilities is dismantlement upon retirement. Therefore, we do not believe it would be appropriate for the Company to backload the dismantlement costs for future ratepayers to pay when the facilities associated with these costs are providing service to current customers. Rather, we find it is appropriate that these costs be shared by all customers that received service from PSI's generation facilities. Accordingly, this Commission finds that dismantlement costs are properly included in determining the depreciation rates approved in this cause.

We believe that there is a sound basis for the traditional approach on this issue that is utilized by a majority of states. Utilizing historical averages as an item to be expensed to current customers means that these customers will be paying for salvage costs at levels that may not be sufficient. That means that the next generation of customers will be paying for salvage costs related to facilities from which they may never have received service. The use of best estimates of future salvage costs addresses this inequity. Moreover, use of historical averages for dismantling costs does not take into account the current configuration of PSI's system with regard to its production, transmission, distribution and general facilities. Facilities in service 40-50 years ago did not take into account the significantly enhanced customer base that PSI now serves, nor the current configuration of PSI's facilities that serve these customers. It seems appropriate to utilize best cost estimates for net salvage values taking into account specific facilities now serving PSI's customers in developing depreciation rates that today's customers should pay. Accordingly, we find that the use of historical averages for net salvage values with regard to transmission, distribution and general plant for the purpose of expensing them outside the context of the depreciation determination should be, and hereby is, rejected.

Q. EARLIER YOU MENTIONED CASES IN WHICH THE KPSC DEALT WITH THIS ISSUE. PLEASE DISCUSS THESE CASES.

1 A. The Kentucky Public Service Commission has dealt with the net
2 salvage issue in several recent cases. Traditionally, the Commission
3 has allowed the incorporation of future net salvage in the
4 determination of annual depreciation accrual rates. In two cases
5 involving relatively small electric cooperatives (Jackson Energy
6 Cooperative Corp. and Fleming-Mason Energy Cooperative), the
7 Commission adopted a five-year average of historical net salvage
8 rather than such an allowance. In both of these cases, the utility did
9 not maintain records of net salvage on an account basis and was
10 unable to provide analyses of historical data in support of their
11 account by account estimates of net salvage percents. In the Fleming-
12 Mason proceeding, Case No. 2001-00244, the Commission stated:

13 While the Commission agrees that net salvage is
14 normally recovered as part of the depreciation rates,
15 the arguments offered by the AG are persuasive
16 reasons for supporting a departure in this case from
17 the normal approach. The Commission finds it
18 reasonable under the circumstances in this case to use
19 the average net salvage allowance approach proposed
20 by the AG. This approach should be utilized until (the
21 utility) undertakes a new depreciation study.
22

23 More recently, in cases involving Louisville Gas and Electric
24 Company and Kentucky Utilities Company, the Commission clearly
25 rejected the proposal of Mr. Majoros on behalf of the Attorney
26 General ("AG"). The Commission's statement in Case No. 2003-
27 00434, Kentucky Utilities Company, was as follows:

1 The AG's (Majoros') claim that KU likely would
2 never incur, or had no legal obligation to incur, the
3 included retirement costs is irrelevant. The real
4 question is whether it is reasonable to capitalize the
5 cost of removal in order to recover those costs over
6 the life of the investment. Capitalizing the cost of
7 removal is a common practice and it has been
8 accepted by this Commission for a number of years.
9 The AG has not presented sufficient evidence in this
10 case to persuade us to change this practice.

11
12 I concur with the Commission's conclusion regarding the alternative
13 method that he presented in the Kentucky Utilities case and recommend that
14 not only that method, but also the other three methods discussed by Mr.
15 Majoros, be rejected in this case as well.

X. SPECIFIC SERVICE LIFE AND NET SALVAGE ESTIMATES

16 **Q. WHAT ARE THE SPECIFIC ACCOUNTS FOR WHICH MR.**
17 **MAJOROS HAS ESTIMATED A SERVICE LIFE OR NET SALVAGE**
18 **PERCENT THAT IS DIFFERENT FROM YOUR ESTIMATE?**

19 **A.** Mr. Majoros has revised my estimates of service life for Accounts 2050,
20 Structures and Improvements; 2110, Liquefied Petroleum Gas Equipment;
21 2741, Rights of Way-General; 2761 Mains-Cast Iron, Copper, All Valves;
22 2763, Mains-Plastic; and 2801, Services – Cast Iron, Copper and Valves. He
23 also has revised my estimates of net salvage for all subaccounts of Account
24 276, Mains, and all subaccounts of Account 280, Services.

25 **Q. PLEASE DISCUSS THE SERVICE LIFE ESTIMATES FOR**
26 **ACCOUNTS 2050, STRUCTURES AND IMPROVEMENTS, AND**
27 **2110, LIQUEFIED PETROLEUM GAS EQUIPMENT.**

1 A. The structures and equipment in these two accounts represent peak shaving
2 facilities. The facilities are located at Erlanger Station and the storage cavern
3 that is 3.1 miles from Erlanger. The structures are pre-fabricated steel
4 buildings initially constructed in 1961. The equipment includes pumps,
5 vaporizers, compressors, boilers, tanks, cooling towers, piping and valves
6 used to transport, vaporize and mix propane for delivery to customers during
7 peak use periods. The equipment also was initially installed in 1961 and has
8 gone through numerous upgrades and replacements, particularly in the past
9 five years.

10 The statistical analyses of service life for these accounts are
11 indeterminate. Although the assets behave like a mass property, a historical
12 data for a single station does not generate sufficient retirement data for a
13 conclusive analysis. The interpretation of the results must be guided by the
14 experience of other utilities with similar properties and judgment. The
15 estimates of service life for structures of this nature that serve this function
16 range from 20 to 50 years. The estimates of service life for equipment of this
17 nature that serves this function range from 20 to 50 years as well.

18 Rather than consider such information, Mr. Majoros has simply
19 estimated the life that produces the best statistical fit to the data for the type
20 curve that I estimated. That is, I have estimated a 50-R4, at the upper end of
21 the typical range of lives for the structures. Mr. Majoros has instead selected
22 the 83-R4 because it is the R4 that best fits the data. Similarly, for the
23 equipment, I have estimated the 35-S1.5 at the midpoint of the typical range

1 of lives and Mr. Majoros selected the 59-S1.5 based on statistics. Mr.
2 Majoros' estimates suggest that these structures and equipment could live as
3 long as 120 years. This is patently unreasonable as are the average lives that
4 are well beyond the typical range of estimates for these accounts. These
5 facilities are subject to significant wear and tear with numerous start-ups and
6 shutdowns, deterioration, potential inadequacy, and obsolescence.

7 Mr. Majoros' estimates for Accounts 2050, Structures and
8 Improvements, and 2110, Liquefied Petroleum Gas Equipment, are
9 unreasonable under the circumstances and should be rejected.

10 **Q. PLEASE DISCUSS THE SERVICE LIFE ESTIMATE FOR**
11 **ACCOUNT 2741, RIGHTS OF WAY – GENERAL.**

12 A. The rights of way in this account relate to easements for certain distribution
13 mains. The statistical analysis for this account is also indeterminate with
14 insignificant information available beyond age 34. I have estimated the 65-
15 R4 and Mr. Majoros has increased the life to his maximum average life of
16 100 years, also with the R4 type curve. This suggests the use of certain rights
17 for a period of 150 years. The typical range of lives for this account is from
18 50 to 100 years.

19 The maximum life of the related mains should be considered in
20 arriving at a judgment for this account. The maximum life that I have
21 estimated for distribution mains is 98.6 years for Steel Mains (53 year
22 average life times maximum age percent of 186 for the R2 type curve). The
23 maximum life that I have estimated for the rights of way 97.5 (65 year

1 average life times maximum age percent of 150 for the R4 type curve)
2 conforms to this maximum life.

3 Mr. Majoros' estimate of 100 years is at the upper end of the typical
4 range for this account and produces a maximum life that is not consistent
5 with the maximum life of the related mains and should be rejected.

