Exhibit No.:	
Issue:	Laclede Gas Company's Depreciation Rates
Witness:	Dr. Ronald E. White
Type of Exhibit:	Surrebuttal Testimony
Sponsoring Party:	Laclede Gas Company
Case No.:	GR-99-315

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LACLEDE GAS COMPANY

GR-99-315

SURREBUTTAL TESTIMONY

OF

DR. RONALD E. WHITE

BEFORE THE
MISSOURI PUBLIC SERVICE COMMISSION
SURREBUTTAL TESTIMONY OF
DR. RONALD E. WHITE
IN CASE NO. GR-99-315

Q. PLEASE STATE YOUR NAME AND ADDRESS?

A. My name is Ronald E. White. My business address is 17595 S. Tamiami Trail, Suite 212, Fort Myers, Florida 33908.

Q. ARE YOU THE SAME RONALD E. WHITE WHO FILED REBUTTAL TESTIMONY IN THIS PROCEEDING ON BEHALF OF LACLEDE GAS COMPANY?

A. Yes, I am.

I. PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. I have been asked by Laclede Gas Company to respond to portions of the pre-filed rebuttal testimony of Paul W. Adam. In particular, I will address Mr. Adam's comments regarding the treatment of net salvage in the formulation of depreciation accrual rates.

Q. WHAT IS YOUR UNDERSTANDING OF THE DISAGREEMENT BETWEEN MR. ADAM AND LACLEDE GAS COMPANY REGARDING THE PROPER TREATMENT OF NET SALVAGE IN THE FORMULATION OF DEPRECIATION RATES?

A. In his pre-filed direct testimony, Company witness Mr. Richard A. Kottemann, Jr. testified that Mr. Adam's treatment of net salvage " ... violates generally accepted depreciation accounting principles by shifting expense recognition and rate recovery to uncertain future periods." (DT page 10, lines 21-23). In response to Mr. Kottemann's testimony, Mr. Adam claims that a) the ultimate principle of depreciation is to allow the Company to collect from its customers the amount of money needed to pay for the original cost of its plant and the cost of removal of the plant less any gross salvage; and b) the method used to develop the currently ordered rates addresses the intergenerational problem which Mr. Kottemann's proposal does not. (RT page 1, lines 18-21 and page 2, lines 5-6).

Presumably, the conventional formulation of depreciation rates used by Mr. Kottemann would " ... collect more, millions of dollars currently, than the Company spends for recovery of plant and net salvage. (RT page 2, lines 8-10). Additionally, according to Mr. Adam, it is uncertain that " ... there will be a future date that the Company's expenses for cost of removal will be greater than the Company's collection of cost of removal dollars from their *(sic)* customers." (RT page 2, lines 16-18).

II. RESPONSE TO MR. ADAM'S REBUTTAL TESTIMONY

Q. DO YOU AGREE WITH MR. ADAM THAT " ... THE ULTIMATE PRINCIPLE OF DEPRECIATION IS TO ALLOW THE COMPANY TO COLLECT FROM THEIR CUSTOMERS THE AMOUNT OF MONEY NEEDED TO PAY FOR THE ORIGINAL COST OF THEIR PLANT AND THE COST OF REMOVAL OF THE PLANT LESS ANY GROSS SALVAGE"?

A. No, I do not. Depreciation, as discussed in my rebuttal testimony, is a measurement of the service potential of an asset (or group of assets) that is consumed during an accounting interval. The service potential of an asset is the present value of future net revenue (*i.e.*, revenue less expenses exclusive of depreciation and other non-cash expenses) or cash inflows attributable to the use of that asset alone. The goal or objective of depreciation accounting is cost allocation over economic life in proportion to the consumption of service potential. The foundation for depreciation is the matching and expense recognition principles of accounting.[1]

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[1]The *matching* principle provides that for any period for which income is recognized, the expenses incurred in generating the recognized revenue should be determined and reported for that period. The *expense recognition* principle provides that costs deferred as assets and subsequently written off as periodic expenses according to the matching principle should be based on cause and effect whenever a direct causal relationship between expenses and revenue can be identified.

