

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Tariff Filing of The)	
Empire District Electric Company to)	
Implement General Rate Increase for)	Case No. ER-2004-0570
Retail Electric Service Provided to)	
Customer in its Missouri Service Area)	

INITIAL BRIEF OF AMERENUE CONCERNING NET SALVAGE

Union Electric Company d/b/a AmerenUE (“AmerenUE”) intervened in this proceeding for the limited purpose of opposing the Commission Staff’s (“Staff”) and the Office of the Public Counsel’s (“OPC”) proposed treatment of net salvage¹ component of The Empire District Electric Company’s (“Empire”) depreciation rates. Although AmerenUE did not submit any testimony or provide any witnesses in this proceeding, that should not be taken as an indication of AmerenUE’s lack of interest in this important issue. AmerenUE supplied extensive testimony on this issue in Case No. GR-99-315, the recent Laclede Gas Company proceeding in which the net salvage issue was also addressed. (*See Re: Laclede Gas Company*, Case No. GR-99-315, Third Report and Order, slip op. issued January 11, 2005 (“*Laclede*”).) AmerenUE elected not to re-file all of the same testimony in this proceeding, but instead to rely on the testimony presented by Empire and Aquila, Inc. (“Aquila”) witnesses, as well as evidence adduced on cross-examination of Staff and OPC witnesses, to support its position on the proper treatment of net salvage.

The Staff’s and OPC’s position concerning net salvage in this case is essentially the same as their position which the Commission recently rejected in Case No. GR-99-315—that net

¹ Net salvage is the gross salvage realized at the time depreciable property is removed from service, less the cost of removal of such property. For many utility assets, net salvage is negative. (Exh. No. 18, p. 12.)

salvage should be treated on a cash basis and included in rates only when it is actually incurred.² The utilities—in this case Empire, Aquila and AmerenUE—argue that net salvage should be handled on an accrual basis, consistent with this Commission’s historical treatment of these costs and consistent with the treatment of net salvage in the overwhelming majority of other jurisdictions throughout the country. (Exh. No. 18, pp. 12-14; Exh. No. 108.)

In AmerenUE’s view there are at least four reasons that the accrual treatment of net salvage costs is significantly superior to the Staff’s and OPC’s proposed cash treatment. First of all, the treatment of net salvage as a cash item defeats the fundamental purpose of depreciation accounting—the ratable allocation of the *full* cost of an asset (including net salvage) over the period in which that asset is used to provide service. The record in this proceeding is rife with citations to authoritative sources that support this fundamental principle. For example, in his direct testimony, Empire witness Donald S. Roff cited this definition of depreciation from the American Institute of Certified Public Accountants:

Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, *less salvage (if any)*, over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. [emphasis supplied] (Exh. No. 18, p. 8.)

Mr. Roff also points out that the NARUC manual on depreciation, Public Utility Depreciation Practices, is in accord and provides as follows:

Under presently accepted concepts, the amount of depreciation to be accrued over the life of an asset is its original cost less net salvage. Net salvage, as the name implies, is the difference between the gross salvage that will be obtained when the asset is disposed of and the cost of removing it. Positive net salvage occurs when gross salvage exceeds cost of removal, and negative net salvage occurs when cost of

² Although OPC Witness Majoros apparently recommends continuing to include net salvage in the depreciation calculation, the amount of net salvage recommended by Mr. Majoros is based on the company’s cash expenditures from 1999 – 2003 (Exh. No. 89, p. 48.)

removal exceeds gross salvage. Thus the intent of the present concept is to allocate the net cost of an asset to annual accounting periods, making due allowance for the net salvage, positive or negative, that will be obtained when the asset is retired. This concept carries with it the thought that ownership of property entails the responsibility for its ultimate abandonment or removal. Hence if current users of the property benefit from its use, they should pay their pro rata share of the costs involved in the abandonment or removal of the property.

This treatment of salvage is in harmony with generally accepted accounting practices and tends to remove from the income statement fluctuations caused by erratic, although necessary, abandonment and uneconomical removal operations. It also has the advantage that current consumers pay a fair share, even though estimated, of costs associated with the property devoted to their service.
(Exh. No. 18, pp. 10-11.)

Aquila witness H. Davis Rooney cites a separate source, definitions contained in the Federal Energy Regulatory Commission's ("FERC") Uniform System of Accounts ("USoA") (which this Commission has adopted), for the same proposition. Specifically the USoA defines "Depreciation" as:

...the loss in *service value* not restored by current maintenance, incurred in connection with the consumption or prospective retirement of electric plant in the course of service from causes which are known to be in current operation and against which the utility is not protected by insurance. Among the causes to be given consideration are wear and tear, decay, action of the elements, inadequacy, obsolescence, changes in the art, changes in demand and the requirements of public authorities. [emphasis supplied]
(Exh. No. 108, pp. 2-3.)

Further, the USoA defines "Service Value" as "...the difference between original cost and net salvage value of electric plant." (Exh. No. 108, p. 3.)

In addition, Staff witness Gregory Macias acknowledged that the textbook Depreciation Systems by Wolfe and Fitch also incorporates the concept of "service value," which includes net salvage as well as original cost, in its treatment of depreciation. Tr. pp. 1795-1796. And finally, earlier this month in its Third Report and Order issued in the Laclede case, this Commission

found that “...the fundamental goal of depreciation accounting is to allocate the full cost of an asset, including its net salvage cost, over its economic or service life so that utility customers will be charged for the cost of the asset in proportion to the benefit they receive from its consumption. The Commission further finds that the method utilized by Laclede [the same method proposed by Empire in this proceeding] is consistent with that fundamental goal.” (*Laclede*, p. 9.)

Staff’s and OPC’s proposal to treat net salvage effectively as a cash item is flatly inconsistent with the goal of depreciation accounting, as described in all of these authoritative sources. Cash treatment does not allocate net salvage costs to the customers who benefited from the use of the underlying assets ratably over the course of the lives of those assets. Instead, it allocates full net salvage costs to customers only *after* the underlying assets are retired. These customers are different than the customers who have benefited from the use of the assets over the course of the assets’ lives.

Staff and OPC may argue that recent cash expenditures for net salvage serve as a good proxy for the amount of net salvage customers would pay under the accrual method. But the evidence shows that in an environment where a utility’s investment in its asset base is growing, and where there is some level of inflation, the amount that should be accrued for net salvage of plant that is currently in service is naturally greater than the amount of net salvage incurred in recent years to retire old plant. (Exh. No. 19, p. 27.) In the recent *Laclede* decision, the Commission recognized these factors accounted for the fact that Laclede’s accrual was greater than its recent cash expenditures for net salvage. In that case, the Commission pointed out that in 1950 Laclede’s total plant in service was only 6 percent of what it is today. (*Laclede*, p. 10.)

In summary, cash treatment of net salvage costs does not result in a ratable allocation of those costs to the customers who benefited from the use of the underlying assets. For this reason it is inconsistent with the fundamental goal of depreciation accounting, as described in the numerous authoritative sources referenced above.

The second reason AmerenUE believes that the cash method must be rejected is that it is inconsistent with the FERC Uniform System of Accounts for electric utilities, which this Commission has adopted. (Exh. No. 108, pp. 2-5.) The USoA generally requires electric utilities to maintain their books on an accrual basis, and it specifically requires net salvage to be accounted for on an accrual basis. Although the USoA does permit the Commission to order deviations from the USoA in appropriate circumstances, in AmerenUE's view the Commission should only permit or require a deviation from the USoA when there is a compelling reason to do so. The USoA puts all utilities on the same accounting footing. It allows investors and analysts to compare apples to apples when viewing utility accounting and financial statements. In addition, the USoA reflects the collective wisdom of the utility industry and regulators from across the country. Absent a compelling reason to do so, the Commission should not require Empire and/or other Missouri utilities to account for net salvage on a more unfavorable basis than other utilities throughout the country. The Staff and OPC have not sustained the burden of showing why such a deviation from the USoA is necessary or appropriate.

The third reason that AmerenUE believes that Staff's and OPC's proposals to address net salvage should not be adopted is that cash treatment is far outside the mainstream of depreciation accounting employed in various jurisdictions throughout the country. OPC witness Michael Majoros, who has spent many years addressing depreciation issues in various jurisdictions, could only cite two jurisdictions—Pennsylvania and New Jersey—that have adopted cash treatment for

net salvage. (Tr. p. 1945.) As the Commission is well aware, Pennsylvania's treatment of net salvage is based on a court interpretation of a specific Pennsylvania statute from the early 1960's. See Penn Sheraton Hotel v. Pennsylvania Public Utility Commission, 184 A.2d 324 (Pa. 1962). Consequently, based on the evidence submitted in this case, it may be that New Jersey is the only other state to have adopted cash treatment of net salvage. Moreover, it is clear that experts in the field of depreciation generally do not support the Staff's and OPC's approach. Staff witness Macias admitted that Depreciation Systems by Wolfe and Fitch supports the inclusion of net salvage in the depreciation calculation, and the Staff and OPC witnesses did not cite any experts, outside of the Commission Staff and Mr. Majoros, that support their position on the issue. (Tr. pp. 1795–1796.) In AmerenUE's view, the Commission should decline the invitation to take a far out-of-the-mainstream approach to net salvage, which would place Empire's and other Missouri utilities' depreciation rates at a level materially below those of other utilities throughout the country.

Finally, AmerenUE opposes cash treatment of net salvage because, to the limited extent it has been adopted in Missouri, it has resulted in demonstrable detriment to the credit ratings of Missouri utilities. Adoption of cash treatment materially impairs the cash flow of utilities, a factor that can adversely affect the credit ratings of those utilities. (Tr. pp. 1673-1674.) Empire was, in fact, placed on Standard & Poor's (S&P) CreditWatch with negative implications, and the S&P report specifically cited the Commission's treatment of Empire's depreciation rates as a factor. (Exh. No. 12, Rebuttal Schedule DAM-1, p. 2.) With lower credit ratings, utilities' borrowing costs will increase, their ability to invest in necessary infrastructure improvements may be impaired, and the utilities become less financially stable. (Tr. pp. 1682–1683; Laclede p.

14.) In AmerenUE's view, these are compelling reasons for the Commission to require the accrual of net salvage.

The Commission addressed all of the arguments raised herein in the Laclede proceeding and decided that the accrual method was the most appropriate method for addressing net salvage in that case. Although the Commission is not bound by *stare decisis*, AmerenUE believes that it is appropriate for the Commission to reach a consistent conclusion in this case. There are no meaningful differences in the facts of these proceedings, at least with regard to net salvage on mass property accounts. All of the stakeholders—including utilities, customers and the financial community—will benefit if the Commission establishes a consistent treatment of net salvage. Moreover, the parties and the Commission can conserve resources if a consistent Commission policy prevents this issue from being litigated over and over in each rate case.

The Staff and OPC may argue that they have presented different and more compelling arguments in this proceeding for adopting the cash approach. However, a review of the record suggests that the evidence they provided in support of their approaches is not very persuasive. Staff's primary witness on this issue, Gregory Macias, has relatively little experience with regard to depreciation matters. Mr. Macias testified that this case represents only the second depreciation study that he has done, and it represents only the fourth time he has testified. (Tr. pp. 1790–1791.) Mr. Macias admitted during cross-examination that he had never had any training in depreciation or net salvage matters other than the mentoring provided by other Staff members. (Tr. pp. 1792–1793.) Perhaps most damaging, Mr. Macias admitted that he would not have been permitted to file testimony supporting a method for addressing net salvage other than the Staff's preferred cash method. On cross-examination by Empire attorney England, Mr. Macias testified as follows:

Q. Let me ask you the question this way: If you in your own professional judgment felt that an accrual for net salvage was appropriate, consistent with the way in which the company was proposing it, would you have been permitted to file that testimony?