6 **Q. PLEASE DISCUSS THE SERVICE LIFE ESTIMATES FOR**
7 **ACCOUNTS 2761, MAINS – CAST IRON, COPPER AND ALL**
8 **VALVES, AND 2801, SERVICES – CAST IRON, COPPER AND**
9 **VALVES.**

10 A. These accounts are affected by the Company's Accelerated Main
11 Replacement Program ("AMRP"). I have incorporated the impacts of the
12 program by obtaining from the Company projections of the retirements
13 during the period 2005 through 2010 and developing original life tables that
14 include such retirements. The results are well defined life characteristics that
15 are described by the 41-R2.5 for mains and the 40-R1.5 for services. Mr.
16 Majoros has incorporated the impacts of the program more directly by
17 assigning a six-year remaining life to both of these subaccounts. The
18 remaining life used by Mr. Majoros is less than the remaining life that I have
19 calculated from the survivor curves of approximately 14-16 years. My
20 remaining lives reflect the fact that not all of the plant in these accounts will
21 be retired as a result of the replacement program. Although shorter than
22 necessary, I have no objection to the remaining life recommendation of Mr.
23 Majoros for these accounts. The use of a shorter remaining life will help to

1 offset the concerns that I have expressed regarding inadequate accruals for
2 negative net salvage.

3 **Q. PLEASE DISCUSS THE SERVICE LIFE ESTIMATE FOR**
4 **ACCOUNT 2763, MAINS – PLASTIC.**

5 A. Plastic mains have been installed on ULH&P's system for 40 years.
6 However, significant amounts of plastic were not installed until 1970, 35
7 years ago. Although the statistical analyses of retirements is not definitive of
8 life characteristics, the rates of retirement through age 35 for this group are
9 very similar to the rates of retirement through age 35 for Account 2762,
10 Mains – Steel. This is logical. The primary causes of retirement for mains,
11 particularly prior to average life, are the same regardless of the material type.
12 These causes include inadequacy, changes in demand, and the requirements
13 of other parties. Typical estimates for plastic mains range from 50 to 60
14 years. The life characteristics of plastic mains beyond age 35 are not known.
15 Some have expressed concern regarding potential brittleness.

16 Mr. Majoros has once again relied entirely on statistics rather than use
17 them with common sense. His 70-R1.5 projects an average life that is twice
18 the oldest significant survivor for this account and a maximum life of 140
19 years. These are both unreasonably long. Given the similarity of the
20 significant portion of the original life table for plastic mains to that of steel
21 mains through age 35 and the typical range of estimates for plastic mains, a
22 life similar to that of ULH&P's steel mains for which Mr. Majoros and I both
23 use the 53-R2 is appropriate. The 50-R2 that I have estimated for plastic

1 mains is similar to the estimate for steel mains and projects a more reasonable
2 maximum life. Mr. Majoros' estimate of 70-R1.5 should be rejected.

3 **Q. PLEASE DISCUSS THE NET SALVAGE ESTIMATE FOR**
4 **ACCOUNT 276, MAINS.**

5 A. I have estimated negative 20 % net salvage for each of the subaccounts of
6 mains as compared to an estimate of negative 5 % made by Mr. Majoros for
7 steel and plastic mains and an estimate of zero percent for cast iron, copper,
8 etc. mains. The historical net salvage data are only available at the account
9 level. This is not really an issue as the costs of retiring mains and gross
10 salvage do not vary with the type material.

11 Mr. Majoros states that he has based his estimate of negative 5 % on
12 the average net salvage for the period 1980-2003 and as a "surrogate for
13 stating the net present value for this account at its net present value." The use
14 of the overall average ignores the trends in both the cost of retiring mains and
15 the gross salvage recorded for mains. The average cost of retiring for the
16 period 1980-2003 is 34 %. This level of removal cost includes a number of
17 years with very significant costs of retiring. More recent experience, the
18 period 1999-2003, has averaged only 20 %. The genesis of the high
19 retirement costs was high disposal costs for mains with gas liquids. More
20 recently, mains have been capped and abandoned in place, eliminating the
21 disposal costs.

22 The average gross salvage for the period 1980-2003 is 29 %. This
23 level of gross salvage includes years during which mains were inserted into

1 old mains and a portion of the old main was considered as reuse salvage and
2 capitalized with the new main. The increased use of horizontal directional
3 drilling rather than insertions has eliminated this source of gross salvage.
4 Thus, the average of nearly zero percent as experienced during the most
5 recent five-year period is more representative of the future net salvage.

