

Exhibit No.:  
Issue: Depreciation  
Witness/Type of Exhibit: John J. Spanos/Surrebuttal  
Sponsoring Party: Missouri-American Water Company  
Case No.: WR-2010-0131 & SR-2010-0135  
Date: May 6, 2010

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. WR-2010-0131 & SR-2010-0135

Surrebuttal Testimony of

JOHN J. SPANOS

on Behalf of

MISSOURI-AMERICAN WATER COMPANY

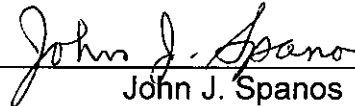
Jefferson City, Missouri

**BEFORE THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF MISSOURI**

<b>IN THE MATTER OF MISSOURI-AMERICAN ) WATER COMPANY FOR AUTHORITY TO ) FILE TARIFFS REFLECTING INCREASED ) RATES FOR WATER AND SEWER ) SERVICE )</b>	<b>CASE NO. WR-2010-0131 CASE NO. SR-2010-0135</b>
--	--

**AFFIDAVIT OF JOHN J. SPANOS**

John J. Spanos being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony entitled "Surrebuttal Testimony of John J. Spanos" that said testimony and schedules were prepared by him and/or under his direction and supervision; that if inquires were made as to the facts in said testimony and schedules, he would respond as therein set forth; and that the aforesaid testimony and schedules are true and correct to the best of his knowledge.

  
\_\_\_\_\_  
John J. Spanos

**Commonwealth of Pennsylvania  
County of Cumberland  
SUBSCRIBED and sworn to  
Before me this 27th day of April 2010.**

  
\_\_\_\_\_  
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

MISSOURI-AMERICAN WATER COMPANY

SURREBUTTAL TESTIMONY OF  
JOHN J. SPANOS

Line No.

INTRODUCTION

- 1 1. Q. Please state your name and business address.
- 2 A. John J. Spanos, 207 Senate Avenue, Camp Hill, Pennsylvania.
- 3 2. Q. Have you previously submitted testimony in this proceeding?
- 4 A. Yes. I submitted direct testimony in October 2009 and rebuttal testimony in
- 5 April 2010.
- 6 3. Q. What is the purpose of this testimony?
- 7 A. The purpose of my surrebuttal is to address the topics discussed by Missouri
- 8 Public Service Commission Staff (Staff) witness, Guy C. Gilbert, in his rebuttal
- 9 testimony. First, Mr. Gilbert refuses to recognize the true purpose of the life
- 10 span methodology for major locations, as well as the resultant life
- 11 characteristics of these assets if the life span methodology is not utilized.
- 12 Second, Mr. Gilbert continues to recommend the whole life method for
- 13 determining depreciation rates, but does not acknowledge the weakness of
- 14 the whole life method, which does not assure full recovery of each asset.
- 15 Third, Mr. Gilbert incorrectly states the variance between the calculated
- 16 accrued depreciation (theoretical reserve) and the book reserve. Finally, Mr.
- 17 Gilbert does not agree with implementing general plant amortization,
- 18 however, the whole life rate is the same.
- 19 4. Q. First, as a general matter, at page 3, lines 3 through 5 of the rebuttal
- 20 testimony of Mr. Gilbert, he notes that the Company's proposed depreciation

1 expense is "a 128% increase over Staff's recommended increase," seeming  
2 to leave the impression that Company's proposed depreciation rates and  
3 expense are excessive. How do you respond?

4 A. Neither the Company's proposed depreciation rates nor the resulting  
5 depreciation expense are excessive. One need look no further than the  
6 Company's proposed composite depreciation rate for all accounts of 2.26%  
7 as compared to the industry range for composite rates of 2.20% to 2.75%. As  
8 can be seen, the Company's proposal in this case is reasonable, in light of  
9 the industry average.

10 5. Q. Please discuss the life span methodology.

11 A. The life span methodology is the most appropriate method for matching  
12 recovery of a major facility to the life characteristics of the assets. Major  
13 facilities, such as treatment plants, do not have life characteristics  
14 comparable to mass assets, so why should recovery patterns of those assets  
15 be the same? The life span method is recognized in the other 49 states, as  
16 well as in Canada. Additionally, the depreciation rates for the assets of the  
17 "old" St. Louis County District were approved utilizing the life span method in  
18 the 2001 case.

19 6. Q. Can you show an example of why the life span methodology makes sense?

20 A. Yes. There is a past occurrence within Missouri American Water Company  
21 that clearly illustrates how the life span methodology better represents the life  
22 characteristics of treatment plant. The St. Joseph treatment plant was  
23 concurrently retired in the year 2000. There were numerous small  
24 retirements for many years; then at one point in time the entire surviving

1 facility was retired. Without the life span methodology at the time of the major  
2 retirement, the assets related to the St. Joseph treatment plant were not close  
3 to being fully recovered, so there was a large amount of under-recovered  
4 assets that needed to be included in depreciation that the customers in 2000  
5 had to pay for in a short amount of time, from which they did not receive much  
6 benefit. However, if the life span methodology was utilized, the depreciation  
7 expense leading up to the final retirement would have been more systematic  
8 and rational each and every year.

9 Mr. Gilbert continues to emphasize the 2004 Empire Case as his  
10 basis for not using the life span methodology. However, the premise of the  
11 order was based on no plants being retired and plants still in service  
12 indefinitely, but that is not the case for Missouri American Water Company.  
13 An example is the St. Joseph plant. Therefore, the issue should not be  
14 whether the life span methodology is utilized, but the soundness of  
15 determining the most appropriate estimated probable retirement date.

16 7. Q. What other factors need to be considered if the life span methodology is not  
17 utilized?

18 A. The analyses performed by Mr. Gilbert utilize the same retirements that were  
19 used in my depreciation study. However, my depreciation study incorporates  
20 the life span methodology which means my analyses did not consider any  
21 final retirements. If the life span methodology is not utilized, then the life  
22 analyses must include all retirements. Thus, Mr. Gilbert's analyses do not  
23 use the life characteristics expected for accounts which will have concurrent  
24 retirements of many assets, and ignores half the historical retirements as well.

1 8. Q. Why is remaining life superior to whole life?

2 A. The remaining life method is designed to recover the full service value of an  
3 asset, no more, no less. If the life estimate changes, then the remaining  
4 value of the asset is recovered equally over the remaining life. In contrast, in  
5 the whole life method, there is no mechanism to insure full recovery. If the life  
6 estimate becomes longer then the asset will be over-recovered at the end of  
7 its service life; if the life estimate is shortened, then the asset will be under-  
8 recovered.

9 9. Q. Has remaining life methodology been approved in Missouri?

10 A. Yes, it has. The following excerpts from Commission Case No. TO-82-3 set  
11 forth the concepts of remaining life and its approval, at least for Telephone  
12 Companies, in Missouri.

13 A secondary goal of depreciation is to match capital recovery  
14 with capital consumption. For years it has been recognized that this  
15 goal is difficult to attain, therefore, the emphasis is upon a systematic  
16 and rational allocation of the expense of capital consumption. The  
17 accounting does not purport to follow the actual rate of consumption of  
18 property during individual accounting periods. Therefore, it is equitable  
19 and sound as a matter of practical accounting to spread the  
20 depreciation expense in equal annual charges over the useful life of  
21 the property, but the actual rate of consumption may be different.  
22

23 Public utilities in this state have been using the straight-line  
24 vintage group (SLVG) and straight-line whole life (SLWL) depreciation  
25 since approximately 1945 and on a national level SLVG has been used  
26 in the regulated utility industry since 1913 with little change.  
27

28 SLVG employs an estimate of the service lives of each year's  
29 (vintage) additions of property. By weighting each of these vintage  
30 lives with surviving investment for that vintage, a composite average  
31 life is obtained. A fixed rate is obtained by subtracting the percentage  
32 of net salvage from 100 percent and dividing by the average service  
33 life. If, at some time during the life of the property, the original  
34 estimates appear to be in error, correction is made by the application of  
35 SLWL.  
36

1 The process may be illustrated by the use of a hypothetical  
2 investment with an original cost of \$2,200 and having an estimated life  
3 of 20 years and \$200 of net salvage value. Under SLVG depreciation  
4 would be accrued at the rate of five percent a year with a total accrual  
5 of \$5,000 after five years. If, at that time, it was realized that the initial  
6 estimate of life was in error and that the property will now only last ten  
7 years, correction is applied for the whole life of the property. Since it is  
8 now known that the proper depreciation rate should have been ten  
9 percent per year, depreciation will then be accrued at that rate.

10  
11 \* \* \*

12  
13 SLRL is the proposed method of correcting the depreciation rate  
14 for an initial error in estimation. SLRL determines an annual rate by  
15 subtracting the percentage of the depreciation reserve and the  
16 percentage of future net salvage from 100 percent and dividing by the  
17 average remaining service life. This rate is then applied to the surviving  
18 plant investment. SLRL results in the same rates as SLVG until the life  
19 estimate changes. Under SLRL, when the life estimate changes, the  
20 rate is additionally adjusted to compensate for presumed over-or-under  
21 accruals due to the improper rate having been applied in the past. This  
22 additional rate adjustment does not occur under SLVG.

23  
24 \* \* \*

25  
26 The most significant advantage of SLRL is that it adjusts the  
27 depreciation rate to effect fuller recovery during the period when the  
28 investment is still used in providing telephone service. Any adjustment  
29 during such period is not retroactive rate-making, because the rates  
30 are prospectively recovered on investment which is still in use.  
31 Underestimating service lives or making post-mortem adjustments  
32 after the investment was retired do not fulfill the objective of return of  
33 capital in a rational and systematic manner over the investment's  
34 service life. Such methods also create a situation wherein the  
35 telephone utilities would be required to wait until the investment retires  
36 before a corrective adjustment is made. SLRL appears to be a  
37 reasonable solution to any capital recovery deficiency in Missouri.

38  
39  
40 *In the Matter of the Investigation of Straight-Line Equal Life Group and*  
41 *Remaining Life Depreciation Methods for Class A and B Missouri*  
42 *Jurisdictional Telephone Utilities, Case No. TO-82-3, Report and Order,*  
43 *25 Mo.P.S.C. (N.S.) 331, 334-36*  
44

1 Although the above-quoted case dealt with the appropriate  
2 depreciation method for telephone companies, the rationale is equally  
3 applicable for water and energy utilities as well.

4 10. Q. Can you address Mr. Gilbert's discussion related to a \$64 million difference  
5 between the theoretical reserve and the book reserve?

6 A. Yes. The \$64 million reserve difference is incorrectly calculated as Mr.  
7 Gilbert erroneously compares the two reserve levels. He mistakenly records  
8 the theoretical reserve for four accounts which totals approximately \$50  
9 million.

10 Mr. Gilbert's presentation of the \$64 million reserve difference can  
11 be reviewed in Appendix 5, Schedule GCG-4, where he shows the actual  
12 reserve of \$379,432,751. This includes \$50,889,082 for Account 316 instead  
13 of \$5,089,082. Additional differences include: \$28,100,173 instead of  
14 \$26,100,173 for Account 331; \$35,559,042 instead of \$33,559,042 for  
15 Account 332; and \$605,023 instead of \$606,023 for Account 392.30.

16 11. Q. Is this error critical in Mr. Gilbert's analyses?

17 A. No, it is not since Mr. Gilbert decides to not address a large over accrual.  
18 However, the critical issue should be; can the depreciation rate adjust for and  
19 incorporate any past over- or under-accrual; the answer is no, when using the  
20 whole life method; and yes, when using the remaining life method.

21 12. Q. Are the whole life rates the same as the general plant amortization rates?

22 A. The rates will be the same once the general plant amortization is properly  
23 implemented.

24 13. Q. What is the difference between the two methodologies?



- 1           A.    The whole life method employed by Mr. Gilbert will calculate depreciation  
2                    expense based on the plant balance.  Thus, if you have a 5-year life which  
3                    produces a 20% rate, the whole life method will continue to record 20% of  
4                    depreciation on the entire plant balance, even if the asset survives longer  
5                    than 5 years.  In contrast, under amortization accounting, a 5-year asset is  
6                    retired after 5 years of service and consequently, only 100% of the investment  
7                    is recovered.
- 8    14.  Q.    Will general plant amortization produce a constant rate?
- 9           A.    Yes.  Once full implementation is in effect, the amortization rate will be  
10                   consistent with the amortization period.
- 11   15.  Q.    Does this conclude your surrebuttal testimony?
- 12           A.    Yes, it does.