A. I don't believe that I would have been allowed to file an accrual method because the Staff's policy is to expense net salvage.

(Tr. p. 1804.)

In other words, Mr. Macias was not permitted to make up his own mind on the issue, but was just required to simply follow the path forged by other Staff members in other proceedings.

The Staff attempted to bolster Mr. Macias' testimony by submitting rebuttal testimony of Guy C. Gilbert, a witness with considerably more experience in the area of depreciation who has recently been hired to head the Commission's depreciation department. Unfortunately for the Staff, Mr. Gilbert has a documented history of opposing treatment of net salvage similar to those proposed by Staff and OPC in this case. For example, in Re: UtiliCorp United d/b/a Missouri Public Service, Case No ER-97-394, Mr. Gilbert recommended restoring the accrual method of addressing net salvage, even though in previous cases the Commission, at the Staff's behest, had lowered net salvage costs in a manner similar to the cash approach advocated in this case. (Tr. pp. 1833–1834, Exh. No. 135.) Similarly, in Re: St. Louis County Water Company, Case No. WR-95-145, Mr. Gilbert argued against the cash approach. (Tr. pp. 1859–1862, Exh. No. 136.) Based on this previous inconsistent testimony, Mr. Gilbert's support for the Staff position in this case should be afforded little weight.

The evidence offered by OPC on this issue is similarly unpersuasive. OPC's witness, Mr. Majoros, has made a career of opposing utilities on depreciation issues, generally on behalf of consumer advocates. (See. Tr. pp. 1931–1934; Exh. No. 89, Schedule MJM-1, p. 8.) In recent years, he has focused his efforts on the net salvage issue, with little apparent success. For

example, in a case involving PSI Energy, Inc., the Indiana Utility Regulatory Commission (“IURC”) recently rejected arguments advanced by Mr. Majoros that are substantially identical to those he presents in this proceeding. The IURC summarized the issue, and its conclusion, as follows:

Turning to the net salvage values for transmission, distribution and general plant, Mr. Selecky and Majoros urged this Commission to utilize historical average of actual net salvage expense incurred by PSI for determining the net salvage to be utilized for these accounts and then expense these averages as a separate cost of service item. In effect, they are proposing that net salvage values be eliminated from the depreciation rates determination in this proceeding. In contrast, Mr. Spanos took the traditional approach and utilized estimated net salvage values for these accounts based on historical net salvage costs as a percent of the original cost of the retired assets that produced the gross salvage or required costs to remove.

...Based on our review of the decisions cited by Mr. Majoros...we note that only one state commission, the Pennsylvania Public Service Commission, following the directive in a decision by the Pennsylvania Supreme Court, has implemented the historical average approach. While the Missouri and Kentucky Public Service Commissions have utilized the historical approach to net salvage values in some cases or on a trial basis, subsequent decisions have adopted the approach advocated by Mr. Spanos.

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. [footnotes omitted.]

PSI Energy, Inc., 2004 Ind. PUC LEXIS 150, 198-201 (May 18, 2004). The logic of the PSI decision matches this Commission's decision in the Laclede case, and it should be followed in this proceeding as well.

A primary argument relied upon by the Staff and OPC in support of the cash approach is the assertion that future net salvage costs associated with plant that is currently in service is not predictable with sufficient certainty to include those costs in rates. (Exh. No. 55, p. 6; Exh. No. 89, pp. 8-9.) Staff, in particular, argued in both this case and the Laclede case that future net salvage costs cannot be included in rates because they are not "known and measurable." (Exh. No. 78, pp. 6-7; Tr. p. 1842.) However, the "known and measurable" standard has been applied in Missouri primarily, if not exclusively, in the context of evaluating updates to certain test year expenses and rate base items. It has never been the threshold test for determining whether any cost could be included in rates, and it has never been a barrier to basing rates on reliable estimates in appropriate circumstances.

For example, the Commission has consistently used estimates in establishing pension expenses. It has also used estimates of future dividend growth, in perpetuity, to establish the appropriate return on equity under the Discounted Cash Flow method, which this Commission has consistently adopted. Laclede, p. 12. Finally, and perhaps most significantly, the Commission has utilized estimates of the service lives of assets as a prime factor in setting depreciation rates. (Tr. pp. 1796-1797.)

The Staff and OPC have offered no explanation as to why the use of best estimates is appropriate in these other ratemaking contexts, but not appropriate in developing net salvage

values. In fact, the evidence shows that net salvage estimates for mass property accounts are based on engineering analysis of reams of actual, historical retirement data for each plant account. (See Mr. Roff's explanation of the historical data upon which proposed net salvage values are based in this case. Exh. No. 20, pp. 4-6; Schedule DSR-1.) The evidence shows that this analysis produces conservative net salvage values, and that actual net salvage values are likely to be higher in the future. (Exh. No. 19, pp 27-28.) Indeed there is simply no reason to reject these conservative estimates, particularly when the alternative is using a cash value for net salvage that clearly provides the wrong net salvage amount for the plant that is currently in service. The Commission explicitly recognized this argument in its recent Laclede decision.

The Commission stated:

The Commission finds that no evidence or satisfactory explanation exists as to why it is inappropriate or unreasonable to use estimates for purposes of determining net salvage costs, but is appropriate to use them for deriving equity returns, allowances for pension costs, decommissioning costs, and the service lives used to allocate the recovery of up-front capital expenditures over many years. Given these considerations, the Commission finds that Laclede's net salvage estimates as derived under the accrual method are reasonable.
Laclede, p. 12.

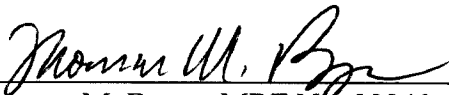
The same logic supports the estimates of net salvage provided by Empire in this case. No party has provided any evidence or explanation as to why these estimates are any less reliable than the other types of estimates used in the ratemaking process. Consequently, the Commission should find, as it did in the Laclede case, that these estimates are reliable.

Finally, to the extent that the estimates do not exactly match Empire's future net salvage costs, there are a number of safeguards that protect customers from suffering any economic harm. First, utilities are required to file updated depreciation studies at least every five years. (Exh. No. 108, p. 7; 4 CSR 240-3.175.) Through this process estimates of net salvage can be

refined as additional data is collected. Second, utilities use the depreciation reserve to track, at least on an aggregate basis, the net salvage that is collected from customers. The depreciation reserve acts as a balancing account to insure that, in the long run, the proper amount of depreciation (including net salvage) is collected from customers. (Tr. pp. 1742-1744.) Third, since the depreciation reserve is deducted from rate base, to the extent that accrual of net salvage permits utilities to pre-collect estimated net salvage costs, customers will effectively receive a return on their pre-payments equal to the overall rate of return earned by the utility. (Tr. p. 1676.) Finally, the Commission's continuing oversight over utilities operates as an important protection for customers in this area, as well as many other areas. With these protections in place, the Commission should have no qualms about following Uniform System of Accounts, the overwhelming majority of other jurisdictions, and its own recent order in the Laclede proceeding, and adopting the accrual approach to net salvage, as recommended in this case by Empire.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that I have this 21st day of January, 2005, served the foregoing Initial Brief of AmerenUE Concerning Net Salvage either by electronic means, or by U. S. mail, postage prepaid addressed to all parties by their attorneys of record as shown below.

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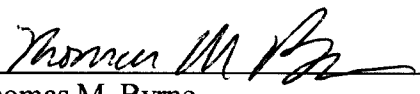
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