Mr. Adam, on the other hand, has crafted his own "ultimate principle of depreciation" that is far removed from any cost allocation or accounting theory. The suggestion that depreciation is intended to "... allow the Company to collect from their customers the amount of money needed to pay for the original cost of their plant and [net salvage]" is contrary to even the most elementary principles of depreciation accounting.

The amount of money needed to "pay" for the original cost of plant and equipment is supplied by lenders and investors. The cost of the property, plant and equipment is analogous to a prepaid expense; the cost is prepaid (*i.e.*, in advance of using the asset) and is, therefore, recorded as an asset. Unlike other prepaid expenses, however, operational assets contribute long-term future benefits to an enterprise, whereas other prepaid expenses are normally consumed within one operating cycle after acquisition. Depreciation accounting is the process of allocating the cost of plant and equipment to the periods of operation in which its service potential is consumed.

Q. WHAT IS CAPITAL RECOVERY?

The term *capital recovery* is used in economics to describe the periodic cash flows available for both return *of* and return *on* investor-supplied capital. The source of return *on* capital is net operating income and the source of return *of* capital is depreciation, deferred income taxes and other non-cash expenses. Full capital recovery will be achieved if, and only if, the present value of the sum of return *of* and return *on* capital is equal to the amount originally supplied by investors. This is one of the most important and widely accepted relationships derived from the theory of interest rates. Absent this principle, the theory of financial mathematics could not be developed.

Q. IS CAPITAL RECOVERY DEPENDENT UPON A REGULATORY ALLOWANCE FOR DEPRECIATION EXPENSE?

A. No, it is not. The present value of return *on* investor-supplied capital in perpetuity is equivalent to the present value of return *of* and return *on* the same investment over a finite period of time. Thus, capital recovery can be achieved under regulation without an allowance for depreciation expense if 1) service markets remain protected from competition; 2) any unrecovered investment from early retirements remains in the rate base; and 3) earnings are sufficient to achieve a fair rate of return.

This is not to suggest that depreciation accounting should be abandoned for rate-making purposes. Such a practice would violate generally accepted accounting principles and create a revenue requirement in perpetuity for the recovery of capital used to provide utility service to current customers. The fact, however, that capital recovery can be achieved without depreciation expense clearly demonstrates why the "ultimate principle of depreciation" is not "... to allow the Company to collect from their customers the amount of money needed to pay for the original cost of their plant and [net salvage]". The goal or objective of depreciation accounting is cost allocation over economic life in proportion to the consumption of service potential.

Q. MR. ADAM HAS TESTIFIED THAT HIS ULTIMATE PRINCIPLE OF DEPRECIATION WAS THE FOUNDATION FOR " ... WHAT [HE] DID TO CALCULATE THE CURRENTLY ORDERED RATES." (RT PAGE 1, LINES 21-22). DOES THIS PROVIDE A SOUND BASIS FOR HIS TREATMENT OF NET SALVAGE?

A. No, it does not. Nothing in cost allocation or depreciation accounting theory even remotely suggests that depreciation rates should " ... collect from the current customers the amount the Company needs for current depreciation." (RT page 2, lines 5-6). The Company has no current "need" for depreciation. The revenue requirement for depreciation is created from the application of accounting principles that aim to distribute the cost of an asset (or group of assets), adjusted for net salvage, over an estimate of economic life. The periodic cash flow derived from revenue sufficient to cover depreciation expense is instrumental in achieving timely capital recovery under rate base/rate of return regulation.

Q. ACCORDING TO MR. ADAM, " ... EACH YEAR THE COMPANY WOULD COLLECT FROM CUSTOMERS MORE MONEY FOR COST OF REMOVAL THAN THE COMPANY SPENDS" IF THE COMMISSION APPROVES THE DEPRECIATION RATES REQUESTED BY LACLEDE. (RT PAGE 2, LINES 13-14). IS THIS THE STANDARD THAT REGULATION SHOULD APPLY IN SETTING DEPRECIATION RATES?

