

Exhibit No.:

Issue:

Depreciation

Gas Holders

Witness:

R. Lawrence Sherwin

Type of Exhibit:

Rebuttal Testimony

Sponsoring Party:

Laclede Gas Company

Case No.:

GR-2002-356

FILED

AUG 02 2002

LACLEDE GAS COMPANY

**Missouri Public
Service Commission**

GR-2002-356

REBUTTAL TESTIMONY

OF

R. LAWRENCE SHERWIN

August, 2002

JOYCE L. JANSEN
Notary Public — Notary Seal
STATE OF MISSOURI
ST. CHARLES COUNTY
My Commission Expires: July 2, 2005

TABLE OF CONTENTS

| | <u>Page</u> |
|--|--------------------|
| 1. Amortization of Depreciation Reserve | 2 |
| 2. Depreciation Rates | 11 |
| 3. Accounting Instructions for Gas Holders | 12 |

1 **REBUTTAL TESTIMONY OF R. LAWRENCE SHERWIN**

2

3 Q. Please state your name and business address.

4 A. My name is R. Lawrence Sherwin, and my business address is 720 Olive Street,
5 St. Louis, Missouri, 63101.

6 Q. Are you the same R. Lawrence Sherwin who filed Direct Testimony concerning
7 depreciation on behalf of the Company in this case?

8 A. Yes.

9 Q. What is the purpose of your rebuttal testimony?

10 A. The purpose of my rebuttal testimony is to respond to the direct testimony of Staff
11 witness Rosella L. Schad. Specifically, I will respond to Ms. Schad's recommendation
12 that the Commission adopt a negative amortization of what she claims is an imbalance
13 between the Company's depreciation reserve and a "theoretical" reserve that she has
14 calculated based on a retrospective application of the Staff's highly unusual method of
15 expensing net salvage costs. Among other things, I will explain why such an
16 amortization, which would be unwarranted under any circumstances, is particularly
17 inappropriate given the extremely unsettled state of the Commission's and accounting
18 profession's policies toward the treatment of net salvage. I will also explain why the
19 depreciation rate changes proposed by Ms. Schad, which would further lower the
20 Company's depreciation rates below levels that are already among the lowest in the
21 country for gas utilities, should not be approved. In response to Ms. Schad's
22 recommendation regarding the depreciation lives for computers, I will also explain
23 why a shorter depreciable life for certain computer assets is appropriate, particularly in
24 the absence of Commission approval of the treatment for these items that I proposed in
25 my direct testimony in this case. Finally, I will provide testimony concerning the

1 accounting instructions that would need to be reflected in any Commission Order in
2 the event the Commission were to approve Staff's recommendation that the cost of
3 removal for Laclede's remaining gas holders be charged to the reserve for
4 depreciation. I should note further that additional revenue requirement should be
5 provided for these costs.

6 **Amortization of Depreciation Reserve**

7 Q. Please discuss Staff witness Schad's proposal to amortize a portion of the Company's
8 depreciation reserve through an adjustment to the Company's depreciation rates.

9 A. As I understand Ms. Schad's proposal, what Staff proposes to do is amortize through
10 an adjustment to the Company's depreciation rates for steel mains and for copper and
11 plastic services the difference between the amount included in the Company's
12 depreciation reserve and the "theoretical reserve" which Ms. Schad has calculated
13 based on a hypothetical assessment of how much depreciation expense the Company
14 should have collected had the Staff's treatment of net salvage expense always been in
15 effect for Laclede.

16 Q. