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Witness:	R. Lawrence Sherwin
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MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. GR-99-315

SUPPLEMENTAL DIRECT TESTIMONY

OF

R. LAWRENCE SHERWIN

ON

BEHALF OF

LACLEDE GAS COMPANY

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SUPPLEMENTAL DIRECT TESTIMONY
OF
R. LAWRENCE SHERWIN

Q. Please state your name and business address.

A. My name is R. Lawrence Sherwin, and my business address is 720 Olive Street, St. Louis, Missouri, 63101.

Q. What is your present position?

A. I am Assistant Vice President - Regulatory Administration of Laclede Gas Company.

Q. Please tell us how long you have held this position and describe your responsibilities.

A. I was appointed in February, 1999. In this position I am responsible for managing the administration of Laclede's tariff and certain other federal and state regulatory matters, and am also responsible for conducting various projects, studies, analyses and other tasks from time to time.

Q. What is your educational background?

A. I graduated from St. Louis University in 1975 with the degree of Bachelor of Science in Business Administration, majoring in Accounting.

Q. Are you a member of any professional organizations?

A. I am a member of the Institute of Management Accountants.

Q. Will you briefly describe your experience with the Company prior to assuming your current position?

A. I joined Laclede in 1975 as an Accountant. I was transferred the following year to the Budget department, where I served in senior staff and assistant managerial

capacities. I later served successively as Supervisor of Corporate Accounting and Manager of Financial Planning. In 1982 I was appointed Manager of Accounting, with responsibility for managing Corporate Accounting, General Accounting and Property Records departments. In 1988 I was named Director of Customer Accounting, with responsibility for Collection and Credit, Customer Accounting, Meter Reading and Methods and Procedures. Cashiers was added to my area of responsibility in 1991. In August 1992 I was elected Assistant Vice President of Customer Accounting. Effective January 1997 I was named Assistant Vice President of Human Resources. Although several of my assignments detailed above have been in other areas, I have assisted in various facets of Laclede's rate matters over much of my employment, including work at times in cases filed by Mississippi River Transmission Corporation, an interstate pipeline that serves Laclede.

Q. Have you previously filed testimony before this Commission?

A. Yes. I have presented testimony in a number of Commission proceedings. Most recently, I submitted testimony in Laclede's last general rate case proceeding, Case No. GR-2002-356 on the issue of depreciation and net salvage. In connection with that testimony, I also prepared various depreciation analyses relating to Laclede's utility property. I have also testified before the Federal Energy Regulatory Commission.

I
PURPOSE AND SUMMARY OF TESTIMONY

Q. What is the purpose of your supplemental direct testimony in this proceeding?

A. The purpose of my supplemental direct testimony is to address the issue of how the net salvage costs associated with removing or retiring the Company's utility facilities should be calculated and reflected in rates. Specifically, I will explain why the

B. Commission should reaffirm its use of the classical or standard method that has been employed for many years to determine how such costs will be handled for ratemaking purposes (hereinafter the "Standard Method") and reject the method that the Commission Staff has proposed for addressing net salvage costs.

Q. What is the primary difference between the Standard Method for determining net salvage and the Staff's method for addressing that issue?

A. Under the Standard Method, the Company estimates -- and reflects as part of its depreciation rates -- the net salvage costs that will be incurred to retire or remove from service the utility facilities that are being used to serve customers today. In contrast, the Staff's method expenses the net salvage costs that have been incurred in the past in connection with those utility facilities that have already been retired and are therefore no longer serving customers. As a result, the Staff's method makes no effort to estimate or reflect in rates the net salvage costs that decades worth of data indicate will be experienced in connection with the retirement of existing facilities.

Q. How will your testimony address the issue of which of these methods is most appropriate?

A. I will begin by providing the Commission with some background information on what the net salvage/depreciation issue is and how it has evolved over the past five years. I believe it is particularly important to provide this kind of background information in a matter like this one where the Missouri regulatory approach to an issue has varied significantly from one case to the next and where no judicially-acceptable method has yet been provided as to why a departure from the Standard Method for addressing the matter is appropriate or reasonable. I will then address why the evidence already presented in this

proceeding, together with the additional information and policy considerations that I will present in my testimony, support the use of the Standard Method for determining the net salvage component of the Company's depreciation rates.