6 Mr. Majoros endeavors to support his estimate as being a surrogate
7 for a net present value approach. For all the reasons cited above, the use of
8 net present value is unreasonable and should not be considered as a factor in
9 support of his judgment. Further, Mr. Majoros' use of the overall average is
10 inappropriate when the circumstances underlying the statistics are reviewed
11 and considered. The most recent five-year average of negative 20 % is a
12 more reasonable estimate of future net salvage and should be adopted by the
13 Commission.

14 **Q. IS MR. MAJOROS USE OF ZERO PERCENT NET SALVAGE FOR**
15 **BOTH THE MAINS AND SERVICES THAT ARE THE SUBJECT OF**
16 **THE AMRP REASONABLE?**

17 A. No, it is not. Mr. Majoros provides three reasons for using zero percent for
18 these two groups. First, the cost of removal is a small proportion of the
19 overall replacement expenditures, i.e., just charge all the costs of replacement
20 to installation. It may be true that the cost of retiring these assets is a small
21 part of the overall replacement cost, but it is no reason to ignore the Uniform
22 System of Accounts, regulatory precedents in this jurisdiction, and
23 considerations of customer equity. The cost of retiring these mains is a part

1 of their service value and should be recovered during their service lives.
2 Second, it is not clear to Mr. Majoros that the net salvage in the historical
3 analyses relates to these types of assets. The underlying data make it clear
4 that the retirements of the mains and services in Accounts 2761 and 2801 are
5 well represented in the historical analyses for the period 1980-2003. Thirty-
6 eight percent of the mains and 25 % of the services retirements for the overall
7 account on a dollar basis represent retirements of the mains and services that
8 are the subject of this program. Finally, Mr. Majoros understates the future
9 cost of retiring simply because the Accumulated Provision for Depreciation
10 for these groups exceeds the calculated or theoretical reserve. This makes no
11 sense at all. The remaining life rate is already reducing the accrual rate to
12 reflect this fortuitous condition and Mr. Majoros justifies the use of zero
13 percent net salvage by a desire to reduce it even further. None of his reasons
14 merit consideration. The net salvage estimate for these mains and services
15 should be the same as it is for the steel and plastic mains and services.

16 **Q. PLEASE DISCUSS THE NET SALVAGE ESTIMATE FOR**
17 **ACCOUNT 280, SERVICES.**

18 A. I have estimated negative 35 %net salvage for each of the subaccounts of
19 services as compared to an estimate of negative 5 % made by Mr. Majoros for
20 steel and plastic services and an estimate of zero percent for cast iron, copper,
21 etc. services. The historical net salvage data are only available at the account
22 level. This is not really an issue as the costs of retiring services and gross
23 salvage do not vary with the type material.

1 Mr. Majoros has arbitrarily adjusted the historical indication of
2 negative 35 % as a result of the response of Mr. Gary Hebbeler regarding the
3 current policy of not charging any cost of retiring to services during a
4 replacement project. The cost of retiring abandoned services continues to be
5 recorded as removal cost against services. What Mr. Majoros has chosen to
6 ignore is that the costs previously allocated as the cost of retiring services is
7 now considered the cost of retiring mains.

8 In contrast, I continued to use the historical indication of negative 35
9 % for this account. The impact of the new policy on the net salvage percents
10 for mains and services is difficult to quantify at this point. What we know is
11 that the cost of retiring services will decrease and the cost of retiring mains
12 will increase. In my opinion, it is more appropriate to continue with the
13 historical indications for both of these accounts until the new levels of net
14 salvage are apparent. Once they are known, the estimates can be adjusted
15 accordingly. In the meantime, the overall amount being accrued for net
16 salvage remains appropriate. Mr. Majoros' arbitrary reduction to one of the
17 affected accounts should be rejected.

