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Ms. Stephanie L. Stumbo
Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
Frankfort, KY 40602

E.ON U.S. LLC
State Regulation and Rates
220 West Main Street
PO Box 32010
Louisville, Kentucky 40232
www.eon-us.com

Robert M. Conroy
Director - Rates
T 502-627-3324
F 502-627-3213
robert.conroy@eon-us.com

July 11, 2008

RE: Application of Louisville Gas and Electric Company to File
Depreciation Study – Case No. 2007-00564

Application of Kentucky Utilities Company to File Depreciation Study
– Case No. 2007-00565

Dear Ms. Stumbo:

Enclosed please find and accept for filing two originals and ten (10) copies of the Joint Rebuttal Testimony of John J. Spanos on behalf of Louisville Gas and Electric Company and Kentucky Utilities Company in the above-referenced matters.

Should you have any questions concerning the enclosed, please do not hesitate to contact me.

Sincerely,

Robert M. Conroy

Enclosures

cc: Parties of Record

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND)	
ELECTRIC COMPANY TO FILE)	CASE NO. 2007-00564
DEPRECIATION STUDY)	

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES)	
COMPANY TO FILE DEPRECIATION)	CASE NO. 2007-00565
STUDY)	

JOINT REBUTTAL TESTIMONY OF
JOHN J. SPANOS

ON BEHALF OF
LOUISVILLE GAS AND ELECTRIC COMPANY
KENTUCKY UTILITIES COMPANY

Filed: July 11, 2008

1 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

2

3 A. My name is John J. Spanos. My business address is 207 Senate Avenue, Camp Hill,
4 Pennsylvania.

5 **Q. HAVE YOU PREVIOUSLY SUBMITTED TESTIMONY IN THIS**
6 **PROCEEDING?**

7 A. Yes. My pre-filed testimony was submitted for both companies on December 28,
8 2007.

9 **Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?**

10 A. The purpose of this testimony is to rebut the pre-filed direct testimony of Attorney
11 General Witness, Mr. Michael J. Majoros, Jr.

12 **Q. WHAT IS THE SUBJECT OF YOUR REBUTTAL TESTIMONY?**

13 A. The subject of my rebuttal testimony is the use of the Equal Life Group (ELG)
14 procedure in calculating depreciation accrual rates for all asset classes for Louisville
15 Gas and Electric Company and Kentucky Utilities Company. I will also address Mr.
16 Majoros's discussion related to cost of removal.

17 **Q. CAN YOU EXPLAIN WHY YOU HAVE PROPOSED DEPRECIATION**
18 **RATES UTILIZING THE EQUAL LIFE GROUP PROCEDURE?**

19 A. The equal life group procedure is the most accurate procedure for matching capital
20 recovery to utilization or consumption of the assets which is one of the major
21 objectives of a depreciation rate.

22 **Q. PLEASE DESCRIBE THE EQUAL LIFE GROUP PROCEDURE.**

23 A. In the Equal Life Group (ELG) procedure, the property group or account is
24 subdivided into groups of equal life based on the estimated survivor characteristics of

1 the account. The depreciation for each equal life group is based on the straight line
2 method, that is, an equal amount of the group's service value is recorded as
3 depreciation in each year of service. The total depreciation for the account is the
4 summation of the depreciation for each equal life group. For this reason, this
5 procedure is also known as the unit summation procedure.

6 **Q. CAN YOU SHOW IN A SIMPLE EXAMPLE HOW THE EQUAL LIFE**
7 **GROUP PROCEDURE COMPARES TO THE AVERAGE SERVICE LIFE**
8 **PROCEDURE?**

9 A. I will use a two unit example to show how the equal life group (ELG) procedure more
10 appropriately matches recovery to consumption. Each unit costs \$1,000. Unit A will
11 be in service for 5 years and Unit B will be in service for 15 years. There is no net
12 salvage anticipated for these units.