Q. Is this issue also being addressed by other Laclede witnesses?

A. Yes. Laclede's Chief Financial Officer, Mr. Barry C. Cooper, is also submitting testimony on this issue. In addition to providing an overview of the reasons Laclede believes the Commission should continue its use of the Standard Method, Mr. Cooper will also address the negative impact that Staff's method has had and will continue to have on the financial ability of Laclede to meet its public utility obligations. A third witness, William M. Stout, is providing expert testimony on behalf of both Laclede and AmerenUE.

II
BACKGROUND

Q. Please explain how the net salvage depreciation issue under consideration in this proceeding developed.

A. Prior to 1999, the Commission utilized the Standard Method for determining what level of net salvage costs should be included in rates. In doing so, the Commission recognized that the overriding goal of depreciation accounting in the utility ratemaking context is to allocate or spread the full cost (including the net salvage cost) of a capital investment made by a utility to provide service over the expected service life of the underlying property.

Q. Is this fundamental goal also recognized by other regulatory jurisdictions?

A. Yes. As other witnesses, including depreciation expert William M. Stout, have discussed, this fundamental objective has also been recognized by virtually every public

utility regulatory body in the United States, including the Commission prior to 1999. It has also been articulated in official publications of the national association to which those regulatory agencies belong. As the National Association of Regulatory Utility Commissioners ("NARUC") has stated, depreciation accounting provides:

> the mechanism through which the capital invested in depreciable plant is recovered. It is the process used to allocate that capital investment to the accounting periods during which the depreciable plant is in service. A system of accounting which allocates the cost *adjusted for salvage* over the estimated useful life of a property unit or group of assets in a systematic and rational manner. (*emphasis supplied*).

Q. How does the Commission's use of the Standard Method achieve this goal?

A. The Standard Method of setting depreciation rates achieves this goal by spreading out the utility's recovery of the asset's cost, be it a main, a service line, or a utility truck, over the years that the asset is expected to be in service. For example, if a main that costs $10,000 to install is expected to be in service for 50 years, the Standard Method will permit the utility to recover through depreciation rates 1/50th of this amount or $200 each year. In this way, those customers benefiting from the use of the main pay their proportionate share of its cost as the main is used to provide them with service. At the same time, the Standard Method also includes an allowance for net salvage costs in depreciation rates that reflects the costs that will be incurred to remove the asset from service at the end of its useful life. Since the cost of removal for many natural gas assets, such as mains and service lines, typically exceeds the proceeds that can be realized from the resale value, if any, of the retired asset, recognition of net salvage in the depreciation rates (through a corresponding increase in those rates) is necessary if the full cost of the asset is to be ratably

allocated to and recovered from customers over the period that they are benefiting from the use of the asset.

Q. Does the inclusion of an allowance for net salvage costs in the calculation of the depreciation rates mean that the utility is recovering more in rates than it is actually spending?

A. No, not at all. In fact, the amount of current costs being deferred for future recovery as a result of the Standard Method far exceeds the amount of future net salvage costs that are being recovered now through the same depreciation rate. For example, Laclede typically spends around $50 million a year on its capital budget. All of these expenditures reflect money that is being spent today, in the form of wages, salaries, material costs, and other expenses, to install the plant, equipment and other capital items required to provide utility service. Of these current expenditures, however, Laclede will typically recover only about $1-1.5 million, or approximately 2.5% of the total amount, each year in depreciation, even under the Standard Method. Indeed, as highlighted by Mr. Cooper, the amount of Laclede's annual capital expenditures are significantly greater than the amount of depreciation that Laclede is allowed to recover on *all* of its plant in service, including cost of removal.

Q. How did the Commission's use of the Standard Method change in 1999?

A. In its 1999 Report and Order in this case, the Commission adopted Staff's method for determining the net salvage component of Laclede's depreciation rates. While Staff's method had been taken into account as part of a previous settlement, this was the first time that the Commission had adopted it based on a litigated record. As previously noted, under this new approach, the Commission effectively began to treat net salvage costs as an

expense item. As a result, instead of making an allowance in rates for the net salvage costs that Laclede will incur in connection with plant that is in service today, the Commission reflected in rates only the annual level of net salvage costs that Laclede had actually been incurring in the past in removing plant from service. The effect of this change was to significantly reduce the level of net salvage costs that would have otherwise been reflected in and recovered through current rates pursuant to the Standard Method.

Q. Does Staff's approach also make changes in that component of the Standard Method that defers the recovery of current capital costs by spreading recovery over the life of the asset?

A. No. While Staff advocated eliminating that aspect of the Standard Method that provides an allowance for future net salvage costs, its approach nevertheless retained that part of the Standard Method that spreads the recovery of current capital expenditures over the many years that the associated plant is expected to be in service. As a result of this "pick and choose" approach, the already modest percentage of current capital expenditures being recovered by Laclede in any given year has become even smaller.

Q. What occurred subsequent to the Commission's adoption of the Staff's method in Laclede's 1999 rate case?

A. Laclede appealed the Commission's decision to adopt this new method. In the initial stages of the appeal, the Circuit Court of Cole County remanded the Commission's decision on the grounds that it was not supported by adequate findings of fact. After the Commission revised its Report and Order to include additional findings the Western District Court of Appeals ruled in May of 2003 that the Commission had not adequately explained or supported its decision with sufficient findings. This remand proceeding resulted.

Q. Has the Commission consistently used the Staff's method since 1999 in other cases?

A. No. During the course of the lengthy appeal process involving the Commission's Order, the Commission has had a number of opportunities to revisit this issue. However, there has yet to be established any consistency in the treatment of net salvage costs. For example, in at least one litigated case involving St. Louis County Water Company, the Commission decided that the Standard Method of determining net salvage costs should be retained. (Case No. WR-2000-844 (2001)). In other litigated cases such as the one in involving Empire District Electric Company, however, the Commission has chosen to adopt the Staff's method. (Case No. ER-2001-299 (2001)). A similar dichotomy has also been evident in various rate case settlements approved by the Commission, some of which reflected the Standard Method (Staff of the Missouri Public Service Commission v. Union Electric Company d/b/a AmerenUE, Case No. EC-2002-1 (2002)), while others reflected adoption of the Staff's method. (Re: Missouri Public Service, ER-2001-672.)

Q. What do these developments indicate to you?

A. At a minimum, they suggest that the Commission has not yet made a definitive policy judgment on whether Staff's method for addressing net salvage costs is a reasonable one. The Commission should have serious reservations about the merits of Staff's approach, given what the evidence in this case says about the inherent shortcomings of Staff's method. Indeed, far from supporting adoption of Staff's method, the record evidence in this case simply reconfirms why the Commission, like nearly all of the other regulatory jurisdictions, should continue to use the Standard Method for determining what level of net salvage costs should be included in rates.

Q. You spoke of a settled case in which the Staff's method was taken into account. Did that settlement constitute any kind of endorsement of the Staff's method?

A. Absolutely not. The overall settlement in that case was based on a number of considerations, as many settlements are, and there was clear understanding, reflected in the settlement itself, that no method of depreciation was being endorsed. It was also clear that the case would soon be followed by another rate increase request – this proceeding, Case No.GR-99-315 – in which Laclede would be free to propose the continued use of the Standard Method.

III
THE RECORD IN CASE NO. GR-99-315

Q. In your view, has the Staff provided any meaningful evidence in this case to support a change in the Commission's treatment of net salvage costs?

A. No. In fact, I believe one of the main reasons that it has been so difficult over the past five years to provide an order with adequate findings of fact is because Staff never has provided the evidence necessary to support such a radical departure from standard depreciation practices. As I indicated previously, Staff's method is inherently flawed. This is because: (a) it is contrary to the overwhelming weight of authority on how the cost of utility facilities should be recovered through depreciation; (b) is based on a flawed criticism of the net salvage estimates derived from the Standard Method; (c) lacks the consumer and utility safeguards inherent in the Standard Method; (d) violates fundamental principles of intergenerational equity and cost responsibility; and (e) carries with it an additional adjustment to depreciation recovery that would further exacerbate all of these negative impacts. As Laclede witness Cooper explains, it would also threaten the financial ability of

Missouri utilities to attract at a reasonable cost the resources necessary to provide essential utility services. Each of these flaws is thoroughly demonstrated by the record in this case.

A. Lack of Authority for Staff's Method

Q. What does the record in this case indicate about the acceptability of Staff's method versus the Standard Method that has traditionally been employed by the Commission?

A. The record in this case shows that Staff's method for calculating net salvage is at odds with the approach taken by nearly every other regulatory jurisdiction that routinely addresses the establishment of depreciation rates for public utilities. Indeed, this view was substantiated in 1999 by both Laclede's in-house depreciation expert, Mr. Richard A. Kottemann, Jr., as well as Dr. Ronald White, a depreciation expert who has decades of experience in teaching and applying depreciation theory and whose testimony on depreciation matters has been adopted in numerous jurisdictions. (Legal File, p. 172; Exhibit 26, p. 2). This view is repeated again by the witnesses filing supplemental direct testimony for Laclede and Ameren in this proceeding. The record also indicates, and is again confirmed, that in addition to being the method of choice among regulators, the Standard Method for calculating net salvage costs is also universally endorsed by authoritative texts on depreciation. Examples of these discussed in the record back in 1999 and confirmed by depreciation expert William M. Stout include the NARUC publication entitled *Public Utility Depreciation Practices*, and the publication *Depreciation Systems* authored by Wolf and Fitch. In contrast, there is no evidence in the record of any authoritative support for Staff's unconventional approach to calculating net salvage costs.

Q. Does the fact that there is overwhelming support among both regulators and the authoritative texts for the Standard Method automatically mean that Staff's method should be rejected?

A. I would never go so far as to suggest that a particular method or practice is inappropriate solely because another approach enjoys universal or near-universal support among the experts and institutions that routinely deal with that matter. I do, however, believe that it is a consideration that should be given considerable weight by the Commission. After all, this broad endorsement of the Standard Method reflects the collective judgment and long experience of a broad array of regulatory authorities regarding how net salvage costs should be handled for public utilities. And it stands in marked contrast to the casual manner in which Staff's method was developed.

Q. What is the basis for your observation that the Staff's method was not developed in a thoughtful and considered manner?

A. The record indicates that in the course of preparing his work papers in an earlier rate case, Mr. Adam suddenly realized that the net salvage rate incorporated into Laclede's depreciation rates under the Standard Method produced an annual recovery of net salvage costs that exceeded the recent net salvage costs being experienced for some accounts. Apparently, based on this single observation alone, Mr. Adam literally scratched out the salvage values he had calculated using the Standard Method and substituted lower net salvage values calculated in accordance with his new method of recognizing only the net salvage costs that have recently been incurred for retired facilities. (Tr. 889-892).

Q. Was the new method developed by Mr. Adam reviewed by other Staff members as a means of ensuring its appropriateness?

A. No. According to Mr. Adam, he did not even discuss his proposal with upper level Staff personnel prior to filing testimony advocating the new method. (Tr. 893). In fact, at the evidentiary hearing in Case No. GR-99-315, Mr. Adam testified that he could only hope that senior Staff members were aware of his proposal by the time he testified. (Tr. 893).

Q. Why is this significant?

A. Staff's proposed revision in the treatment of net salvage costs represents a major departure from existing, long-standing policies on how the cost of utility facilities should be recovered. Moreover, it is a departure that promises to have a significant financial impact on both Missouri utilities and ratepayers alike. Given these considerations, the Commission should not only expect, but demand, that such a policy change be proposed only after a careful, thorough and meticulous evaluation of its appropriateness and impact. That did not happen here. Instead, a major modification to regulatory policies was recommended by a Staff member with relatively little experience in the area based apparently on nothing more than a relatively brief consideration of only a few tidbits of information. Even worse, it was recommended without the benefit of any meaningful review or supervision by senior Staff members. This is not the kind of considered analysis that the Commission should require before it jettisons a long-standing ratemaking convention that has withstood the test of time.

B. <u>Reliability of Estimates</u>

Q. Has Staff's inadequate approach towards analyzing this issue resulted in any major flaws in its reasoning for advocating its treatment of net salvage costs in place of the Standard Method?

A. Yes. I think the inadequacy of Staff's approach to analyzing this issue is most graphically demonstrated by the fundamental flaws in its basic argument as to why its method rather than the Standard Method is more appropriate. I am referring, of course, to Mr. Adam's contention that the estimates of net salvage costs produced by the Standard Method are too uncertain to be used for ratemaking purposes, largely because Laclede is accruing and reflecting in rates more depreciation expense than it is currently incurring. In effect, Staff has suggested that because of this uncertainty it is necessary to reflect only the net salvage costs that have actually been incurred by Laclede in the recent past to retire plant that is no longer in service.

Q. Does the record in this case indicate that this is a valid criticism?

A. No. The record in this case indicates that such a criticism really has nothing to do with the integrity of the specific estimates of net salvage costs produced by the Standard Method. After cross-examination had already concluded in the evidentiary hearing in this case, Staff witness Adam did mention a few plant accounts covering very minor cost items in which there had been some volatility in the level of net salvage costs being estimated. However, he never provided any evidence to show that such estimates were incorrect. Even more significantly, however, Mr. Adam freely conceded in his direct testimony, Exhibit 92, page 8, line 18, that his concerns about a potential over-statement of depreciation expense may be due to the *possibility* that "the computed average service life is wrong...it is possible that the survivor curve has been misanalyzed and the average life understated." In other words, Mr. Adam acknowledged that this so-called overstatement of depreciation expense may be completely unrelated to any flaws in Laclede's calculation of net salvage expense but instead be driven by other factors. As a consequence, Mr. Adam's

own testimony establishes the complete lack of any evidence that would show, or even tend to show, that Laclede's particular net salvage estimates were flawed.

Q. Do you agree in any event with Mr. Adam's concern that there is some mismatch between the amount of net salvage expense being accrued and the amount of net salvage being experienced by Laclede?

A. No. In fact, for the reasons addressed by Laclede and AmerenUE witness Stout and others it would be highly unusual if the amount of net salvage being accrued wasn't higher than the amount currently being experienced by Laclede. That is precisely the result one would expect for a utility that, like Laclede, has a growing rate base and a capital expenditure program that is subject to the kind of inflationary pressures that inevitably drives up capital expenditures over time – all factors that would make estimates of future net salvage costs higher than current net salvage costs. The fact that Mr. Adam would express surprise at such a result, let alone use it to suggest that there is some inherent flaw in the way net salvage costs are estimated under the Standard Method, indicates that he did not have a clear understanding of how depreciation works in a utility context.

Q. But even if Mr. Adam did not provide any evidence to dispute the reliability of the specific net salvage estimates derived under the Standard Method, isn't it reasonable to question the reasonableness of using estimates at all to determine this cost?

A. No. At the outset it should be recognized that Staff's method and the Standard Method both use estimates to derive the level of net salvage costs that should be reflected in rates. The main difference is that Staff's method uses only a very limited amount of recent historical data to derive its estimate of net salvage costs. Specifically, the Staff only

looks at the net salvage costs incurred to remove plant that has already been retired to derive its estimate of net salvage costs. This backward looking and extremely limited consideration of net salvage experience has little or no predictive value regarding the net salvage costs that will be incurred in connection with the plant that is currently being used to provide service.

Q. Please explain what you mean when you state that Staff's method has no predictive value in terms of the net salvage costs that will be incurred for plant currently in service.

A. Since Staff's method only recognizes the net salvage cost realized by Laclede in the recent past on property that has been retired, it effectively eliminates any allowance for the predictable escalations in net salvage costs that are certain to occur over the useful life of the assets that Laclede is using *today* to provide utility service to its customers. In other words, it makes absolutely no allowance for the fact that the payroll, equipment and other costs that will be incurred to remove say a 50 year old distribution main are certain to increase over the 50-year period that the main will be operational. It therefore results in an estimate that does not even attempt to account for the net salvage costs that Laclede will experience with respect to future retirements of existing plant. Indeed, such an approach is tantamount to trying to determine what kind of pension payments employees retiring thirty years from now will need to live on by assessing what employees who have retired over the past five years are receiving.

Q. How does this compare to the Standard Method?

A. In contrast to the Staff's method, the Standard Method looks at a much more robust set of historical data. Under this approach, the retirement history of each asset, or group of assets, is thoroughly studied. The net salvage percentage is then estimated based on

the historical relationship between the net salvage cost of an asset, or group of assets, and the original cost of that same asset or group of assets. By comparing how the net salvage cost of an asset has historically related in comparison to the original cost of the asset, such an analysis gives a measure of how salvage costs for new plant additions can be expected to increase over time. In short, the Standard Method actually focuses on the expected removal costs of the facilities for which depreciation rates are being established rather than on the removal costs for facilities that have already been retired. It will therefore produce a much more relevant and reliable estimate of such costs than Staff's method.

Q. Are there other flaws in Staff's generalized criticism of using estimates to derive net salvage costs?

A. Yes. I think it is important to recognize that Staff's generalized disdain for using estimates could just as easily be applied to that aspect of the Standard Method that spreads out the recovery of current capital expenditures over the many years that the utility plant in question will be in service. Imagine for a moment that a utility witness were to come before the Commission, like Mr. Adam did five years ago, and testify that the amount currently being spent by the utility on capital projects each year was significantly greater than the amount currently being recovered through its depreciation rates. Assume further that the witness pointed out, as Mr. Adam did with respect to net salvage costs, that there is no absolute certainty regarding the service life estimates that were being used to spread the recovery of those capital expenditures over the many years that asset was expected to be in service. And finally assume that the witness recommended because of these considerations that the full amount of those expenditures be recovered in rates now. In other words, rather than recovering only about 2 to 3 percent of its annual $50 million capital budget each year

through depreciation rates, these amounts should be expensed rather than capitalized, and Laclede should be allowed to increase its rates to recover the full $50 million each year in one fell swoop. Under such circumstances, I suspect that the Staff would be at the forefront of those arguing that the use of estimates for determining service lives was entirely appropriate, that concerns over their lack of certainty were overblown and unfounded, and that there was absolutely no basis for revising the Standard Method's approach for spreading the recovery of such costs of many years. And Staff would be right in leveling those criticisms – as right as it is wrong now in raising such concerns in the context of the net salvage issue. The fact remains that it is essential to use forward-looking estimates in both the calculation of the service lives that are used to spread the recovery of current costs over the many years that an asset will be in service, as well in the determination of the net salvage costs that will incurred once those assets are retired.

Q. Has this need to use estimates in both contexts also been recognized by the Commission?

A. Yes. The Commission has previously recognized that developing forward-looking estimates is absolutely required if any of the costs of a capital asset are to be spread over its entire useful life so that all customers who benefit from the use of the asset pay their fair share of the cost. Moreover, the Commission has recognized that the allocation process requires a consideration of all of the asset's costs, including the cost of removing it. As the Commission stated in ***Re: St. Louis County Water Company,*** 4 Mo.P.S.C.3d 94 (1995):

> Depreciation accounting is a system of accounting which generally aims to distribute costs or other basic values of tangible capital assets less salvage, over the *estimated* useful life of the unit or group of units in a systematic nature. It is a process of allocation, not of valuation. Depreciation is an attempt to match capital recovery with capital consumption. The

emphasis is upon a systematic and rational allocation of the expense of capital consumption. ... *Any attempt to allocate such costs over a period of time requires an analysis of expected future events such as useful life, salvage value, and cost of removal. Id.* at 102-103. (*emphasis supplied*).

Q. Has the Commission also rejected previous Staff's efforts to disturb this even handed use of estimates in the calculation of both service lives and net salvage costs?

A. Yes. Shortly after this Commission issued its Second Report and Order in this case, it considered an identical set of assertions by the Commission Staff in a case involving St. Louis County Water Company. (Case No. WR-2000-844). In that case, however, the Commission explicitly found that "[w]hile Staff criticizes Mr. Stout's estimates of net salvage costs in general, it does not note any specific problem with any specific estimate. Rather, the criticisms are based on the fact that the costs are estimates." Report and Order at pp. 17-18. The Commission also went on to find that such generalized criticisms of the use of estimates were not sufficient to warrant rejection of the Standard Method and its computation of net salvage costs. The exact same thing is true of Staff's contentions in this case and the exact same result should be reached by the Commission.

Q. Do you have any concluding comments to make about Staff's contentions regarding the use of forward looking estimates to determine what level of net salvage costs should be included in rates?

A. Given the considerations discussed above, I believe the record in this case is quite clear that Staff's method is not justified by any alleged, let alone demonstrated, problem with the accuracy of the net salvage estimates produced by the Standard Method. Rather, Staff's method is simply a technique for eliminating the use of those estimates that,

over the short-term, tend to increase revenue requirement, while fully preserving the use of those estimates that decrease revenue requirement. This kind of unsupported, results-oriented approach should be rejected by the Commission.

C. Why the Standard Method Provides Greater Consumer Safeguards

Q. If there actually was some unacceptable level of uncertainty in the net salvage estimates produced by the Standard Method, would that warrant use of the method proposed by Staff?

A. No. In fact, if there actually was any problematic level of uncertainty in the net salvage estimates produced by the Standard Method, then continued use of that method would still be a far more preferable alternative than use of the kind of method of expensing net salvage costs which has evolved from the method proposed by Staff in this case.

Q. Why is that?

A. Because the Standard Method has inherent safeguards that protect both the ratepayer and the utility in the event that actual net salvage costs vary from estimated net salvage costs – safeguards that are nowhere to be found in the method evolving from that proposed by Staff.

Q. Please describe how the Standard Method safeguards the financial interests of both ratepayers and the utility.

A. It does so in two ways. First, because the Standard Method incorporates net salvage costs as a part of the depreciation rate, any difference between actual and estimated net salvage costs will be reflected in adjustments to the depreciation reserve. The depreciation reserve, in turn, acts as a kind of balancing account. In other words, to the extent the depreciation reserve has grown because estimated net salvage costs exceed actual

net salvage costs, adjustments to depreciation rates will eventually be made to bring the reserve down. At the same time, to the extent the depreciation reserve has been reduced because estimated net salvage costs are less than actual, similar adjustments to the depreciation rate will eventually be made to make up the difference. The point is the Standard Method ensures that the utility will not over- or under-collect its net salvage costs and, in doing so, ensures that the ratepayer will not over- or under-pay for such costs. Everything is reconciled back to zero in the end.

Q. What is the second way that the Standard Method protects ratepayers?

A. By reflecting any difference between estimated and actual net salvage costs in the depreciation reserve, the Standard Method also makes it possible for ratepayers to be compensated for the "use" of their money in those instances where the level of estimated net salvage costs being reflected in rates temporarily exceeds the level of net salvage costs being incurred by the utility.

Q. How does this compensation occur?

A. Under the Commission's rules, there is a provision specifying that utilities should credit ratepayers an annual amount equal to three percent of the value of the depreciation reserve as compensation for the use of their money. However, the Commission's practice for some years has been to compensate ratepayers at a rate that is significantly higher than that provided by the Commission's rules. The Commission does so by simply deducting the depreciation reserve from the utility's rate base. This, in turn, results in ratepayers being fully compensated for the use of their money at a rate equal to the utility's overall rate of return whenever the utility's outlays for net salvage are less than what has been included in depreciation rates.

Q. Are these same safeguards present in the Staff's method of expensing net salvage costs?

A. No, the Staff's method has none of these safeguards. Instead, any difference between its estimate of net salvage costs and actual net salvage costs are either absorbed by the utility or borne by the customer. In short, Staff's method responds to the uncertainty inherent in any estimating process by making certain that there will be "winners" and "losers" if estimates of net salvage costs do indeed vary from actual experience, while the Standard Method ensures that everyone will be made whole under such a scenario. Accordingly, to the extent uncertainty over the reliability or accuracy of net salvage estimates is an actual concern, it strongly argues in favor of the Commission's retention of the Standard Method and rejection of the method proposed by the Commission Staff.

D. <u>Intergenerational Equity and Proper Allocation of Cost Responsibility</u>

Q. In evaluating whether to adopt Staff's method in lieu of the Standard Method should the Commission consider principles of intergenerational equity and making those who benefit from a particular cost pay for that cost?

A. One of the basic tenets of proper rate design as well as proper depreciation accounting is to have costs allocated to ratepayers in a way that reflects who is causing and benefiting from those costs. From an intergenerational equity standpoint, such an approach ensures that one group of ratepayers receiving service from the utility will not subsidize another group of ratepayers who receive service at a different point in time.

Q. Which method best accomplishes this fundamental goal?

A. By estimating what the net salvage costs will be for facilities currently in service, and by ensuring that those costs are included in rates as the facilities are used up, the

Standard Method does a much better job of ensuring intergenerational equity and complying with the basic principle that those benefiting from, or causing, a cost should generally pay for it.

Q. How does the Staff's method do in terms of these basic goals?

A. It is difficult to conceive of a method that would do a poorer job of meeting these basic goals. By only recognizing the net salvage costs associated with facilities that have already been removed from service, the Staff method effectively jettisons these principles by making future customers responsible for the cost of facilities that are being used to serve customers today. In fact, Staff's method effectively ensures that no one, except by pure happenstance, will ever pay for the cost of the facilities that are being used to serve them but instead only for those facilities that were used to serve others.

E. <u>Amortization of the Depreciation Reserve</u>

Q. Are there any final considerations that you believe the Commission should take into account as it decides this issue?

A. Yes, I think it is very important for the Commission to keep in mind that Staff's method also involves a second step, the consequences of which were never addressed by Staff during the course of this proceeding. Specifically, it has become clear through subsequent proceedings that Staff views adoption of the method proposed in this proceeding as only a precursor to a further adjustment.

Q. What kind of additional adjustment are you referring to?

A. Once the Commission adopts its method, it has been Staff's practice to propose that a portion of the depreciation reserve be amortized as necessary to "return"

monies that were supposedly collected by the utility in the past to recover the level of net salvage costs derived under the Standard Method.

Q. What is the impact of this additional adjustment?

A. It will substantially exacerbate all of the shortcomings that both I and Laclede witness Cooper have described in our testimony to the detriment of both the utility and its customers. Specifically, it will make for an even greater disparity between the level of net salvage costs that are going to be incurred by the utility and the amount that is actually reflected in rates, exacerbate the intergenerational equity problems associated with Staff's method, further impair the ability of Missouri utilities to attract capital on favorable terms by reducing cash flow yet again, and raise overall costs for ratepayers in the process. Although I believe there are a number of conceptual flaws underlying this additional adjustment, the fact that it will be proposed and, if adopted, exacerbate even more the detrimental impacts of Staff's method, is yet another reason why the Commission should not embark on the path proposed by Staff in this proceeding.

Q. Does this conclude your supplemental direct testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Laclede Gas Company's Tariff to Revise Natural Gas Rate Schedules.	)))	Case No. GR-99-315

AFFIDAVIT

STATE OF MISSOURI)
) SS.
CITY OF ST. LOUIS)

R. Lawrence Sherwin, of lawful age, being first duly sworn, deposes and states:

1. My name is R. Lawrence Sherwin. My business address is 720 Olive Street, St. Louis, Missouri 63101; and I am Assistant Vice President-Regulatory Administration of Laclede Gas Company.

2. Attached hereto and made a part hereof for all purposes is my supplemental direct testimony.

3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct to the best of my knowledge and belief.

R. Lawrence Sherwin

Subscribed and sworn to before me this 19th day of August, 2004.

KAREN A. ZURLIENE
NOTARY PUBLIC - NOTARY SEAL
STATE OF MISSOURI, CITY OF ST. LOUIS
MY COMMISSION EXPIRES FEBRUARY 18, 2008