A. No, it is not. While the <u>accrual</u> for net salvage may or may not exceed actual removal expense in any given year, the standard or criterion that should be used to judge the adequacy of a net salvage rate is the reasonableness of the estimate in relation to the amount of salvage and removal expense likely to be incurred when plant and equipment presently in service is eventually retired or replaced.

An estimate of the net salvage rate applicable to future retirements is usually obtained from an analysis of gross salvage and removal expense realized in the past. An analysis of past recorded experience—including an examination of trends over time—provides an appropriate starting point for estimating future salvage and cost of removal. However, consideration should also be given to events that may cause deviations from the net salvage realized in the past. Among the factors that should be considered are the age of plant retirements; the portion of retirements likely to be reused; changes in the method of removing plant; the type of plant to be retired in the future; inflation expectations; the shape of the projection life curve; and economic conditions that may warrant greater or lesser weight to be given to the net salvage observed in the past.

Q. DO YOU AGREE WITH MR. ADAM THAT "THE METHOD USED TO DEVELOP THE CURRENTLY ORDERED RATES ADDRESSES THE INTERGENERATIONAL PROBLEM WHICH MR. KOTTEMANN'S PROPOSAL DOES NOT."?

A. No, I do not. Presumably, the "intergenerational problem" Mr. Adam has identified relates to an accrual for net salvage that may exceed "the amount the Company currently needs for interim cost of removal". (RT page 2, lines 21-22). While I fail to understand how cost of removal for mass plant accounts can be "interim" and accruing for net salvage can create an "intergenerational problem", the treatment of net salvage proposed by Mr. Adam will shift the recovery of incurred costs to future accounting periods. Contrary to the opinion of Mr. Adam, this <u>creates</u> the "intergenerational problem" that Mr. Kottemann is attempting to correct.

Recalling that a revenue requirement for net salvage is created when an asset is placed in service, accrual accounting provides an allocation of the estimated cost of removal (net of estimated gross salvage) to the accounting periods in which revenue is collected. This is an application of the matching principle of accounting. To the extent that regulation permits current-period recovery of the revenue requirement for net salvage, customers receiving service from the plant will be charged a proportionate share of the final removal cost.

Mr. Adam, on the other hand, is advocating that regulation disallow any accrual for net salvage until an asset is retired from service and the expenditure for removal has been incurred. Recovery of the expenditure would be provided by an allowance for amortization collected from customers no longer receiving service from the retired plant. Thus, in my opinion, Mr. Kottemann has properly addressed the "intergenerational problem" created by Mr. Adam. Although Laclede is not requesting full restoration of accrual accounting, the Company's proposal does alleviate some of the cost-shifts inherent in the previously settled depreciation rates.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Laclede Gas Company's)
General Rate Case) Case No. GR-99-315

AFFIDAVIT

STATE OF FLORIDA)
) SS:
COUNTY OF LEE)

Ronald E. White, of lawful age, being first duly sworn, deposes and states:

1. My name is Ronald E. White. My business address is 17595 S. Tamiami Trail, Suite 212, Fort Myers, Florida 33908; and I am Executive Vice President of Foster Associates, Inc.
2. Attached hereto and made a part hereof for all purposes is my surrebuttal testimony, consisting of pages 1 to 6.
3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded and the information contained in the attached schedule are true and correct to the best of my knowledge and belief.

Ronald E. White

Subscribed and sworn to before me on this 17th day of August, 1999.

NOTARY PUBLIC in and for
the State of Florida

OFFICIAL NOTARY SEAL
MARGARET E LANGE
NOTARY PUBLIC STATE OF FLORIDA
COMMISSION NO. CC683204
MY COMMISSION EXP. OCT. 19,2001