13 If depreciation is determined using the Average Service Life (ASL)
14 Procedure, then it would be determined that the average service life for the two units
15 is 10 years $((5 + 15)/2)$ and the depreciation rate is 10% $(1/10 \text{ years})$. Therefore, the
16 total account original cost is \$2,000 and the annual depreciation amount is \$200
17 $(\$2,000 \text{ times } 10\%)$. At the end of year 5, the total annual accrual for the account is
18 \$1,000 $(200 \text{ times } 5)$. Also affecting the accumulated depreciation is the retirement
19 of Unit A for \$1,000. Thus, the accumulated depreciation for the account at the end
20 of year 5 is zero $(\$1,000 \text{ annual accruals minus } \$1,000 \text{ retirements})$. At the beginning
21 of year 6, we have \$1,000 of original cost, an accumulated depreciation level of \$0
22 and one unit that has one-third of its service life expired. With the average service
23 life procedure, the 10% rate or \$100 of annual expense is booked for years 6 through

1 15 and at the end of year 15 we retire Unit B. We collected \$1,000 in annual accruals
2 during years 6 through 15 and made a retirement of \$1,000 at year 15, so our original
3 cost and accumulated depreciation are both zero, so full recovery was achieved.
4 However, if we focus on the end of year 5, we had one unit remaining with two-thirds
5 of its life expectancy still to be consumed, but 100% of the investment to be
6 recovered. This method did not match recovery to consumption in the most
7 appropriate manner.

8 In contrast, if depreciation is determined using the equal life group (ELG)
9 procedure, then the depreciation expense would be recorded quite differently. I will
10 use the same two unit example to illustrate the ELG calculation. Unit A will be in
11 service for 5 years, therefore it will have a 20% (100 divided by 5 years) rate. Unit B
12 will be in service for 15 years, and will have a 6.67% (100 divided by 15 years) rate.
13 Consequently, depreciation expense for years 1 through 5 would be \$200 (\$1,000
14 times 20%) for Unit A and \$66.67 (\$1,000 times 6.67%) for Unit B. At the end of
15 year 5, the total annual accruals would be approximately \$1,334 (\$1,000 for Unit A
16 and \$334 for Unit B). Unit A would be retired at the end of year 5, so the
17 accumulated depreciation at the end of year 5 is \$334 (\$1,334 of annual accruals
18 minus \$1,000 retirement). In years 6 through 15, the annual accruals would be
19 \$66.67 for a total to \$666 for the 10-year period. Thus, at the end of year 15, the
20 accumulated depreciation is \$0 (\$1,000 of accruals minus the \$1,000 retirement of
21 Unit B), so full recovery was once again achieved. However, if we look back at the
22 end of year 5, we can see recovery of Unit A matched consumption of Unit A at the
23 time the unit went out of service, and more importantly Unit B has survived one-third

1 of its expected life and recovery was one-third (334/1000) of the expected recovery.

2 A much more appropriate recovery pattern is recorded using the ELG procedure.

3 This two unit example is used to understand the recovery patterns of the two
4 procedures; however, there are many historical transactions that affect the rate of each
5 of these procedures that complicates the depreciation rate for each account. The
6 following table sets forth the activity for the accumulated depreciation using the two
7 methodologies.

COMPARISON OF ACCUMULATED DEPRECIATION
AND ANNUAL ACCRUALS USING THE
ASL VS ELG PROCEDURES

Year	ASL				ELG		
	Plant Balance	Annual* Accruals	Retirements	Accum. Depr. Balance	Annual** Accruals	Retirements	Accum. Depr. Balance
1	2,000	200	0	200	267	0	267
2	2,000	200	0	400	267	0	534
3	2,000	200	0	600	266	0	800
4	2,000	200	0	800	267	0	1,067
5	2,000	200	1,000	0	267	1,000	334
6	1,000	100	0	100	66	0	400
7	1,000	100	0	200	67	0	467
8	1,000	100	0	300	67	0	534
9	1,000	100	0	400	66	0	600
10	1,000	100	0	500	67	0	667
11	1,000	100	0	600	67	0	734
12	1,000	100	0	700	66	0	800
13	1,000	100	0	800	67	0	867
14	1,000	100	0	900	67	0	934
15	1,000	100	1,000	0	66	1,000	0

* Annual Accruals = Plant Balance Multiplied by Rate (10%)

** Annual Accruals = Plant Balance Multiplied by Rate for Each Unit

8 **Q. IS THE ELG PROCEDURE MORE COMPLEX TO UNDERSTAND?**

1 A. Yes, it can be characterized as a more complex procedure; however, with the use of
2 computers today, the annual calculations are not difficult to compute as shown by the
3 two unit example. Furthermore, both procedures are straight-line, however, the ELG
4 procedure calculates straight-line of each unit by vintage while the ASL procedure
5 calculates straight-line regardless of age. Both procedures assure full recovery, no
6 more, no less, but ELG is a better match of recovery to consumption than the ASL
7 procedure.

8 **Q. THROUGHOUT MUCH OF HIS TESTIMONY MR. MAJOROS IS**
9 **CRITICAL OF THE ELG PROCEDURE. CAN YOU EXPLAIN?**

10 A. As described previously in this testimony, both the ASL and ELG procedure fully
11 recover the capital investment in a rational manner. However, in my opinion, the
12 ELG procedure is the superior procedure. The most appropriate depreciation study
13 should utilize the procedure that best matches future recovery plans of the Company
14 while not unfairly burdening ratepayers. Consequently, I often recommend the ELG
15 procedure when conducting depreciation studies, as has been the case in other
16 Kentucky proceedings such as Union Light, Heat and Power Company.

17 **Q. ON PAGE 8 OF HIS TESTIMONY, MR. MAJOROS DISCUSSES**
18 **RETROACTIVE VERSUS GOING FORWARD IMPLEMENTATION OF**
19 **THE ELG PROCEDURE. DO YOU THINK RETROACTIVE**
20 **IMPLEMENTATION IS WRONG?**

21 A. No, I do not. In either my study or Mr. Majoros's ASL presentation, the same
22 amount of future accruals and a remaining life basis for determining the annual
23 depreciation expense in this proceeding, are used. Since the amount of future

1 accruals related to this topic is the same whether the ELG or ASL procedures are used
2 for embedded plant, as reflected in the fact that the future accruals are the same, there
3 can be no retroactive implementation. The future accruals are determined by
4 subtracting the actual book reserve from the original cost, so past recovery is not a
5 variable based on depreciation procedure.

6 The issue in this proceeding is the grouping of the future accruals. The future
7 accruals can be segregated into groups of equal life or can remain as a single amount
8 at the property group level. The use of the ELG procedure will permit the recovery of
9 future accruals related to each item over its actual remaining life rather than the use of
10 averages with the future accruals for the entire account.

11 **Q. IF THE ELG PROCEDURE IS SUPERIOR TO THE ASL PROCEDURE IN**
12 **MATCHING DEPRECIATION EXPENSE WITH THE LIFE OF THE**
13 **ASSETS, WHY WAS THE ASL METHOD ONCE COMMONLY USED IN**
14 **DEPRECIATION STUDIES?**

15 A. Although the ELG or unit summation procedure has been known to experts for many
16 years (it was described by Robley Winfrey, well-known expert in depreciation issues,
17 as the only mathematically correct procedure in 1942), its widespread use was
18 constrained by the large amount of computations required. However, the ASL
19 procedure could readily be performed without the aid of computers and became the
20 choice of experts by default. With the advent of modern computer equipment, this
21 constraint has been removed. Therefore, the ELG procedure, which is unquestionably
22 more accurate, is now available to all companies.

1 **Q. ARE THERE REGULATORY PRECEDENTS FOR THE USE OF THE ELG**
2 **PROCEDURE FOR ALL VINTAGES OF A UTILITY'S PROPERTY?**

3 A. Yes, there are. The ELG procedure has been accepted by the Kentucky Public
4 Service Commission (KPSC or the Commission) and other state and federal
5 commissions. The Federal Communication Commission (FCC) accepts ELG for all
6 telephone utilities and state commissions such as Indiana and Pennsylvania, to name a
7 few, accept ELG for all utilities.

8 **Q. WHAT IS YOUR CONCLUSION WITH RESPECT TO THE USE OF THE**
9 **ELG PROCEDURE FOR ALL VINTAGES OF UTILITY PLANT FOR BOTH**
10 **LOUISVILLE GAS AND ELECTRIC COMPANY AND KENTUCKY**
11 **UTILITIES COMPANY?**

12 A. The ELG procedure provides a better match of depreciation expense with the
13 consumption of an asset's service value. This characteristic has previously been
14 recognized by this Commission in prior proceedings. The improved matching exists
15 whether the procedure is implemented during or at the beginning of an asset's service
16 life. Implementation of ELG during the life of an asset does not constitute retroactive
17 ratemaking. The future accruals are the same whether the ELG or ASL procedure is
18 used. The ELG procedure simply improves the future matching of expense and
19 consumption of service value and should be adopted in this proceeding in the manner
20 that I have proposed. Mr. Majoros's proposal of the Average Service Life Procedure
21 or adoption of the ELG procedure on a going forward basis should not be accepted.

22 **NET SALVAGE FOR ACCOUNTS**

23 **Q. WHAT ARE NET SALVAGE AND NEGATIVE NET SALVAGE?**

1 A. Net salvage is the gross salvage value of retired property less the cost of removal of
2 such property. If cost of removal exceeds salvage value, the net salvage is negative,
3 hence, negative net salvage.

4 **Q. IN THE DIRECT TESTIMONY OF MR. MAJOROS, WHAT HAS HE**
5 **PROPOSED AS A RATEMAKING ALLOWANCE FOR NET SALVAGE?**

6 A. He has proposed a radical change in the basis for determining the Companies'
7 allowance for net salvage for all accounts for both Louisville Gas and Electric
8 Company and Kentucky Utilities Company. His proposal is that net salvage should
9 be discounted to a present value level for determining the calculation of depreciation.

10 **Q. HAS MR. MAJOROS CONSISTENTLY MADE THIS PROPOSAL FOR**
11 **CHANGING NET SALVAGE PERCENTS FROM THOSE PROPOSED BY**
12 **MR. SPANOS?**

13 A. No, he has not. Mr. Majoros continually makes different proposals to adjust net
14 salvage percents, seemingly with the single motive of reducing depreciation expense
15 not just proper recovery. As can be seen in past cases in Kentucky alone, he switches
16 from the cash basis proposal to the present value proposal to a normalization
17 proposal. None of these proposals are designed to accomplish the definition of
18 depreciation which is recovery of the full service value of the assets during the life of
19 the asset in a rational manner which is the basis of Mr. Spanos' traditional proposal.
20 Depreciation is not intended to be a result oriented calculation, yet Mr. Majoros
21 continually changes his approaches in order to reduce depreciation.

22 **Q. DO AUTHORITATIVE TEXTS ON DEPRECIATION SUPPORT YOUR**
23 **PROPOSAL RELATED TO NET SALVAGE?**

1 A. All authoritative texts on the subject of depreciation support my proposal to accrue
2 for net salvage in the traditional manner presented in my study. The two depreciation
3 texts most often cited by depreciation experts as authoritative support the traditional
4 approach that I have proposed. Public Utility Depreciation Practices, published in
5 1996 by the National Association of Regulatory Utility Commissioners states:

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

13 Depreciation Systems, another widely accepted text states the concept in this manner:

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

19 **Q. WHAT TREATMENT OF NET SALVAGE DO YOU PROPOSE?**

20 A. I propose, consistent with the authoritative texts and the policy of the very large
21 majority of regulatory commissions, the traditional incorporation of net salvage in the
22 determination of depreciation. The traditional approach has been used by this
23 Commission in establishing the Companies' ratemaking allowances for depreciation
24 for decades. The traditional approach collects net salvage costs ratably over the life
25 of plant from the customers served by the plant. This approach is equitable and
26 conforms to the definition of depreciation as the loss in service value, where service
27 value is the difference between original cost and net salvage.

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 **Q. YOU STATED THAT IT IS MORE APPROPRIATE AND EQUITABLE TO**
2 **RECOGNIZE NET SALVAGE COSTS DURING THE LIFE OF THE**
3 **RELATED PLANT. PLEASE EXPLAIN.**

4 A. The net salvage cost of an item of plant is a part of its service value and, therefore, it
5 is a part of the item's cost of providing service. The cost of the item providing
6 service should be collected from the customers that receive the service. Thus, an
7 allocable portion of the net salvage cost should be recovered each year from the
8 customers receiving the value of the service rendered by the item of plant in the same
9 way that an allocable portion of the item's original cost is recovered from such
10 customers each year. This approach is equitable in that customers are responsible for
11 the costs of plant that provide service to them. This is a sound ratemaking principle.
12 This concept does not state anywhere that there is a need to also discount to present
13 value the future recovery because the results are too high.

14 **Q. PLEASE ILLUSTRATE THIS PRINCIPLE AS IT APPLIES TO NET**
15 **SALVAGE COSTS WITH A SIMPLE EXAMPLE.**

16 A. Consider a single customer, Customer A, served by a section of distribution pole line
17 that does not provide service to other customers. The original cost of the pole line is
18 \$5,000 and it is installed when the customer is added to the system. The estimated
19 life of the pole line is 50 years and the estimated net salvage is negative 60 percent.
20 The annual depreciation expense to be recovered from this customer using the straight
21 line whole life accrual of net salvage is \$160 per year ($\$5,000 \times 1.60 / 50$ years). The
22 annual depreciation expense to be recovered from this customer using Mr. Majoros's
23 present value approach of net salvage is \$112 per year ($\$5,000 \times 1.12 / 50$ years).

1 (The 12% is extracted from Exhibit MJM-2, page 15 of 18 for Account 364.)

