Exhibit No.:	
Issue:	*Depreciation*
Witness:	*Donald S. Roff*
Sponsoring Party:	*Empire District*
Type of Exhibit:	*Rebuttal Testimony*
Case No.:	*ER-2004-0570*
Date:	*November 4, 2004*

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

REBUTTAL TESTIMONY

OF

DONALD S. ROFF

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2004-0570

REBUTTAL TESTIMONY
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OUTLINE

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INTRODUCTION

Q. PLEASE STATE YOUR NAME, POSITION AND BUSINESS ADDRESS.

A. My name is Donald S. Roff and I am a Director with the public accounting firm Deloitte & Touche LLP. My business address is 2200 Ross Avenue, Suite 1600, Dallas, Texas 75201.

Q. ARE YOU THE SAME DONALD S. ROFF THAT FILED DIRECT TESTIMONY IN THIS PROCEEDING?

A. Yes, I am.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. The purpose of my rebuttal testimony is to respond to the direct testimony and positions put forth by Missouri Public Service Commission Staff ("Staff") witnesses Mr. Gregory E. Macias and Ms. Leasha S. Teel and Missouri Office of the Public Counsel ("OPC") witness Mr. Michael J. Majoros, Jr. on the subjects of depreciation and depreciation accounting. I shall demonstrate that the Staff proposal is improper, is lacking in support, ignores regulatory rules, and represents virtually no change to the existing, approved depreciation rates for many asset categories. While no change to the existing approved depreciation rates may be an acceptable result if no outside factors or requirements are in place, it is a totally unacceptable result when such factors and requirements are in effect. I shall demonstrate that the OPC testimony and proposal is without merit as Mr. Majoros incorrectly commingles accounting principles, regulatory accounting requirements and ratemaking concepts, as well as presents misleading and incorrect interpretations of accounting standards and regulatory rules. In both instances, the opposing parties propose depreciation expense levels that are inadequate by any reasonable measure.

Q. WHAT DID YOU DO TO DEVELOP THIS REBUTTAL TESTIMONY?

A. In general, I read Mr. Majoros', Mr. Macias' and Ms. Teel's testimonies and reviewed their various Schedules and Exhibits. I reviewed the work papers developed in my depreciation study. I reviewed and evaluated various data requests and responses prepared in this proceeding. I reviewed Missouri Statutes and Rules concerning asset accounting and depreciation, in particular 4 CSR 240-20, as well as the Report and Order from Case No. ER-2001-299. I also re-examined Order No. 631 of the Federal Energy Regulatory Commission ("FERC") and the provisions and requirements of Statement of Financial Accounting Standards No. 143, *Accounting for Asset Retirement Obligations*. I have also read various testimonies in other proceedings before this Commission on the topic net salvage, in particular Case No. GR-99-315.

Q. DO YOU SPONSOR ANY EXHIBITS?

A. Yes. Rebuttal Exhibit DSR-1R has been prepared to summarize the depreciation proposals of the various parties in this proceeding. Exhibit DSR-2R is a similar summary but utilizes the actual depreciation rates requested by the Company's filing. This issue will be address later in my rebuttal testimony. Additional exhibits in the form of workpapers will be described later in my rebuttal testimony.

Q. CAN YOU SUMMARIZE THE MOST IMPORTANT DEPRECIATION ISSUE IN THIS PROCEEDING?

A. There is no dispute as to this matter. The single, most important issue related to depreciation in this proceeding is the subject of net salvage[1] and its inclusion in depreciation rates.

<u>POSITION OF STAFF WITNESSES MR. MACIAS AND MS. TEEL</u>

Q. PLEASE SUMMARIZE THE POSITION OF STAFF WITNESSES MR. MACIAS AND MS. TEEL.

A. Mr. Macias has, in my opinion, performed a very limited review of historical depreciation data. With respect to Production Plant, Mr. Macias recommends continuation of the use of the existing depreciation rates, with the exception of those asset categories for which the accumulated depreciation balance exceeds the plant balance. For Transmission, Distribution and General Plant (mass asset accounts), he has relied solely upon historical analysis results with little or no interpretation of results, consideration of asset mix, or evaluation of

[1] Net salvage is the difference between salvage and cost of removal; when cost of removal exceeds salvage, negative net salvage occurs.

Company plans and expectations. More importantly, he has neglected to incorporate net salvage into his depreciation rate proposals. Ms. Teel proposes to recover net salvage as a separate expense item based upon a five-year average of historic net salvage costs. As shown on Exhibit DSR-1R, use of the Staff proposed depreciation rates applied to June 30, 2004 test year jurisdictional balances results in a decrease in annual depreciation expense of about $788,000 from the level of depreciation expense developed by application of the existing depreciation rates to the same balances, (i.e., the difference between Column 5 and Column 11). Use of the Staff proposed depreciation rates results in a reduction in annual depreciation expense of over $25.9 million compared with the application of my recommended depreciation rates applied to the same balances (i.e., the difference between Column 7 and Column 11).

Q. DO YOU HAVE ANY COMMENTS REGARDING THE LIFE ANALYSES CONDUCTED AND UTILIZED BY MR. MACIAS FOR THE TRANSMISSION, DISTRIBUTION AND GENERAL PLANT ASSET CATEGORIES?

A. Yes. I am concerned with Mr. Macias' rather strict reliance solely on history. There are general conditions that must be met in order to judge the value of inferences drawn from data used in statistical life analysis. These include:

1. Some uniform and consistent relationship between retirements and age exists;
2. Experience be homogeneous throughout the period of study; and

3. No material changes in conditions affecting the series of data have taken place.[2]

I have reviewed the life analysis plots provided by Mr. Macias in his workpapers. While I have no quarrel with the visible quality of the curve fits provided, there is little or no qualitative information contained in Mr. Macias' workpapers or testimony. My study, on the other hand, encompassed both an evaluation of history and an evaluation of future expectations.

POSITION OF OPC WITNESS MR. MAJOROS

Q. DO YOU HAVE ANY COMMENTS REGARDING THE LIFE ANALYSIS OF PRODUCTION PLANT CONDUCTED BY MR. MAJOROS?

A. Yes. First, I would point out that the life analysis of Production Plant conducted by Mr. Majoros suffers the same data constraints as described above. It is unclear to me that the data utilized for the life analysis of Production Plant meets these data constraints. Second, while it is true that Empire has the aged property accounting data from which to construct actuarial life tables, it does not follow that such data produce reliable and predictive life analysis indications. The number of surviving units contained in the life analysis of the Steam Production function is no more than five. By this I mean there are only five generating units contained in the actuarial population. This is truly a limited sample and makes reliance on the output results tenuous, at best. I believe that Mr. Majoros has conducted a technically correct actuarial life analysis of each of the accounts within the

[2] *Methods of Estimating Utility Plant Life*, Edison Electric Institute, 1952, page 5.

Production Plant function; that is, Mr. Majoros has utilized aged retirement and survivor information in developing historical life tables. However, such results are unreliable and, more importantly, inconclusive with respect to their relevance to future service life patterns and depreciation calculations because the results are predicated on a limited sample population not predictive of future activity. More to the point, a valid and predictive actuarial analysis should contain past retirements of full generating units. The actuarial data for Steam Production Plant does not contain such activity, making survivor curve predictions inaccurate. The life span approach that I have employed more properly reflects the survival relationship of these asset groups, and, in turn, develops more appropriate depreciation rates.

Q. CAN YOU EXPLAIN THIS LAST POINT FURTHER?

A. Yes. For example, Mr. Majoros has selected an R2.0 retirement dispersion with an average service life of 93 years for Account 311, Steam – Structures and Improvements, based ***solely*** on history. This curve and life combination indicates a final retirement for this asset group at age 172 years! And over 54% of the original asset base will attain an age of 93 years prior to retirement. Such a result is illogical and the associated life is **excessive** for the determination of appropriate depreciation rates. The investments in Account 311 for the Iatan Plant, installed in 1980, will not become fully depreciated until the year 2152, and will only become 50% depreciated some 34 years from today. The life span procedure that I have utilized will result in the Iatan Plant being fully depreciated in the 2020. This dramatic difference is cause for concern. It should be noted that the Staff's average service life recommendation for Account 311 is even longer than the OPC selection. Taking Production Plant as a whole, the composite average service life developed by the Staff in this proceeding is over 49 years. This is exceeded by the composite average service life of over 52 years developed by the OPC. My composite average service life is just under 36 years. These differences are too large to ignore.

Q. ARE THE LIFE ANALYSES THAT WERE CONDUCTED BY OPC IN THIS PROCEEDING MEANINGFUL?

A. They may be meaningful in that they reflect what history has occurred, but they are NOT conclusive or predictive for estimating services lives to be used for calculating depreciation rates. In fact, on several of his work papers Mr. Majoros has included notes saying "Not enough data for Actuarial Analysis" or "insufficient retirements/exposures".

Q. WHY DID YOU USE A LIFE SPAN FORECAST APPROACH?

A. I utilized a life span forecast approach because such a methodology best matches what happens in real life to generation facilities. What happens to generation facilities in real life is that they die (retire) at one point in time. My approach is designed to recognize this eventuality.

Q. IS MR. MAJOROS CORRECT IN SAYING THAT THIS COMMISSION FOUND THE LIFE SPAN METHOD TO BE

INAPPROPRIATE IN CASE NO. ER-2001-299 AND THAT IT WAS SPECIFICALLY REJECTED BYTHIS COMMISSION[3]?

A. No. I believe the Order and Report in that case stated that the Commission found the unit retirement dates sponsored by Empire's consultant were not credible. The Commission did not reject the life span methodology.

Q. WHAT MAKES THE RETIREMENT DATES THAT YOU HAVE USED IN YOUR LIFE SPAN METHODOLOGY CREDIBLE?

A. Based upon my discussions with Company personnel, the retirement dates provided to me were based upon consideration of economic and operating factors in force today and represent the Company's best estimate of a life span for cost allocation purposes for depreciation expense determination recognizing routine maintenance and normal capital replacements. Thus these dates represent Empire's particular experience and planning.

Q. PLEASE SUMMARIZE THE POSITION OF OPC WITNESS MR. MAJOROS.

A. Mr. Majoros makes no changes to my service life recommendations for mass asset categories (Transmission, Distribution and General Plant functional categories)[4]. For the Production Plant categories, he claims Empire's proposed depreciation rates are excessive because they are based on lives that are too short or unsupportable net salvage allowances.[5] As shown on Rebuttal Exhibit DSR-1R, the effect on annual depreciation expense resulting from application of the OPC proposed depreciation rates is an increase of about

[3] Majoros Testimony, page 4, lines 9 and 10.
[4] Majoros Direct Testimony, page 5, line 10.
[5] Ibid, page 12, lines 12 through 15.

$630,000 (i.e., the difference between Column 5 and Column 9), when compared with the level of depreciation expense developed by application of the existing depreciation rates. The OPC proposed depreciation expense is approximately $24.5 million lower when compared to the application of my recommended depreciation rates to the same balances (i.e., the difference between Column 7 and Column 9).

Mr. Majoros effectively proposes the use of a "cash" basis for the net salvage component of depreciation expense. Mr. Majoros also claims that Empire's filing, through my direct testimony, reverses several decisions made by this Commission just three years ago. I will demonstrate that this is not the case. Finally, Mr. Majoros makes a very restrictive and incorrect interpretation of the provisions of SFAS No. 143 and FERC Order No. 631. I will provide a proper interpretation and demonstrate the flaws contained in his testimony.

Q. DO YOU HAVE ANY ADDITIONAL COMMENTS REGARDING THE TESTMONY OF MR. MAJOROS ON THE ISSUE OF NET SALVAGE?

A. Yes. A careful reading of his testimony and a knowledgeable understanding of depreciation accounting reveals that Mr. Majoros has provided incorrect interpretations of regulatory rules and accounting pronouncements and commingled regulatory accounting requirements with financial reporting standards and ratemaking principles. Further, Mr. Majoros makes unsupported claims and comments in his testimony. My rebuttal testimony sorts out these misinterpretations, and properly segregates the separate components of regulatory accounting, financial reporting and ratemaking, as well as highlights the areas where Mr. Majoros provides unsupported statements. In order to understand the significance of these comments, a discussion of regulatory accounting principles, financial reporting principles and ratemaking concepts will follow. The purpose of these discussions is to illustrate how regulatory accounting, financial reporting and ratemaking are separate and distinct concepts and activities, and that it is improper to combine them.

<u>NET SALVAGE REGULATORY ACCOUNTING PRINCIPLES</u>

Q. WHAT ARE THE PERTINENT REGULATORY ACCOUNTING PRINCIPLES WITH RESPECT TO NET SALVAGE AS A COMPONENT OF DEPRECIATION?

A. The Uniform System of Accounts ("USOA") provides the regulatory accounting framework for depreciation. The pertinent definitions are listed on page 1 of Schedule DSR-3, as part of my direct testimony. These regulatory definitions clearly include net salvage as a component of depreciation. In addition, there are basic accounting instructions within the USOA that indicate the intent of the USOA with respect to depreciation and net salvage, e.g.,

> When a retirement unit is retired from electric plant, with or without replacement, the book cost thereof shall be credited to the electric plant account in which it was included, determined in the manner set forth in paragraph D, below. If the retirement unit is of a depreciable class, the book cost of the unit retired and credited to electric plant shall be charged to the accumulated provision for depreciation applicable to such property. ***The cost of removal and the salvage***

> ***shall be charged or credited, as appropriate, to such depreciation account.***[6] (Emphasis added)

Also under the description for Account 403, Depreciation Expense,

> The utility shall keep such records of property and property retirements as will reflect the service life of property which has been retired and aid in estimating probable service life by mortality, turnover, or other appropriate methods; and also such records as will reflect ***the percentage of salvage and costs of removal for property retired from each account, or subdivision thereof, for depreciable electric plant.*** (Emphasis added).