XI. CALCULATION OF ANNUAL DEPRECIATION RATES

18 **Q. ON PAGE 7, MR. MAJOROS STATES THAT HE "...IS NOT**
19 **ACCEPTING ELG IN THIS PROCEEDING" AND RECOMMENDS**
20 **"THAT THE KPSC NOT CONSIDER ULH&P'S USE OF ELG TO BE**
21 **ESTABLISHED AS A PRECEDENT." PLEASE COMMENT.**

1 A. I used the Equal Life Group ("ELG") procedure in this proceeding and also in
2 the last depreciation study that I prepared for ULH&P. It is the basis for
3 ULH&P's currently authorized depreciation rates. I have compared and
4 explained the ELG procedure and the Average Service Life ("ASL" or
5 "ALG") procedure on pages II-29 through II-33 of my depreciation study
6 report. Depreciation expense based on the ELG procedure results is a better
7 match with the loss in service value of assets. It should be retained for
8 ULH&P.

9 **Q. ON PAGES 37 AND 38 OF HIS DIRECT TESTIMONY, MR.**
10 **MAJOROS RECOMMENDS THE ESTABLISHMENT OF**
11 **SEPARATE DEPRECIATION RATES FOR THE RECOVERY OF**
12 **ORIGINAL COST AND THE RECOVERY OF NET SALVAGE. IS**
13 **THIS NECESSARY?**

A. No, it is not. Further, Mr. Majoros was kind enough to remind the
Commission of its determination in the Kentucky Utilities Company case in
which he made the same recommendation. In that proceeding, the
Commission agreed with the Federal Energy Regulatory Commission's Order
No. 631 which does not require such a separation. ULH&P maintains the
necessary subsidiary records. Separation of the depreciation rates is not
necessary.

XII. SUMMARY AND CONCLUSION

14 **Q. PLEASE SUMMARIZE YOUR REBUTTAL TESTIMONY.**

1 A. The service life and net salvage proposals of Mr. Majoros should be rejected.
2 Mr. Majoros' attempt to impose his concepts of depreciation as influenced
3 by financial accounting standards through the back door rather than the
4 continuation of this Commission's sound ratemaking policies is
5 unreasonable. Depreciation, including both the original cost and net salvage,
6 should be recognized ratably during the life of the related asset. Expensing
7 net salvage after the related asset is retired conflicts with the regulatory
8 principle of intergenerational equity. The other three alternatives proposed by
9 Mr. Majoros also should be rejected. None of the alternatives provides for
10 both complete capital recovery and intergenerational equity.

11 The traditional approach to estimating future net salvage used by
12 ULH&P is appropriate and results in estimates of net salvage that actually
13 may understate future net salvage costs. The regulatory liability recorded on
14 ULH&P's financial statements is the amount of past accruals toward future
15 net salvage. There is no need for special recognition of such amounts as they
16 are reflected in the Accumulated Provision for Depreciation balance that is
17 used in the determination of both rate base and annual depreciation accrual
18 rates. The potential disposition of such amounts as suggested by Mr. Majoros
19 would be the subject of regulatory proceedings in the event that ULH&P's
20 delivery business was deregulated.

21 The estimates of service life and net salvage of Mr. Majoros are the
22 result of a slavish adherence to the statistics in some cases, an unwillingness
23 to consider the circumstances that produced the data in other cases, and

1 arbitrary adjustments of the statistics in yet others. The estimation of service
2 life and net salvage requires judgment that considers appropriate factors as I
3 have described above. Mr. Majoros' estimates do not properly incorporate
4 such factors and should be rejected.

5 The depreciation rates proposed by ULH&P should be adopted.

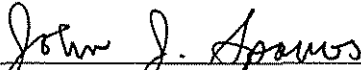
6 **Q. DOES THIS CONCLUDE YOUR PRE-FILED REBUTTAL**
7 **TESTIMONY?**

8 A. Yes.

VERIFICATION


State of Pennsylvania)
) SS:
County of Cumberland)

The undersigned, John J. Spanos, being duly sworn, deposes and says that he is a Vice President associated with the firm of Gannett Fleming, Inc., and that he has personal knowledge of the matters set forth in the foregoing testimony, and that the answers contained therein are true and correct to the best of his information, knowledge and belief.



John J. Spanos, Affiant

Subscribed and sworn to before me by John J. Spanos on this 15th day of July, 2005.



NOTARY PUBLIC

My Commission Expires:

