

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-080416

DOCKET NO. UG-080417

REBUTTAL TESTIMONY OF

JOHN J. SPANOS

ON BEHALF OF AVISTA CORPORATION

**I. INTRODUCTION**

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**Q. Please state your name, employer and business address.**

A. My name is John J. Spanos and I am employed as the Vice President of the Valuation and Rate Division of Gannett Fleming, Inc. (Gannett), at 207 Senate Avenue, Camp Hill, Pennsylvania.

**Q. Please describe the Valuation and Rate Division.**

A. The Valuation and Rate Division of Gannett Fleming, Inc. provides consulting services to public utilities and railroads. The Gannett Fleming affiliated companies employ over 1,900 people in 40 offices throughout the United States.

The Valuation and Rate Division has a long history of client services encompassing valuations; depreciation studies; revenue requirement, cost allocation and rate design studies; analyses of accounting systems; and acquisition and feasibility studies.

**Q. Would you briefly describe your educational background and professional experience?**

A. Yes. I have Bachelor of Science degrees in Industrial Management and Mathematics from Carnegie-Mellon University and a Master of Business Administration from York College of Pennsylvania.

After my graduation In June 1986, I was employed by Gannett Fleming Valuation and Rate Consultants, Inc. as a depreciation analyst. During the period June 1986 through December 1995, I assisted in the preparation of numerous depreciation and original cost studies for telephone, railroad, electric, gas and water companies.

1           In January 1996, I was assigned to the position of supervisor of Depreciation Studies. In  
2 July 1999, I was promoted to the position of manager, Depreciation and Valuation Studies. In  
3 December 2000, I was appointed to my current position of Vice President.

4           I am responsible for conducting depreciation, valuation and original cost studies, including  
5 the preparation of final exhibits and responses to data requests for submission to the appropriate  
6 regulatory bodies. My additional duties include determining final life and salvage estimates,  
7 conducting field reviews, presenting recommended depreciation rates to management for its  
8 consideration and supporting such rates before regulatory bodies.

9           **Q. Do you belong to any professional societies?**

10          A. Yes. I am a member of the Society of Depreciation Professionals and the American  
11 Gas Association/Edison Electric Institute Industry Accounting Committee.

12          **Q. Do you hold any special certification as a depreciation expert?**

13          A. Yes. The Society of Depreciation Professionals has established national standards  
14 for depreciation professionals. The Society administers an examination to become certified in this  
15 field. I passed the certification exam in September 1997, and was recertified in August 2003 and  
16 January 2008.

17          **Q. Have you received any additional education relating to utility plant  
18 depreciation?**

19          A. Yes. I have completed the following courses conducted by Depreciation Programs,  
20 Inc.: “Techniques of Life Analysis,” “Techniques of Salvage and Depreciation Analysis,”  
21 “Forecasting Life and Salvage,” “Modeling and Life Analysis Using Simulation” and “Managing a  
22 Depreciation Study.”

1           **Q.    What is the scope of your rebuttal testimony in this proceeding?**

2           A.    My rebuttal testimony responds to the Public Counsel Section of the Washington  
3 State Attorney General’s Office (Public Counsel) and the Industrial Customers of Northwest  
4 Utilities (ICNU) witness Charles King on the subject of net salvage. Within the overall topic of  
5 net salvage, I will explain the estimation of future net salvage, the differences between financial  
6 and regulatory reporting and ratemaking, the methods of allocating net salvage to each year of an  
7 asset’s service life, and the treatment of net salvage used in other jurisdictions and recommended  
8 in authoritative texts.

9           **Q.    Please summarize your rebuttal testimony with regard to Public**  
10 **Counsel/ICNU’s proposed ratemaking treatment of net salvage.**

11          A.    As discussed in more detail below, I disagree with Public Counsel/ICNU’s proposal  
12 to replace the traditional straight line method of determining the net salvage component of the  
13 annual depreciation accrual rate with a net salvage factor based on the discounted value of  
14 estimated future net salvage. Public Counsel/ICNU’s proposal would fail to generate sufficient  
15 allowances to cover the cost of removing plant at the end of its life and would therefore burden  
16 future customers with the costs of removing plant used today.

17          **Q.    Please summarize the key topics related to depreciation issues in this case.**

18          A.    The primary topic with regard to depreciation in this case is net salvage. The key  
19 issues can be highlighted as follows:

- 20                   • The depreciation rates and their parameters have recently been agreed upon.
- 21                   • Public Counsel/ICNU’s methodology has not been embraced by this Commission.
- 22                   • The traditional net salvage accrual, as presented by Avista, properly matches

1 recovery of service value across generations of ratepayers.

2 • Financial Accounting Standard (“FAS”) No. 143 is not relevant in the development  
3 of regulatory depreciation rates.

4 **Q. Would you please elaborate on these points?**

5 A. The use of the “discounted value accrual” for net salvage – also known as “sinking  
6 fund depreciation” – suffers from several shortcomings. It is inconsistent with the pattern in which  
7 the plant renders service. As such, it is inequitable because it does not properly match the service  
8 value of the plant with the generation of customers being served. It simply serves to reduce rates  
9 for today’s customers at the expense of tomorrow’s customers.

10 Instead, it is appropriate to continue to allocate net salvage costs on a “straight line basis”  
11 during the life of the related plant. It is the method used by nearly all state commissions, including  
12 this Commission. By charging customers for the future cost of removal during the life of the plant,  
13 the customers that benefit from the plant (i.e., consume its value) are the ones that pay for such  
14 service. Simply put, the net salvage cost of an item is a part of its “service value” and is, therefore,  
15 a part of the cost of providing service and should be collected from the customers that receive the  
16 service.

17 By improper reliance on FAS 143, Mr. King erroneously applies a standard for GAAP  
18 financial reporting on the ratemaking process. FAS 143 does not apply to ratemaking in general  
19 and does not prescribe the depreciation methodologies for a regulated utility such as Avista.  
20 Company witness Mr. Felsenthal discusses in more detail FAS 143 and Public Counsel/ICNU’s  
21 improper use of this statement.

22

1           **Q. Mr. King provided testimony in the Puget Sound Energy’s general rate case**  
2 **(Docket Nos. UE-72300 and UG-72301) regarding similar proposed adjustments relating to**  
3 **depreciation. Have you reviewed this testimony?**

4           A. Yes, I have. In addition, I have reviewed the testimonies of Puget Sound Energy’s  
5 rebuttal witnesses C. Richard Clarke, Jan A. Umbaugh, and William M. Stout on this issue and  
6 have reached similar conclusions with respect to the shortcomings of Mr. King’s testimony.

7           **Q. Please explain the concept of a “discounted value accrual” as proposed by Mr.**  
8 **King.**

9           A. The discounted value accrual for net salvage removes inflation from the estimated  
10 future net salvage, divides this by the average life, and then adds an amount for accretion each  
11 year. This approach is also known as “sinking fund depreciation”. The sum of the accruals based  
12 on the discounted value is significantly less than the amount required to retire assets at the end of  
13 their lives and relies on the accretion amount to insure complete capital recovery. The amount of  
14 accretion grows during the life of the asset and results in a total expense related to net salvage  
15 recovery that is greatest in the final year of service.

16           There are several flaws in using this approach. First, the backend loading of capital  
17 recovery can result in significant shortfalls in the event assets are retired even a few years prior to  
18 their estimated service lives. Second, as the accretion component increases every year, the result is  
19 an increase in the accrual rate related to net salvage that would not be reflected in rates to  
20 customers unless a rate case was filed every year. Third, application of the sinking fund method to  
21 group properties is difficult and complex. To apply the method correctly, each vintage should be  
22 segregated into groups of equal life in order to correctly calculate the annual factors. Accordingly,

1 there are inherent flaws in this approach, and Public Counsel/ICNU makes no provision for such  
2 potential shortfalls. Further, as noted below, if the service value of the asset is to be adjusted to  
3 current price levels, the future net salvage and the historical original cost should both be adjusted.

4 **Q. Please explain the basis for your disagreement with Public Counsel/ICNU on**  
5 **the method for determining net salvage.**

6 A. As described above, Mr. King has determined the net salvage allowance to be  
7 included in Avista's annual depreciation rates based on the discounted value of estimated future  
8 net salvage plus an amount for accretion. The amount of net salvage that should be included in the  
9 annual cost of service and collected from current customers is a portion of the future net salvage  
10 related to the current plant in service as a result of allocating these costs in equal amounts, i.e., on a  
11 straight line basis, to each year of service rendered by such plant. Accruing net salvage on the  
12 basis of a discounted value plus an amount for accretion results in an ever increasing net salvage  
13 accrual which is inconsistent with the pattern in which the plant renders service. The use of  
14 current net salvage costs is further removed from matching the service value rendered by plant in  
15 service as such costs are related to plant that previously rendered service.

16 Allocating net salvage costs on a straight line basis during the life of the related plant is  
17 appropriate and equitable and is in accord with the policy of the vast majority of state utility  
18 commissions and authoritative texts. Delaying collection by the allocation of discounted values  
19 results in a charge to customers that does not match the service value rendered or a charge that is  
20 related to plant from which they did not receive service.

21 Public Counsel/ICNU believe it is inappropriate to charge ratepayers now for the future  
22 costs of removing plant at the time of retirement, and instead propose a radical departure from the

1 traditional approach that has been used by Avista and other Washington utilities for decades. The  
2 basis for Mr. King's support of the proposal to allocate the discounted value of future net salvage  
3 is the recent accounting pronouncements of the Financial Accounting Standards Board ("FASB")  
4 that apply to financial reporting as part of Generally Accepted Accounting Principles ("GAAP").  
5 In effect, Mr. King has imposed a standard for financial reporting on the ratemaking process.  
6 Moreover, his support for his proposal to use current levels of net salvage have only been  
7 embraced by one state commission. This proposal is inappropriate and does not incorporate all  
8 the factors that should be considered in ratemaking, particularly the equitable treatment of different  
9 generations of customers. As such, it does not appropriately match the value of the plant rendering  
10 service with the customers receiving service at the time. Mr. King's proposal also suffers from  
11 short-term thinking. It is designed to reduce rates for today's customers but do so at the expense of  
12 tomorrow's customers. This Commission should reject this unsupported proposal and continue  
13 with the traditional straight line accrual for net salvage that has been embraced by nearly every  
14 state commission.

15 The remainder of my rebuttal testimony and the rebuttal testimony of Mr. Felsenthal, on  
16 behalf of the Company, will address the concepts and theories put forth by Mr. King and his  
17 criticisms of the traditional approach to accruing for net salvage. I will address both Mr. King's  
18 concerns related to the estimation of net salvage and his proposals for allocating net salvage costs.



**II. RECENT REVIEW OF AVISTA'S DEPRECIATION RATES**

1  
2 **Q. Was Mr. King's testimony in response to a depreciation study proposed in this**  
3 **case?**

4 A. No. In 2007, Avista proposed changes to the Company's depreciation rates and  
5 methodology in Docket Nos. UE-070804 and UG-070805. In those cases, the Commission  
6 approved the uncontested Settlement Stipulation reached by all parties, including Public  
7 Counsel/ICNU. All parties had agreed to implement new depreciation rates effective January 1,  
8 2008, based on a depreciation study that had been performed by Gannett Fleming in 2005 and  
9 modified for changes proposed by the parties.

10 **Q. Why did Avista have a depreciation study performed?**

11 A. Avista hired Gannett Fleming, Inc. to undertake a depreciation study of its  
12 depreciable electric, gas and common plant in service as of December 31, 2004. The objective of  
13 this assignment was to recommend depreciation rates to be utilized by Avista for accounting and  
14 ratemaking purposes.

15 **Q. What is the main purpose of a depreciation study?**

16 A. The primary purpose of a depreciation study is to establish annual depreciation  
17 accruals and depreciation rates by utility plant account. Periodic review and revisions are normally  
18 required to maintain continued use of appropriate annual depreciation accrual rates with the goal of  
19 matching the remaining plant investment on the Company's balance sheet with the remaining life  
20 of the assets. An assumption that accrual rates can remain unchanged over a long period of time  
21 implies a disregard for the inherent variability in service lives and salvage and for the change of the  
22 composition of property in service. However, depreciation studies entail a significant amount of

1 effort and because service lives and salvage values do not generally fluctuate dramatically over the  
2 course of only a few years, depreciation studies are generally only conducted on a periodic basis  
3 every several years. The annual accrual rates proposed in the most recent filing in 2007 were  
4 calculated in accordance with the straight-line remaining life method of depreciation using the  
5 average service life procedures based on estimates which reflect considerations of historical  
6 evidence and expected future conditions.

7 **Q. Do you agree with Mr. King's statement that the depreciation study was given**  
8 **little scrutiny by any of the parties in the previous rate case?**

9 A. No, I do not. The Company provided extensive testimony and workpapers to all  
10 parties, including Public Counsel and ICNU. Also, numerous data requests were responded to by  
11 Avista and provided to all parties. In addition, Staff met with Avista during on-site visits to  
12 discuss the depreciation study and my firm of Gannett Fleming was made available to all parties.  
13 During the settlement discussions, Staff proposed a number of changes to the original depreciation  
14 proposal that were reviewed by and agreed to by Avista and all other parties.

15 **Q. Did any of the parties in the recently concluded rate case have a concern about**  
16 **Avista's approach for calculating net removal costs?**

17 A. No. Staff proposed new rates for four electric FERC accounts for changes in  
18 estimates used to calculate net salvage values. However, the methodology was not a concern and  
19 the depreciation rates on the four accounts that Avista agreed to change were computed in a  
20 consistent manner.

21 **Q. What is the process used by Avista when implementing new depreciation**  
22 **rates?**

1           A.     Avista operates in three jurisdictions, Washington, Idaho and Oregon. Since a  
2 majority of the plant is common plant (not directly assigned to each jurisdiction), it is necessary for  
3 Avista to coordinate changing depreciation rates in all jurisdictions with retail rate changes. The  
4 2004 depreciation study, as modified, was reviewed, approved and was implemented in all  
5 jurisdictions on January 1, 2008. Any change in methodology and/or depreciation rates would  
6 require the Company to again obtain approval by all state Commissions.

7           **Q.     Please summarize the Company's testimony regarding its analysis supporting**  
8 **the gross salvage and cost of removal ratios that were proposed by the Company in its**  
9 **recently concluded general rate case?**

10          A.     The analysis was based upon actual salvage and cost of removal experience from  
11 1983 through 2004. Salvage and cost of removal factors were developed for each property group  
12 by dividing salvage and cost of removal amounts by the original cost of the retired property. Since  
13 the average dollar age of retirements of plant is young relative to the expected age of surviving  
14 property at retirement, this results in overstating salvage factors and understating the cost of  
15 removal factors applicable to surviving property, if history serves as the sole basis for net salvage  
16 determination. From this, salvage factors would be overstated because young property retirements  
17 are more likely to have a greater salvage value than older reused items. In addition, cost of  
18 removal factors are understated because the amount of inflation reflected in the cost to remove  
19 young property is much less than the amount that will be reflected in the cost to remove the  
20 surviving property when it is retired. The average age of original installations at retirement is  
21 equal to the average service life, meaning that the average age of surviving property at retirement

1 will be higher than the average service life and much higher than the age of current retirements.  
2 Accordingly, it is necessary to make an inflation adjustment to historical cost of removal ratios.

3 **III. ESTIMATION OF NET SALVAGE**

4 **Q. Public Counsel/ICNU witness King refers to what he calls the “traditional**  
5 **inflated future cost approach” or “TIFCA” beginning at page 8 of this testimony. Are you**  
6 **familiar with this approach?**

7 A. Yes, I am.

8 **Q. Have you ever heard or read of it referred to as “TIFCA”?**

9 A. Only in testimony from the principals of Snavely King Majoros O’Connor &  
10 Bedell, Inc., Mr. King’s firm.

11 **Q. Mr. King argues starting at page 8 that “TIFCA” net salvage studies relate**  
12 **removal costs in current dollars to retirements in historical dollars. Is that correct?**

13 A. Yes, it is. Traditional studies of net salvage use as their statistical bases data that  
14 relate the cost of retiring an asset or group of assets to its original cost.

15 **Q. Please describe the statistical bases for Avista’s net salvage estimates?**

16 A. The statistical bases for my estimates of net salvage were the historical net salvage  
17 costs as a percent of the original cost of the retired assets that produced the gross salvage or  
18 required the costs to remove. The use of historical indications of net salvage as a percentage of the  
19 original cost retired incorporates the change in price level between installation and retirement of  
20 assets removed from service in recent years. Application of such percentages to the current plant  
21 in service will result in the collection of net salvage costs at a price level that is greater than the  
22 price level at the time the current plant in service was installed. However, given the average period

1 between installation and retirement that is reflected in the statistical analysis of net salvage, such  
2 application also assumes that there will be substantial improvements in technology, comparable or  
3 lesser environmental regulations and a significant reduction in inflation.

4 **Q. How does the use of net salvage percentages that reflect historical indications**  
5 **assume these events?**

6 A. Net salvage percentages are the net salvage costs divided by the original costs of the  
7 assets that have been retired and expressed as percentages. Net salvage percentages reflect the  
8 retirement of plant that, on average, is significantly younger than the average service life of the  
9 plant in service, on an original cost dollar weighted basis.

10 For example, the age of Gas Services, Account 380, retired during the period 1983 through  
11 2004, ranged from 12 to 40 years, with a dollar weighted average age that was most likely less than  
12 22 years. The average net salvage percentage related to these retirements was negative 22 percent.  
13 In other words, after less than 22 years in service, the plant was retired and the cost to remove the  
14 plant was 22 percent of the cost to install the same plant. Costs to remove the plant are affected by  
15 inflation, technological changes and other factors. The estimate of negative 25 percent net salvage  
16 after 40 years of service, a period approximately twice as long as the likely average age of the  
17 1983–2004 retirements, is probably inadequate unless there is a reduction of inflation or  
18 improvements in technology that reduce the overall effort required to remove plant.

19 The future retirements of the total current gas services in service will have an average age  
20 that actually exceeds the average life. Thus, the average age of future retirements of the plant in  
21 service today will be over twice as long as the average age of the plant retired during the period  
22 1983-2004. For retirements at such ages to experience net salvage that is only negative 25 percent

1 of the cost to install, there will have to be a reduction in the rate of inflation adjusted for  
2 technological improvements. If the annual rate of inflation adjusted for technological  
3 improvements that occurred between the installation and retirement of plant retired during the  
4 period 1983–2004 occurred over a period that is twice as long, the net salvage cost would be much  
5 greater as a percentage of the original cost of the plant retired.

6 **Q. What is the practical implication of the assumption that a future rate of**  
7 **inflation adjusted for technological improvements will be less than the historical rate?**

8 A. The practical implication of this assumption, as reflected in Avista’s estimates of  
9 net salvage percentages, is that the resulting net salvage accruals are most likely a conservative  
10 estimate of the total net salvage costs over the entire life cycle of the plant currently in service.

11 **Q. Is this the case with the amount of salvage costs estimated by Avista?**

12 A. Yes, I believe so. My net salvage estimates will almost certainly result in the  
13 recovery of less, not more, net salvage than the actual costs incurred.

14 **Q. Have you compared your estimates of net salvage with the typical levels of net**  
15 **salvage used in the industry?**

16 A. Yes. My estimates of net salvage for production plant and for mass property are  
17 comparable or less negative than the typical levels of net salvage in the electric and gas industries.  
18 Further, I would note that Mr. King used my estimates in developing his discounted value net  
19 salvage accruals.

20 **IV. FINANCIAL REPORTING AND RATEMAKING PRINCIPLES**

21 **Q. Where are the principles of the traditional net salvage approach outlined?**

22 A. The Uniform System of Accounts outlines the principles for determining net

1 salvage accruals. The Uniform System of Accounts defines depreciation as “the loss in service  
2 value not restored by current maintenance incurred in connection with the consumption or  
3 prospective retirement of property in the course of service from causes which are known to be in  
4 current operation and against which the utility is not protected by insurance.”<sup>1</sup> The operative  
5 words in this definition are "service value". The Uniform System of Accounts goes on to define  
6 service value as “the difference between the original cost and the net salvage value of the utility  
7 plant”, not as just the original cost.<sup>2</sup> The service value rendered by an asset, i.e., depreciation,  
8 must reflect both its original cost and its net salvage.

9 **Q. Does the Uniform System of Accounts also address the manner in which**  
10 **depreciation is to be recognized?**

11 A. Yes, it does. The Uniform System of Accounts requires that depreciation be  
12 recognized through accrual accounting. That is, the service value of an asset must be accrued  
13 during the life of the asset. Because net salvage is a part of the service value, it must be accrued  
14 during the life of the related asset in order to comply with the Uniform System of Accounts.

15 **Q. Why should ratemaking follow the procedure outlined in the Uniform System**  
16 **of Accounts?**

17 A. The Uniform System of Accounts was developed for public utilities and adopted by  
18 regulatory commissions to provide useful information for regulatory reporting and ratemaking  
19 purposes. This cannot be said of GAAP. As such, the Uniform System of Accounts considers  
20 issues such as customer equity and matching that are no longer reflected in GAAP.

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<sup>1</sup> 18 CFR Ch. 1 (4-1-07 Edition), Part 101, P. 353, ¶ 12

<sup>2</sup> 18 CFR Ch. 1 (4-1-07 Edition), Part 101, P. 355, ¶ 37

1           **Q. Do you agree with Public Counsel/ICNU that FAS No. 143 applies to this**  
2 **proceeding?**

3           A. No. The recent accounting pronouncements stated in FAS 143 do not affect the  
4 regulatory policies of this Commission and do not prescribe depreciation methodologies for a  
5 regulated utility such as Avista. Therefore, FAS 143 does not apply to ratemaking in general, or to  
6 this proceeding in particular.

7           Generally Accepted Accounting Principles, as embodied in the statements of the FASB,  
8 have in recent years moved away from the matching principle in favor of an asset and liability  
9 based approach. While this movement may improve a potential investor's ability to ascertain a  
10 company's financial condition, compliance with such standards for ratemaking purposes would  
11 violate principles of customer equity. Further, FAS 143 requires a legal obligation to retire plant  
12 before it can be recognized as a liability. In utility operations, a utility may not have a legal  
13 obligation to remove plant, but it nevertheless does so on a regular basis and will continue to do so  
14 in the future.

15           **Q. Is there a need for the Commission to specifically recognize a regulatory**  
16 **liability for regulatory and ratemaking purposes?**

17           A. No, there is not. As I stated above, FAS 143 is a financial accounting standard.  
18 There is no need to recognize a financial accounting entry for ratemaking purposes.

19                                   **V. METHOD OF ALLOCATING NET SALVAGE**

20           **Q. Do you agree with Mr. King's statement at Page 9 of his testimony that "The**  
21 **TIFCA procedure charges ratepayers now for the nominal dollar cost of removing**  
22 **plant at the time of its retirement"?**



1           A.     I agree that the intent of the TIFCA procedure is to charge ratepayers for the  
2 nominal dollar cost, although for the reasons already described, the procedure usually understates  
3 the dollars to be charged.

4           **Q.     Is it appropriate to ask current customers to pay for future costs of plant**  
5 **removal using a straight-line accrual method?**

6           A.     Yes. The future cost to remove an item of plant is part of the service value that it  
7 renders to current customers, and a ratable portion of such cost should be recovered from these  
8 customers. That is the purpose of depreciation, i.e., to capture the loss in service value during a  
9 specific period. As these future costs are recovered from current customers, they are deducted  
10 from rate base. This reduction in the amount on which the utility is entitled to earn a fair return, in  
11 effect, represents an amount on which the customer earns a return. That is, as customers provide  
12 for the future cost of removal, they effectively receive a return on such amounts. This is fair  
13 compensation for making payment prior to the cost incurrence by the utility. Further, by charging  
14 customers for these costs during the life of the plant, the customers that benefit from the plant  
15 (consume its service value) are the ones that pay for such service. Customers paying today for  
16 future costs of removal and, in effect, receiving a return on such payments, is no different than the  
17 utility recovering today amounts that it invested many years ago, but on which it earned a return  
18 until the amount was recovered from customers.

19           **Q.     Do you agree with Mr. King's contention that at page 9 of his testimony that**  
20 **Avista's method for accruing net salvage does not properly recognize the time value of**  
21 **money?**

22           A.     No, I do not. Although the amount that Avista proposes to collect from customers

1 for future net salvage costs is greater than the present values of such costs, the amount that Avista  
2 proposes to collect from customers for historic original cost is far less than the present value of  
3 such original cost, i.e., a trended original cost. If net salvage accruals should be limited to the  
4 present value of future net salvage expenditures, then the portion of depreciation expense related to  
5 the recovery of original cost should be increased to the present value of the historic plant additions.  
6 The amount for recovery of original cost is far less than a ratable portion of the present value of the  
7 original cost. Equity considerations require that customers pay for the service value (original cost  
8 less net salvage) of the plant from which they receive service. The fact that this results in accruals  
9 for net salvage that are greater than the present value of such costs is fairly balanced against the  
10 utility's accrual of original costs that are substantially less than the present value of such costs.

11 **Q. Why are Avista's net salvage accruals for gas plant so much greater than the**  
12 **current removal cost expenditures?**

13 A. The difference in price level, as described above, is part of the difference. Another  
14 significant difference is that the current experience is related to plant retirements that largely come  
15 from an older plant base that was constructed to serve fewer customers, whereas the current net  
16 salvage accruals relate to the plant presently in service that serves a much larger customer base.

17 **Q. Why is it more appropriate and equitable to recognize net salvage costs during**  
18 **the life of the related plant?**

19 A. The net salvage cost of an item of plant is a part of its service value and, therefore,  
20 it is a part of the item's cost of providing service. The cost of the item providing service should be  
21 collected from the customers that receive the service. Thus, an allocable portion of the net salvage  
22 cost should be recovered each year from the customers receiving the value of the service rendered

1 by the item of plant in the same way that an allocable portion of the item's original cost is  
2 recovered from such customers each year. This approach is equitable because customers are  
3 responsible for the costs of plant that provide service to them. This is also a sound ratemaking  
4 principle based on matching.

5 **Q. Do authoritative texts on depreciation support Mr. King's proposals related to**  
6 **net salvage?**

7 A. I am not aware of any authoritative text on the subject of depreciation that supports  
8 Mr. King's proposals to accrue on the basis of discounted costs or to expense net salvage costs.  
9 The two depreciation texts most often cited by depreciation experts support the allocation of  
10 service value to the periods during which an asset renders service, as proposed by Avista. Public  
11 Utility Depreciation Practices<sup>3</sup> states:

12 Closely associated with this reasoning are the accounting principles that revenues be  
13 matched with costs and the regulatory principle that utility customers who benefit  
14 from the consumption of plant pay for the cost of that plant, no more, no less. The  
15 application of the latter principle also requires that the estimated cost of removal of  
16 plant be recovered over its life.

17  
18 Depreciation Systems, another widely accepted text, states the concept in this manner:

19 The matching principle specifies that all costs incurred to produce a service should  
20 be matched against the revenue produced. Estimated future costs of retiring of an  
21 asset currently in service must be accrued and allocated as part of the current  
22 expenses.<sup>4</sup>

23  
24 Public Utility Depreciation Practices also addresses the method of allocating the service  
25 value to each year of service:

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<sup>3</sup> National Association of Regulatory Utility Commissioners, Public Utility Depreciation Practices 157 (1996).

<sup>4</sup> Frank K. Wolf and W. Chester Fitch, Depreciation Systems 7 (Iowa State Univ. Press (1994)).

1           The straight-line method is almost universally used in the utility rate making  
2           process...Interest methods, such as the sinking fund method, are no longer in general  
3           use.<sup>5</sup>  
4

5           **Q.     Have any states adopted the discounted value accrual for net salvage?**

6           A.     Yes. The Maryland Public Service Commission in its Order No. 81517 in a case  
7           involving Potomac Electric Power Company adopted a discounted net salvage accrual, referring to  
8           it as the Present Value Method. The Commission's rationale was that ratepayers pay for net  
9           salvage in real dollars. Given the effective return provided to ratepayers for payments of net  
10          salvage and the recovery of original cost in nominal—not real—dollars, I disagree with the  
11          rationale of the Maryland PSC.

12          **Q.     Please explain how the vast majority of states treat negative net salvage when**  
13          **determining annual depreciation rates.**

14          A.     To the best of my knowledge, 47 state utility commissions primarily or exclusively  
15          use the traditional method of accruing negative net salvage on a straight line basis to determine  
16          appropriate depreciation rates, which is consistent with Avista's approach in this case.

17          In fact, the Missouri Public Service Commission, the Indiana Utility Regulatory  
18          Commission, and the California Public Utilities Commission all recently re-affirmed the use of the  
19          traditional straight line accrual of net salvage during the life of the related property.

20          **Q.     Please describe how the Missouri Commission recently dealt with the issue of**  
21          **net salvage?**

22          A.     The Missouri Public Service Commission has been dealing with the issue of net  
23          salvage for a number of years. In its 2005 order involving Laclede Gas Company, the

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<sup>5</sup> Public Utility Depreciation Practices, *supra* note 1, at 61.

1 Commission concluded:

2 The Commission finds that the fundamental goal of depreciation accounting is to allocate  
3 the full cost of an asset, including its net salvage cost, over its economic or service life so  
4 that utility customers will be charged for the cost of the asset in proportion to the benefit  
5 they receive from its consumption. The Commission further finds that the method utilized  
6 by Laclede is consistent with that fundamental goal.<sup>6</sup>  
7

8 **Q. What conclusions did the Indiana Commission reach in its recent rulings on**  
9 **this subject?**

10 A. The Indiana Utility Regulatory Commission considered the net salvage issue in its  
11 2004 order involving PSI Energy. It dealt with net salvage related both to production plant and to  
12 delivery assets, i.e., transmission and distribution plant. The Commission's conclusions regarding  
13 the appropriate recognition of net salvage for both types of facilities are instructive:

14 The next issue is the timing of the collection of such costs. The parties did not disagree that  
15 dismantling costs are a part of the cost of current facilities providing current service. They  
16 disagreed as to the timing of the collection of such costs and their amount. This  
17 Commission can either find that current customers should pay a share of dismantling costs,  
18 which will not be incurred for a number of years, or, in the alternative, conclude that these  
19 costs should be passed on to a future generation of customers. This Commission does not  
20 believe that the latter alternative constitutes sound regulatory policy, or is based on sound  
21 ratemaking principles. Current customers are receiving service from PSI's generation  
22 facilities. A part of the costs of those facilities is dismantlement upon retirement. Therefore,  
23 we do not believe it would be appropriate for the Company to backload the dismantlement  
24 costs for future ratepayers to pay when the facilities associated with these costs are  
25 providing service to current customers. Rather, we find it is appropriate that these costs be  
26 shared by all customers that received service from PSI's generation facilities. Accordingly,  
27 this Commission finds that dismantlement costs are properly included in determining the  
28 depreciation rates approved in this cause. (emphasis added)  
29

30 We believe that there is a sound basis for the traditional approach on this issue that is  
31 utilized by a majority of states. Utilizing historical averages as an item to be expensed to  
32 current customers means that these customers will be paying for salvage costs at levels that  
33 may not be sufficient. That means that the next generation of customers will be paying for  
34 salvage costs related to facilities from which they may never have received service. The use

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<sup>6</sup> In re Laclede Gas Co., Missouri P.S.C., Case No. GR-99-315 (Jan. 11, 2005), 2005 WL 65953 at \*5.

1 of best estimates of future salvage costs addresses this inequity. Moreover, use of historical  
 2 averages for dismantling costs does not take into account the current configuration of PSI's  
 3 system with regard to its production, transmission, distribution and general facilities.  
 4 Facilities in service 40-50 years ago did not take into account the significantly enhanced  
 5 customer base that PSI now serves, nor the current configuration of PSI's facilities that  
 6 serve these customers. It seems appropriate to utilize best cost estimates for net salvage  
 7 values taking into account specific facilities now serving PSI's customers in developing  
 8 depreciation rates that today's customers should pay. Accordingly, we find that the use of  
 9 historical averages for net salvage values with regard to transmission, distribution and  
 10 general plant for the purpose of expensing them outside the context of the depreciation  
 11 determination should be, and hereby is, rejected.<sup>7</sup> (emphasis added)

12  
 13 **Q. How did the California Commission deal with proposals to change from the**  
 14 **traditional straight line accrual method?**

15 A. The California Public Utilities Commission has also rejected the discounted value  
 16 approach in cases involving Southern California Edison Company, Pacific Gas & Electric  
 17 Company, San Diego Gas & Electric Company, and Southern California Gas Company. In these  
 18 proceedings, The Utility Reform Network ("TURN") had proposed the use of discounted net  
 19 salvage accruals. In the most recent case, A.06-12-009, et al, involving San Diego and Southern  
 20 California Gas, the Administrative Law Judge in his draft decision for the Commission observed:

21 The alternative methodology proposed by TURN was also rejected in the most recent  
 22 Pacific Gas & Electric Company (PG&E) and Southern California Edison Company (SCE)  
 23 GRCs. We therefore deny with prejudice the recommendations of DRA, TURN, and  
 24 UCAN on depreciation and net salvage. The purpose of this denial is to avoid an  
 25 unnecessary repetition in subsequent proceedings. Any party that raises these issues again  
 26 should have new analysis and new arguments which may persuade us, unlike the arguments  
 27 raised here or in other recent rate proceedings.<sup>8</sup>

28  
 29 **Q. How has this Commission treated net salvage?**

30 A. To the best of my knowledge, the Washington Utilities & Transportation  
 31 Commission has consistently used the traditional straight line accrual of net salvage.

<sup>7</sup> In re PSE Energy, Inc., 234 P.U.R. 4th 1, 65-66 (Ind. U.R.C. 2004)

<sup>8</sup> In re San Diego Gas and Electric Co., et. al., Case No. A.06-12-009, 21-22 (May 22, 2007).

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**VI. SUMMARY AND CONCLUSION**

**Q. Please summarize your rebuttal testimony.**

A. Public Counsel/ICNU’s net salvage proposal should be rejected. Its attempt to substitute financial accounting standards for sound and tested ratemaking policies is unreasonable. Depreciation is the loss in service value, and service value is the original cost less net salvage. Depreciation, including both the original cost and net salvage, should be recognized ratably on a straight line basis during the life of the related asset.

The traditional approach to estimating future net salvage used by Avista is appropriate and results in estimates of net salvage that, if anything, may actually understate future net salvage costs.

**Q. Does this conclude your rebuttal testimony?**

A. Yes, it does.