Also, General Instruction 22 states the following:

> Depreciation Accounting.
> A. Method. Utilities must use a method of depreciation that allocates in a systematic and rational manner the service value (difference between original cost and net salvage value of utility plant) of depreciable property over the service life of the property.
> B. Service lives. Estimated useful service lives of depreciable property must be supported by engineering, economic, or other depreciation studies.
> C. Rates. Utilities must use percentage rates of depreciation that are based on a method of depreciation that allocates in a systematic and rational manner the service value of depreciable property to the service life of the property. Where composite depreciation rates are used, they should be based on the weighted average estimated useful lives of the depreciable property comprising the composite group.

Q. WHY HAVE YOU EMPHASIZED THESE INSTRUCTIONS?

A. These instructions have been emphasized to demonstrate that the regulatory rules ***<u>require</u>*** inclusion of net salvage in the depreciation rate calculation.

Q. ARE THERE ANY OTHER REGULATORY RULES RELATIVE TO DEPRECIATION OR NET SALVAGE?

A. Yes. FERC Order No. 631 provides the regulatory framework for the accounting, financial reporting and ratemaking related to Asset Retirement

[6] Electric Plant Instruction ("EPI") 10.B.2

Obligations ("ARO's") defined for financial reporting purposes in Statement of Financial Accounting Standards ("SFAS") No. 143, *Accounting for Asset Retirement Obligations*. Essentially Order No. 631 amended the various USOA's promulgated by the FERC, and added certain new accounts to record ARO's asset retirement costs ("ARC's") and accretion expense. Contrary to Mr. Majoros' interpretation, Order No. 631 did not address the accounting for non-legal obligations, as clearly demonstrated by the following two statements:

> The Commission did not propose any changes to its existing accounting requirements for cost of removal for non-legal retirement obligations.[7]
>
> The accounting for removal costs that do not qualify as legal retirement obligations falls outside the scope of this rule. The Commission is aware that there is an ongoing discussion in the accounting community as to whether the cost of removal should be considered as a component of depreciation. However, this issue is beyond the scope of this rule and we are not convinced that there is a need to fundamentally change accounting concepts at this time.[8] (Emphasis added)

This calls into question the underlying premise of Mr. Majoros' testimony concerning Order No. 631. There is a significant difference between ***accounting*** for cost of removal and ***maintaining*** subsidiary records[9,10]. As a

[7] Order No. 631, Paragraph 36.
[8] Ibid, Paragraph 37.
[9] Ibid, Paragraph 38. "Instead we will require jurisdictional entities to maintain separate subsidiary records for cost of removal for non-legal retirement obligations that are included as specific identifiable allowances recorded in accumulated depreciation in order to separately identify such information to facilitate external reporting and for regulatory analysis, and rate setting purposes. Therefore, the Commission is amending the instructions for account 108 and 110 in Parts 101, 201 and account 31, Accrued depreciation – Carrier property, in Part 352 to require jurisdictional entities to maintain separate subsidiary records for the purpose of identifying the amount of specific allowances collected in rates for non-legal retirement obligations included in the depreciation accruals."

result, Mr. Majoros has reached an incorrect conclusion and provided misleading testimony. For example, a company likely maintains time cards to support payroll expense (i.e., subsidiary records), but it does not account for each person's payroll costs on its Balance Sheet or Income Statement. Moreover, only specific identifiable allowances collected in rates must be separately quantified. Empire has no specific identifiable cost of removal component in any of its approved depreciation rates making this requirement moot. A further discussion regarding net salvage will be provided later in my rebuttal.

FINANCIAL REPORTING PRINCIPLES

Q. WHY DO YOU SEGREGATE REGULATORY ACCOUNTING FROM FINANCIAL REPORTING?

A. I differentiate regulatory accounting from financial reporting because they are, in fact, two different concepts. In my view, regulatory accounting refers to the process of recording cost information as prescribed by the USOA and Missouri Public Service Commission Rules. Financial reporting deals with the preparation of financial statements consistent with Generally Accepted Accounting Principles ("GAAP") as mandated by the Securities and Exchange Commission ("SEC") for public companies, and includes application of the

[9] Ibid, Paragraph 39. "Jurisdictional entities must identify and quantify in separate subsidiary records the amounts, if any, of previous and current accrued accumulated removal costs for other than legal retirement obligations recorded as part of the depreciation accrual in accounts 108 and 110 for public utilities and licensees, account 108 for natural gas companies, and account 31 for oil pipeline companies. If jurisdictional entities do not have the required records to separately identify such prior accruals for specific identifiable allowances collected in rates for non-legal asset retirement obligations recorded in accumulated depreciation, the Commission will require that the jurisdictional entities separately identify and quantify prospectively the amount of current accruals for specific allowances collected in rate for non-legal obligations."

Financial Accounting Standards Board's ("FASB") various standards. Regulatory accounting develops similar financial statements only reflective of the rules and reporting requirements of the Missouri Public Service Commission.

Q. WHAT IS THE PRIMARY DIFFERENCE BETWEEN UTILITY REGULATORY ACCOUNTING AND GAAP FINANCIAL STATEMENTS?

A. In my view, the only difference is the ability to create and record regulatory assets and regulatory liabilities. These two items represent deferrals on the balance sheet that would not be allowed under conventional GAAP.

Q. CAN YOU PROVIDE AN EXAMPLE OF A REGULATORY ASSET OR REGULATORY LIABILITY?

A. Yes. At page 28 of its 2003 Annual Report, Empire states the following with respect to SFAS No. 143:

> Upon adoption of this statement in the first quarter of 2003, we recorded a non-recurring discounted liability and a regulatory asset of approximately $630,000 because we expect to recover these costs of removal in electric rates. This liability will be accreted over the period up to the estimated settlement date. The balance at the end of 2003 was approximately $656,000. Also, we reclassified the accrued cost of dismantling and removing plant from service upon retirement, which is not considered an asset retirement obligation under FAS 143, from accumulated depreciation to a regulatory liability.

Q. WHAT IS THE GAAP FRAMEWORK FOR DEPRECIATION ACCOUNTING?

A. The GAAP framework for depreciation accounting is described at page 8 of my direct testimony and quoted again as follows:

> 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.

This definition of depreciation accounting contains several key concepts. First, that salvage (net salvage) is to be recognized. A review of the history of regulation reveals that regulatory accounting rules predate this GAAP definition and the terms "salvage" and "net salvage" were often used interchangeably.[11] Second, that depreciation accounting is a cost allocation process. Third, that the cost allocation is over the useful life of the asset(s). Thus, an estimate of useful life is required. Fourth, that grouping of assets is permissible. Fifth, that depreciation accounting is NOT a valuation process. This includes the net salvage component of cost. And sixth, that depreciation accounting must be systematic and rational. Systematic means something other than discretionary and implies the use of a formula. The depreciation rate formulas that I have used are shown on Exhibit DSR-1, page 5. Rational means that the pattern of depreciation should match either the revenues produced by the asset, or the consumption of the asset. Asset consumption in my depreciation study is measured by either interim retirement factors for Production Plant or Iowa curves and average service life combinations for mass assets.

[11] Reports of Committee on Depreciation for the Years 1943 and 1944, National Association of Railroad and Utilities Commissioners, page 42. "The cost of removing many materials which constitute the operating units of property often results in a very small net salvage. In many individual cases and possibly in the cases of some entire classes of property the salvage may be negative."

Q. WHY HAVE YOU DEVOTED SO MUCH EFFORT TO THESE CONCEPTS?

A. It was necessary to lay this background so I can now explain how Mr. Majoros has misapplied these principles and produced improper results which are inconsistent with regulatory rules and accounting principles. And, as will be discussed next, he has incorrectly commingled both regulatory and financial accounting concepts with ratemaking concepts. Also, the recommendations of Mr. Macias and Ms. Teel ignore certain regulatory accounting rules.

RATEMAKING CONCEPTS

Q. WHAT RATEMAKING CONCEPTS HAVE RELEVANCE TO DEPRECIATION?

A. There are two ratemaking concepts that have relevance to depreciation. The first is that a utility is entitled to fair and reasonable recovery of its prudently incurred costs. The second is that of intergenerational equity, meaning that the generation of customers that caused costs to be incurred should provide revenues for those costs.

Q. HAVING PROVIDED THE CONCEPTUAL BACKGROUND AND RELATED PRINCIPLES, WHAT DO YOU INTEND TO DEMONSTRATE?

A. There are a number of issues and areas where Mr. Majoros has provided testimony that is based upon incorrect commingling of these separate concepts and results in improper recommendations that should be rejected by this

Commission. I will address areas where Mr. Majoros has incorrectly applied these separate concepts. In addition, I believe that the regulatory accounting rules of this Commission are clear with respect to requiring net salvage as a component of appropriate depreciation rates. Because Staff witness Macias has not included such an allowance in his depreciation rate recommendations, those recommendations must be dismissed by this Commission as they produce an inadequate level of depreciation expense.

Q. CAN YOU PROVIDE SPECIFIC EXAMPLES WHERE MR. MAJOROS HAS COMMINGLED THE SEPARATE CONCEPTS OF REGULATORY ACCOUNTING, FINANCIAL REPORTING AND RATEMAKING?

A. Yes. While I will not list or discuss all such examples, the first instance is at page 4, line 12 of his testimony where Mr. Majoros asserts that Empire has bundled future net salvage into depreciation rates even though such a practice was rejected in Case No. ER-2001-299 and Empire has no obligation or liability to incur these costs. This assertion stems from Mr. Majoros' attempt to link the identification and measurement of an Asset Retirement Obligation ("ARO") under SFAS No. 143 with the regulatory accounting requirements of the USOA and FERC Order No. 631. In my reading of the Report and Order in Case No. ER-2001-299, I could find no language that requires Empire to segregate its depreciation rates into components. SFAS No. 143 recognizes that current regulatory accounting and ratemaking allow for costs that fall within the scope of SFAS No. 143 and other costs that do not fall within the scope of SFAS No.143. The fact that Empire has not recorded a legal liability (under financial accounting and reporting) does not mean that such costs are incorrectly recorded under regulatory accounting, i.e., negative net salvage.

The second instance begins at page 12, lines 1 through 8. Here Mr. Majoros confuses regulatory accounting and associated bookkeeping (the recording of depreciation expense) with ratemaking (the recovery of the revenue requirement). Capital recovery only occurs when expenses (or other costs) are incorporated into a revenue stream. His assertions regarding excessive depreciation are misplaced and unfounded, and are addressed below.

A third example occurs at page 13, lines 5 and 6, where Mr. Majoros asserts that "depreciation expense is a charge to operating expense to reflect recovery of a company's previously expended capital". In the regulatory accounting world, depreciation expense is a charge to operating expense. In the ratemaking world, depreciation becomes capital recovery. On the same page at line 18, he goes on to say that depreciation is a non-cash expense (regulatory accounting) and then makes depreciation expense a component of the revenue requirement (ratemaking). It is important that these separate concepts not be confused and haphazardly lumped together.

A fourth example is shown at page 34, lines 14 through 18. Mr. Majoros states that "Empire had collected $3.8 million in excess net salvage." It may well be true that Empire has ***recorded*** depreciation accruals for cost of removal that were different from the actual cost of removal that Empire incurred over the period 1980 through 2003, but there is no way to tell how much Empire has actually ***collected***. The point here is that, once again, Mr. Majoros has commingled accounting concepts with ratemaking concepts. The fact is that there is merely a difference between the recorded depreciation accrual for cost of removal and the actual incurrence of cost of removal. This is a common situation. This is because the accrual for cost of removal relates to ALL future retirements of presently surviving property, and the actual incurred cost of removal relates to the retirements in just one year. Further, and at least as important, this amount represents a ***difference***, not ***excess*** net salvage. Empire has recorded only the level of depreciation expense consistent with its authorized depreciation rates.

Q. YOU SEEM TO BE DWELLING ON THESE DIFFERENT CONCEPTS, WHAT IS THEIR SIGNIFICANCE TO YOUR DEPRECIATION RECOMMENDATIONS AND THOSE OF MR. MACIAS AND MR. MAJOROS?

A. The significance to Mr. Macias' testimony and depreciation recommendations is quite simple. I believe that regulatory rules require the inclusion of net salvage in the depreciation rate. Mr. Macias has included no such allowance and therefore his depreciation rate recommendations are improper, and in this case, inadequate.

Mr. Majoros takes a different and somewhat novel approach by misinterpreting the provisions of SFAS No. 143 (a financial reporting requirement) and weaving this misinterpretation into the ***regulatory accounting*** requirements of FERC Order No. 631 and then claiming that

SFAS No. 143 supersedes regulatory accounting rules. His entire logic is first misdirected, second inconsistent with regulatory accounting rules, and third, just plain wrong. Finally, his claims regarding this Commission's Order in Case No. ER-2001-299 fall somewhat short of accurate.

Q. WHAT IS YOUR READING OF THE COMMISSION'S REPORT AND ORDER IN CASE NO. ER-2001-299?

A. My interpretation of the Report and Order is much different from that of Mr. Majoros. I do agree that Mr. Majoros has correctly cited the language contained in the Report and Order issued September 20, 2001. However, the only reference that I see in the Report and Order related to depreciation is under the Section entitled "IT IS THEREFORE ORDERED:

1. That the Commission adopts the average service lives that are attached as Appendix A to this Report and Order."

What Mr. Majoros references at page 6, lines 9 through 11, is merely a finding based on the facts of that particular case. I have violated neither of these findings by incorporating net salvage into my depreciation rate recommendations. As stated there, my depreciation rate recommendations, including net salvage, are based on historical net salvage cost (related to retirements) and have been treated as an expense (a portion of depreciation expense). Thus my rates do not violate any Commission practice, nor have I "reversed" any Commission decisions. The most compelling discussion on the topics of net salvage and depreciation in that Report and Order was in the Dissenting Opinion of Commissioner Connie Murray, summarized best in the last paragraph: "**Empire should be allowed to include the cost of net salvage in its calculation of whole life depreciation for both the existing and the SLCC plant**." (Emphasis added).

SFAS NO.143 – ACCOUNTING FOR ASSET RETIREMENT OBLIGATIONS

Q. WHY IS SFAS NO. 143 SIGNIFICANT TO YOUR REBUTTAL TESTIMONY?

A. SFAS No. 143 is significant to my rebuttal testimony because of the incorrect interpretation of this Standard made by Mr. Majoros and the inferences he makes to his depreciation recommendations, as well as the further incorrect conclusions he makes relative to FERC Order No. 631.

Q. PLEASE EXPLAIN.

A. Mr. Majoros correctly describes the treatment of legal obligations under Statement 143 (financial accounting) and the associated treatment of legal obligations under Order No. 631 (regulatory accounting). Mr. Majoros apparently assumes that if a legal obligation does not exist (a financial accounting determination) then no future cost of removal can be contained in depreciation expense (a regulatory accounting determination).[12] This is NOT what either the accounting standard (Statement 143) or the regulatory standard (Order No. 631) requires. In fact, Statement 143 recognizes just the opposite and includes provisions for handling the regulatory accounting differences. At paragraph B73, the Statement says:

> Many rate-regulated entities currently provide for the costs related to asset retirement obligations in their financial statements and recover

[12] See Majoros Testimony, page 26, lines 12 through 14.

> those amounts in rates charged to their customers. Some of those costs relate to asset retirement obligations within the scope of this Statement; others are not within the scope of this Statement and, therefore, cannot be recognized as liabilities under its provisions. The objective of including those amounts in rates currently charged to customers is to allocate costs to customers over the lives of those assets. The amount charged to customers is adjusted periodically to reflect excess or deficiency of the amounts charged over the amounts incurred for the retirement of long-lived assets. The Board concluded that is asset retirement costs are charged to customers of rate-regulated entities but no liability is recognized, a regulatory liability should be recognized if the requirements of Statement 71 are met.

He goes on to say, at page 27, lines 17 through 20, that such costs cannot be included in the company's depreciation expense on its general purpose financial statements. Statement 143 says no such thing nor does it require such treatment. Mr. Majoros' interpretation is flatly wrong and must be rejected.

Q. DOES MR. MAJOROS MAKE ANY OTHER INCORRECT CLAIMS REGARDING STATEMENT 143?

A. Yes. At page 28, line 7, Mr. Majoros misstates the facts. He claims that a regulated utility must "determine the amount of any prior cost of removal collections relating to non-ARO's that is now included in their accumulated depreciation accounts, and record these and any such future charges as a regulatory liability to ratepayers". The truth is that such "reclassification" occurs only on the financial books, and nothing is done differently for regulatory accounting. He seems to hint that Empire improperly implemented Statement 143 and that Empire is not entitled to recovery of such amounts. The first argument is emphatically wrong and the second argument is up to this Commission, not Mr. Majoros to decide.

<u>EXCESSIVE DEPRECIATION</u>

Q. AT VARIOUS PLACES THROUGHOUT HIS TESTIMONY, MR. MAJOROS MAKES NUMEROUS REFERENCES TO THE CONCEPT OF "EXCESSIVE DEPRECIATION" AND EVEN PROVIDES EXCERPTS FROM A UNITED STATES' SUPREME COURT CASE. DO YOU HAVE ANY COMMENTS?

A. Yes. This is a recurrent theme in his testimonies where depreciation is the subject. It would seem that when there is disagreement between recommended depreciation rates, Mr. Majoros' lower depreciation rates must be correct and all other depreciation rates are "excessive". In the Supreme Court case cited, Mr. Majoros confuses the concept of excessive depreciation due to past accumulations of depreciation expense with the use of estimated service lives and net salvage allowances used to make prospective revisions to depreciation rates. My understanding of the <u>*Lindheimer*</u> case is that the Supreme Court was addressing a claim of confiscation by the company and that, with "confiscation being the issue", the company had the burden of showing that its past accumulation of depreciation had not been excessive. In Empire's case, the past accumulation of depreciation is not an issue, nor could not have been excessive because it was predicated on the application of Commission authorized depreciation rates. Empire has recorded (accounting) and the customer has paid (ratemaking) precisely what has been allowed through the regulatory process. As the Court indicated, depreciation rates are based on estimates of the future and those estimates must unquestionably be reviewed from time to time, with mid-stream adjustments applied prospectively to reflect the controlling test of experience. A more careful review of the *Lindheimer* case and decision also reveals that the Supreme Court was reviewing a rate order based on a "fair value" rate base. This means that at least some significant portion of the rate base would reflect the reconstruction cost new ("RCN") value of plant. With such an approach to valuation, the determination of the appropriate depreciation reserve and whether a booked reserve that reflects original cost can be deemed to be "excessive" or "confiscatory" is particularly problematic in Empire's case. In my view, Mr. Majoros' reliance on the *Lindheimer* decision is severely misplaced.

Q. WHY DO YOU SAY THAT EXCESSIVE DEPRECIATION IS A RECURRENT THEME IN MR. MAJOROS' TESTIMONIES?

A. In the past few years, in other proceedings, Mr. Majoros has provided to me through the discovery process, several prior testimonies he submitted on the issue of depreciation. These included three testimonies in New Jersey, one in Oklahoma (not really testimony, but more of a position paper and a stipulation agreement), one in Kentucky, two in Kansas, one in Vermont, one in Hawaii and one in Nevada. The following statements were made in these various testimonies:

> Yes. In my opinion, the Company's depreciation proposal is unreasonable. It will produce excessive depreciation in this rate case and unnecessarily increase the revenue requirement.[13]

[13] Direct Testimony of Michael J. Majoros, Jr. BPU Docket No. ER02100724, Rockland Electric Company, page 3, line 4. (emphasis added)

> Yes. In my opinion, the Company's depreciation proposal is unreasonable. It will produce excessive depreciation expense in this rate case and unnecessarily increase the revenue requirement.[14]
> The Company's proposal produces excessive depreciation because it includes an unsupportable and unreasonable request for negative net salvage in its depreciation rate calculations.[15]
> The Company filed a depreciation study conducted by Mr. Spanos indicating that the existing depreciation rates are excessive. Mr. Spanos proposed a depreciation rate reduction. …. Yes, I agree that the Company's depreciation rates are excessive.[16]
> The proposals are unreasonable because they produce excessive depreciation and thereby unnecessarily increase the revenue requirement.[17]
> Yes. In my opinion, the Company's depreciation proposal is unreasonable. It will produce excessive depreciation in this rate case and unnecessarily increase the revenue requirement.[18]
> The Company's depreciation proposal is unreasonable because the proposal produces excessive depreciation expense which will, in turn, be charged to ratepayers in this rate case.[19]
> In my opinion, the Company's depreciation proposal is: unreasonable because the proposal produces an excessive depreciation expense which will, in turn, be charged to ratepayers in the next case.[20]

It should be apparent that the only non-excessive depreciation rate is one proposed by Mr. Majoros on behalf of the Office of the Public Counsel. The Commission needs to view the OPC testimony on the subject of excessive depreciation with skepticism. Given Mr. Majoros' line of reasoning, I would

[14] Direct Testimony of Michael J. Majoros, Jr. BPU Docket No. ER02080506, Jersey Central Power & Light Company, page 2, line 18. (emphasis added)
[13]Direct Testimony of Michael J. Majoros, Jr. BPU Docket No. GR02040245, Elizabethtown Gas Company, page 5, line 28. (emphasis added)
[16] Direct Testimony of Michael J. Majoros, Jr. Kentucky Public Service Commission Docket No. 2002-00145, Columbia Gas of Kentucky, page 7, lines 16 and 19. (emphasis added)
[17] Direct Testimony of Michael J. Majoros, Jr. Kansas Corporation Commission Docket No. 02-MDWG-922-RTS, Midwest Energy, Inc., page 2, line 13. (emphasis added)
[18] Direct Testimony of Michael J. Majoros, Jr. State of Nevada Public Utilities Commission Docket No. 01-11031, Sierra Pacific Power Company, page 3, line 11. (emphasis added)
[19] Direct Testimony of Michael J. Majoros, Jr. Kansas Corporation Commission Docket No. 02-0391, Kansas Gas Service, page 2, line 22 and page 3, line 1. (emphasis added)
[20] Direct Testimony of Michael J. Majoros, Jr., Hawaii Public Service Commission Docket No. 02-0391, Hawaiian Electric Company, Inc., page 3, line 17. (emphasis added)

conclude that his proposed depreciation rates are inadequate simply because they are lower those proposed by the Company.

Q. HOW DID THE REGULATORY BODIES ASSOCIATED WITH THE ABOVE CASES REACT TO MR. MAJOROS' CHARACTERIZATION?

A. I could find no Order that supported the contention by Mr. Majoros that the respective company's depreciation rates were excessive.

NET SALVAGE

Q. HAVE EITHER MR. MACIAS, MS. TEEL OR MR. MAJOROS INCLUDED A PROVISION FOR NET SALVAGE IN THEIR DEPRECIATION RECOMMENDATIONS?

A. Mr. Macias did ***not*** include a provision for net salvage in his depreciation recommendations. Ms. Teel proposes to include a provision for net salvage as a current expense included in cost of service, based upon the five-year average of actual net salvage. Mr. Majoros did include a provision for net salvage. However, the net salvage allowance provided by Mr. Majoros is inadequate and inconsistent with regulatory accounting rules.

Q. WHY DO YOU BELIEVE THAT NET SALVAGE SHOULD BE A COMPONENT OF DEPRECIATION RATES?

A. There are several reasons why I believe that net salvage should be a component of depreciation rates. First, I believe that Empire is properly entitled to recovery of these costs. Second, I believe that making net salvage a component of the depreciation rate is required by regulatory rules. Third, I believe that such accounting treatment appropriately allocates all components of cost over useful life in a consistent manner. Fourth, I believe that treating these net salvage costs as a component of depreciation rates (depreciation expense for ratemaking purposes) results in intergenerational equity, such that no generation of customers is improperly charged. Finally, such treatment is consistent with the way depreciation rates and depreciation expenses are handled in the vast majority of jurisdictions where I have testified.

Q. HAS MR. MAJOROS ACCURATELY AND CORRECTLY IDENTIFIED YOUR DEPRECIATION RECOMMENDATIONS WITH RESPECT TO NET SALVAGE?

A. I would hesitate to characterize Mr. Majoros' testimony with respect to my depreciation recommendations as either accurate or correct. Let me begin with the question and answer starting at the top of page 35 of his testimony. Here Mr. Majoros states that I am proposing to charge Empire's customers about $20.8 million in additional future removal costs. First, my recommended depreciation rates are designed to allocate Empire's plant costs, including net salvage, over the life of the associated assets, consistent with regulatory accounting rules, nothing more or nothing less. I am not proposing to charge Empire's customers anything but a fair and reasonable depreciation expense. I have built net salvage ratios into depreciation rates as required by regulatory accounting rules. Depreciation expense will increase as plant balances increase. This is merely a fact of asset growth, not an anomaly nor an intended "penalty" to customers. In fact, under current ratemaking provisions, the fact that depreciation expense will increase is NOT even reflected in the revenue requirement calculation! It is true, however, that the reclassified regulatory liability (a financial reporting requirement) may increase. Lastly, while Mr. Majoros may not like my recommendations, they are reasonable and consistent with regulatory accounting rules.

Q. MR. MAJOROS ATTEMPTS TO DEMONSTRATE THAT YOUR PROPOSAL IS UNREASONABLE AT PAGE 35, LINES 12 THROUGH 18. IS HE CORRECT?

A. Mr. Majoros is only correct that the Company has incurred actual removal costs over the last 24 years. My records indicate that the actual cost of removal incurred between 1980 and 2003 is in excess of $36 million

Q. MR. MAJOROS ASSERTS AT PAGE 22 THAT THE RESULTS OF YOUR SALVAGE AND COST OF REMOVAL ANALYSES ARE "SO ASTRONOMICAL AS TO DEFY REASON". IS THIS STATEMENT TRUE?

A. No. Net salvage is the "netting" of gross salvage and cost of removal. As quoted in the National Association of Regulatory Utility Commissioners ("NARUC") text *Public Utility Depreciation Practices* (1996 Edition), at page 18:

> Net salvage is expressed as a percentage of plant retired by dividing the dollars of net salvage by the dollars of original cost of plant retired.

I have made this exact net salvage calculation for every asset category in my depreciation study. The fact that the result of these calculations is a large ratio or percentage is no reason to dismiss the validity of the result. For certain asset groups, net salvage is a significant percentage and should be appropriately recognized in the depreciation rate calculation. It has been my personal experience that net salvage ratios of 250% are not unusual for certain asset categories and to characterize them as astronomical takes the concept of hyperbole to a new level.

Q. FROM A RATE MAKING PERSPECTIVE, HOW IS THE COMPANY AFFECTED BY EITHER INADEQUATE OR EXCESSIVE DEPRECIATION RATES AND RELATED DEPRECIATION EXPENSE?

A. Depreciation expense is recorded into the accumulated provision for depreciation account. For rate making purposes, the accumulated provision for depreciation is deducted from the original cost plant in service to determine rate base, the base upon which earnings are allowed. The deduction insures that, if past depreciation expense has been greater than required, the Company will be provided with an effective return on such lower amounts until reduced depreciation rates correct the imbalance. Similarly, the Company receives a greater return to the extent that such depreciation accruals were less than required. In either case, the customer is assured the same balanced treatment.

Q. IN YOUR OPINION, IS MR. MAJOROS' INTERPRETATION OF SFAS 143 CORRECT?

A. No. Mr. Majoros seems to believe that you must have a legal obligation to recognize negative net salvage. If such a legal obligation exists, then an asset retirement liability is recorded (financial accounting). The flaw in Mr. Majoros' interpretation is that negative net salvage does exist even without the legal obligation threshold of SFAS 143, and such costs are required to be included in depreciation rates. I have made no attempt to hide this. There is a flaw in Mr. Majoros' logic. At page 45, line 3 he makes reference to the term "this money"[21] when talking about asset retirement obligations, implying that these liabilities are a source of cash ripe for the utility's picking. When we discuss these accounts, (e.g., the accumulated provision for depreciation and regulatory liabilities) we are discussing figures recorded on the Company's Balance Sheet, not money or cash. Mr. Majoros admits this fact when he states that accumulated depreciation is an "unfunded account."[22] So there is no cash or money that can flow to income. His own testimony is contradictory on this point.

Q. IS THE APPROACH TO THE TREATMENT OF NET SALVAGE EMPLOYED BY MR. MAJOROS WIDELY USED?

A. No. In fact, to the best of my knowledge, only three jurisdictions have approved such an approach or similar approaches. They are Pennsylvania, Kentucky (I believe on a test basis) and here in Missouri. Accordingly, the testimony provided by Mr. Majoros at page 45 and 46 is somewhat misleading.

REMAINING LIFE DEPRECIATION TECHNIQUE

[20] If this Commission were to accept such an excess charge, GAAP and the SEC will require that it be recorded as a regulatory liability and if recent activity is indicative of any utility's intent with respect to this money, they will try everything in their power to take it into income and never return it to ratepayers.
[22] Majoros testimony, page 17, line 18.

Q. WHAT IS THE DIFFERENCE BETWEEN A REMAINING LIFE RATE AND A WHOLE LIFE RATE?

A. Let me first say that with respect to depreciation theory, the technique refers to the portion of the service life used in the depreciation rate calculation. Whole life rates depreciate gross investment, adjusted for net salvage, over the average service life of an asset category.[23] Remaining life rates depreciate net investment (gross investment adjusted for net salvage less accumulated depreciation) over the average remaining life of an asset category.[24]

Q. WHY IS A REMAINING LIFE RATE DESIRABLE?

A. There are two reasons. First, a remaining life rate gives consideration to past depreciation. Second, an asset category cannot be depreciated beyond its gross cost adjusted for net salvage. Third, a remaining life rate automatically adjusts for past experience being slightly different from expectations. Each of these characteristics encompasses principles of equity and fairness.

Q. WHAT DEPRECIATION TECHNIQUE HAVE YOU RECOMMENDED AND WHY?

A. I have recommended the use of the remaining life technique. I believe the remaining life technique possesses the characteristics described above, making it a superior choice to the whole life technique. Roughly a third of the increase in annual depreciation indicated by my study is due to inadequate past depreciation compared to my study parameters. The remaining life technique captures this depreciation difference in an appropriate manner.

[23] See Exhibit DSR-3, bottom of page 5.
[24] Ibid.

Q. HAS MR. MAJOROS EVER PROPOSED DEPRECIATION RATES DEVELOPED USING THE REMAINING LIFE TECHNIQUE?

A. Yes. To the best of my knowledge, Mr. Majoros has proposed remaining life rates for the vast majority of the proceedings listed on Schedule MJM-1 for the last two years.

Q. HAS THIS COMMISSION CONSIDERED THE ISSUE OF REMAINING LIFE DEPECIATION RATES IN OTHER PROCEEDINGS?

A. Yes. In 1982, in Case No. TYO-82-3, this Commission deliberated a number of issues related to depreciation and depreciation rates. In that Report and Order, the Commission reached the following conclusion regarding the remaining life technique:

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

The Commission goes on to say and order:

> This Commission's rules permit the use of SLRL and SLELG (straight-line equal life group), and the same are consistent with the statutory directive that this Commission follow the Uniform System of Accounts for a telephone corporation as nearly as may be. Section 392.210(2), RSMo 1978.

> It is, therefore,
>
> …Ordered: 3. That the use of straight-line remaining life depreciation technique is hereby approved for Missouri Class A and B jurisdictional telephone utilities.

Clearly, the remaining life technique is a viable and approved methodology in the State of Missouri.

CASH FLOW CONCERNS

Q. MR. MAJOROS CLAIMS THAT THE GOAL OF MANY PUBLIC UTILITIES WITH RESPECT TO THE OBJECTIVE OF DEPRECIATION IS TO MAXIMIZE CASH FLOW.[25] DO YOU AGREE?