2 In year 30, the customer moves out and another customer, Customer B, moves
3 into the residence served by this pole line. During the 30 years, a total of \$4,800
4 (\$160 x 30 years) was collected from the Customer A under the straight line whole
5 life accrual of net salvage. Only \$3,360 (\$112 x 30 years) would be collected under
6 the present value method.

7 At the end of year 50, the pole line is replaced at a total cost of \$8,000, \$3,000
8 to remove the old pole line and \$5,000 to install the new pole line. (I have excluded
9 inflation from the example to promote a better understanding of the principle.) Under
10 the straight line whole life accrual method, the depreciation expense in year 50 would
11 continue at \$160 ($\$5,000 \times 1.60 / 50$ years). Under the present value method, the sum
12 of the depreciation collected would be \$5,600 ($\112×50 years), however, the total
13 cost would have been \$8,000. Thus, the present value approach recovers a portion of
14 the service value of the asset, but did not accomplish full recovery of the total service
15 value. Therefore, using the remaining life technique, Customer B would actually pay
16 the difference in rates between the \$5,600 of accruals and the \$8,000 of actual
17 expenditures. This is not equitable between customers.

18 This example is obviously simplified and excludes inflation, but it does not
19 change the fact that Mr. Majoros's approach will not give full recovery of the service
20 value of each asset. In this example, it is undeniable that \$8,000 is the cost to the
21 utility for this pole line, which should be recovered in depreciation expense. Unlike
22 Mr. Majoros's approach, the traditional approach, which I recommend and which is
23 used exclusively by almost all regulatory bodies, provides full recovery of the service

1 value of the asset.

2 **Q. DOES THIS SIMPLE EXAMPLE REALLY APPLY OVER TIME GIVEN**
3 **THE EXISTENCE OF INFLATION AND SERVICE BEING PROVIDED TO**
4 **MANY CUSTOMERS, NOT ONE CUSTOMER?**

5 A. Yes, it does. Although the addition of customers and the introduction of inflation into
6 the simple example described above make it complex, the principle that is illustrated
7 remains the same. The real system is only the summation of many, many instances
8 that are identical to the illustration.

9 **Q. WHAT WERE THE STATISTICAL BASES FOR YOUR NET SALVAGE**
10 **ESTIMATES?**

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

14 **Q. DOES THE USE OF THESE STATISTICAL BASES RESULT IN THE**
15 **COLLECTION OF FUTURE INFLATED REMOVAL COSTS FROM**
16 **CURRENT CUSTOMERS?**

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

22 **Q. HOW DOES USE OF NET SALVAGE PERCENTS THAT ARE**
23 **COMPARABLE TO THE HISTORICAL INDICATIONS ASSUME THESE**

1 **EVENTS?**

2 A. The net salvage percents, which are the net salvage costs divided by the original costs
3 of the assets that have been retired and expressed as percents, are related to the
4 retirement of plant that on average is significantly younger than the average service
5 life of the plant in service, on an original cost dollar weighted basis. For example, the
6 average age of retirements of distribution poles during the most recent 20 years,
7 1988-2007, is approximately 30 years. This is less than the average life of 50 years
8 estimated for this account.

9 The average net salvage percent related to these retirements, made on average
10 at age 30, was negative 60 percent. That is, after 30 years in service, the plant was
11 retired and the cost to remove the plant, as a result of inflation, technological changes
12 and other factors, was 60 percent of the cost to install the same plant.

13 The future retirements of the total current distribution poles in service will
14 have an average age that actually exceeds the average life. Thus, future retirements
15 will be of plant that has been in service nearly one and one-half times as long as the
16 plant retired during the period 1988-2007. For retirements at such ages to experience
17 net salvage that is 60 percent of the cost to install, there will have to be a reduction in
18 the rate of inflation adjusted for technological improvements. If the rate of inflation
19 adjusted for technological improvements that occurred between the installation and
20 retirement of plant retired during the period 1988-2007 occurred over a period that is
21 one and one-half times as long, the net salvage cost would be much greater as a
22 percent of the original cost of the plant retired.

23 **Q. WHAT IS THE IMPLICATION OF THE ASSUMPTION THAT THE**

1 **FUTURE RATE OF INFLATION ADJUSTED FOR TECHNOLOGICAL**
2 **IMPROVE-MENTS WILL BE LESS THAN THE HISTORICAL RATE?**

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

6 **Q. DO YOU HAVE ANY CONCERN THAT THE LEVEL OF NET SALVAGE**
7 **COSTS INCURRED WILL BE LESS THAN THE AMOUNTS THAT YOU**
8 **HAVE ESTIMATED?**

9 A. No, I do not. Net salvage costs will be incurred. The estimates that I have made will
10 almost certainly result in the recovery of less, not more, net salvage than the actual
11 costs incurred.

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

15 A. Yes, it is. The future cost to remove an item of plant is part of the service value that it
16 renders to current customers and a ratable portion of such costs should be recovered
17 from these customers. That is the theory of depreciation, i.e., the loss in service value
18 during a specific period. As these future costs are recovered from current customers,
19 they are deducted from rate base. This deduction in the amount on which the utility is
20 entitled to earn a fair return, in effect, represents an amount on which the customer
21 earns a return or otherwise stated the utility reduces its requirement for return. That
22 is, as customers provide for the future cost of removal, they receive a return on such
23 amounts because less rate base is required. This is fair compensation for making

1 payment prior to the cost incurrence by the utility. Further, as already noted, by
2 charging customers for these costs during the life of the plant; the customers that
3 benefit from the plant, or consume its service value, are the ones who pay for such
4 service. Customers paying today for future costs of removal and receiving a return on
5 such payments is no different than the utility recovering today amounts that it
6 invested many years ago, but on which it earned a return until the amount was
7 recovered from customers.

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

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

15 **Q. IS IT APPROPRIATE FOR LOUISVILLE GAS AND ELECTRIC COMPANY**
16 **AND KENTUCKY UTILITIES COMPANY TO COLLECT AMOUNTS FOR**
17 **FUTURE NET SALVAGE COSTS THAT ARE GREATER THAN THE**
18 **AMOUNTS CURRENTLY EXPENDED FOR SUCH COSTS?**

19 A. Yes, it is. Although the amount that the study proposes to collect from customers for
20 future net salvage costs is greater than the amount currently expended for such costs,
21 the amount that both companies spend for plant additions is far greater than the
22 amount that it proposes for the recovery of original cost. If net salvage accruals
23 should be limited to discounted net salvage expenditures, then full recovery will not

1 be achieved during the life of an asset. Thus, the amount for recovery of costs is far
2 less than actual expenditures. Equity considerations require that customers pay for
3 the service value, original cost less net salvage, of the plant from which they receive
4 service. The fact that this results in accruals for net salvage that are greater than the
5 current experience is not inappropriate.

6 **Q. PLEASE SUMMARIZE YOUR TESTIMONY RELATED TO NET SALVAGE.**

7 A. The portion of the annual depreciation accrual rates and amounts proposed by the
8 Companies in this proceeding that is related to net salvage is reasonable and in accord
9 with sound ratemaking principles. Depreciation is the loss in service value and
10 service value is the difference between original cost and net salvage value. Thus, net
11 salvage should be a part of the straight line whole life depreciation accrual.

12 Net salvage costs should be recovered from customers served by the plant that
13 results in the expenditure of net salvage costs. The use of a straight line whole life
14 accrual over the life of the asset accomplishes this equity. The present value net
15 salvage approach does not. It is appropriate for the net salvage accrual to exceed the
16 current net salvage cost during a period of system growth and prior to reaching a
17 steady state for the plant.

18 The estimates of net salvage percents used in developing the net salvage
19 accrual are very reasonable and likely understate the future net salvage costs that will
20 occur. Almost every state, including Kentucky, uses the traditional approach of
21 straight line whole life or remaining life accrual of net salvage during the life of the
22 asset, as I have recommended. Considerations of customer equity with regard to the
23 matching of depreciation expense with the consumption of service value should

1 control. The proposal to discount net salvage costs should be rejected and the
2 traditional approach of accruing for such costs during the life of the related asset
3 should be retained.

4 **Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

5 A. Yes, it does.

VERIFICATION

COMMONWEALTH OF PENNSYLVANIA)
) SS:
COUNTY OF CUMBERLAND)

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

John J. Spanos

JOHN J. SPANOS

Subscribed and sworn to before me, a Notary Public in and before said County and State, this 10th day of July, 2008.

[Signature] (SEAL)

Notary Public

My Commission Expires:

February 20, 2011

COMMONWEALTH OF PENNSYLVANIA
Notarial Seal
Cheryl Ann Rutter, Notary Public
East Pennsboro Twp., Cumberland County
My Commission Expires Feb. 20, 2011
Member, Pennsylvania Association of Notaries