A. No. I can find no evidence or documentation that supports that this is true for Empire District. Further, I can find no evidence or documentation that supports that this is true for any other of my other clients. Cash flow is important to both the Company and the financial community. While depreciation expense is *a non-cash* item, it does have significant *cash flow* impacts. I have specifically reviewed the Company's capital activity for the past five years (1999 through 2003) to evaluate the level of internal and external financing sources relative to this activity. I have removed the significant additions and retirements relative to the State Line units, as this activity should rightly be financed through new external sources. The average annual expenditure on plant is approximately $43.7 million. The average annual depreciation expense is approximately $28.0 million. Thus on annual

[25] Majoros Testimony, page 14, line 23.

basis, Empire District must seek additional external financing of over $15 million per year. Clearly, the internal cash flow effect of depreciation expense is significant, but has been inadequate in the recent past. Empire's cash flow situation would be enhanced by an upward adjustment to depreciation rates. But my recommended depreciation rates are in no way based on the need for greater cash flow, rather they are based on a valid analysis of historical data and future expectations. Mr. Knapp provides additional rebuttal testimony relative to this topic.

ADEQUACY OF STAFF AND OPC DEPRECIATION PROPOSALS IN LIGHT OF INDUSTRY APPROVED RATES

Q. IS THERE ANY OTHER TOPIC THAT YOU WISH TO ADDRESS?

A. Yes. Because neither the Staff nor the OPC witness testimony discusses this issue, I ask this Commission to review my direct testimony at pages 6 and 7 addressing depreciation rate comparisons and their adequacy. I repeat here the observations that I made then with particular reference to the Staff and OPC depreciation proposals. A composite depreciation rate of at least 3.00% seems to be in the normal range for an electric utility (See Schedule DSR-4). With the exception of the Empire District line, shown at the top, the remaining Company depreciation rate calculation information is arranged in ascending order by the magnitude of the depreciation rate. There is no doubt that the Empire District composite depreciation rate falls into the bottom quartile of this distribution. In addition the depreciation rates proposed by the Staff and OPC fall dramatically below the 3.00% composite average level. The Staff composite depreciation rate is roughly 2.40%; and the OPC composite depreciation including net salvage allowance is barely 2.50%. These proposals are unreasonable because they are inadequate. Under any circumstance, it is difficult for me to accept any claim that Empire's depreciation rates have been excessive.

ALTERNATIVE METHODOLOGY

Q. AS ADDRESSED IN MR. WILLIAM L. GIBSON'S DIRECT TESTIMONY AT PAGE 5, WHAT MEASURES CAN BE TAKEN TO MITIGATE THE INCREASE IN DEPRECIATION EXPENSE THAT YOU PROPOSE?

A. It is my understanding that the Company still supports the depreciation recommendations that I have made and filed in conjunction with my direct testimony which result in a total increase in annual depreciation expense of about $25.6 million. One measure that can be taken to mitigate this increase is simply to reduce the depreciation rates by a percentage amount so that instead of generating $25.6 million in additional depreciation expenses, they only increase annual depreciation expense by $10.2 million. In fact, it is my understanding that the Company's rate revenue tariffs filed in this case are based on an increase in depreciation expense of only $10.2 million as opposed to the $25.6 million supported by my study.

Q. IS THERE ANOTHERAPPROACH TO ARRIVE AT THE $10.2 MILLION AMOUNT?

A. Yes. In addition to the percentage reduction approach indicated above, I have examined different depreciation methodologies to mitigate the full impact of my proposal. In this regard, I began with an evaluation of where the depreciation adjustment was the greatest and which depreciation parameters or factors influenced that change. The cause of the greatest depreciation expense change was net salvage. The first adjustment was to limit net salvage to negative 100% for the four accounts where the negative net salvage allowances were the greatest. These accounts are Account 355, Transmission – Poles and Fixtures; Account 364, Distribution – Poles, Towers and Fixtures; Account 365, Distribution – Overhead Conductors and Devices; and Account 369, Distribution – Services. The effect on annual depreciation expense by implementing this limitation on net salvage factors is $5.8 million. This amount is determined on Exhibit DSR-3R.

Q. WHAT WAS THE NEXT ADJUSTMENT THAT WAS CONSIDERED?

A. The next adjustment that was considered was the use of whole life rates. Whole life rates give no consideration to the reserve position as discussed above at page 30. The effect of this adjustment on annual depreciation expense is $0.7 million as shown on Exhibit DSR-4R.

Q. WAS THERE ANY OTHER ADJUSTMENT CONSIDERED?

A. Yes. Because the second largest difference in my study related to Production Plant, an adjustment was made to the estimated retirement date for the Asbury Plant by extending the retirement date to 2020. The effect of this adjustment on annual depreciation expense is $2.6 million as shown on Exhibit DSR-5R.

Q. IS THERE ANY OTHER FACTOR TO BE CONSIDERED?

A. Yes. Due to the differences between the study balances (12/31/2003) and the jurisdictional test year balances (6/30/2004), there is one additional impact on annual depreciation expense. The effect of this adjustment is $1.2 million and is shown on Exhibit DSR-6R.

Q. WHAT IS THE TOTAL IMPACT ON ANNUAL DEPRECIATION EXPENSE OF THESE ADJUSTMENTS?

A. The total impact on annual depreciation expense of these adjustments is the sum of these four amounts, or $10.3 million.

Q. WHY DOES THIS DIFFERENCE NOT EQUAL THE CHANGE FROM $25.6 MILLION ANNUAL DEPRECIATION EXPENSE AMOUNT PRODUCED BY YOUR STUDY AND THE $10.2 MILLION DEPRECIATION EXPENSE AMOUNT SUGGESTED BY MR. GIBSON AND SHOWN ON EXHIBIT DSR-2R?

A. The depreciation parameters and methodologies have inter-relationship effects. While I have tried to isolate the impact of each singular adjustment, when depreciation rates and related annual depreciation expenses are determined, they are developed on the combination of each underlying parameter and methodology. Quite simply the differences cannot be completely segregated. For example, the change in net salvage parameters affects not only the net salvage calculations, but also the whole life rates and remaining life rates.

<u>SUMMARY AND CONCLUSION</u>

Q. PLEASE SUMARIZE YOUR REBUTTAL TESTIMONY.

A. My rebuttal testimony exposes the flaws, misstatements and inaccuracies contained in the testimonies of Mr. Macias, Ms. Teel and Mr. Majoros. My original recommendations in this proceeding are consistent with accounting rules and regulatory principles and result in a fair and reasonable level of depreciation expense. The proposals advanced by Mr. Macias, Ms. Teel and Mr. Majoros are improper, inadequate and incorrect and should not be endorsed by this Commission. While I and the Company stand behind my study recommendations, I have been asked to consider an alternative position that mitigates the change in annual depreciation expense in this proceeding. I have provided such an.

Q. DOES THIS COMPLETE YOUR REBUTTAL TESTIMONY?

A. Yes, it does. However, the fact that I have not addressed all of the topics or issues raised by Mr. Majoros, Ms. Teel and Mr. Macias, does not necessarily signify my agreement with their positions.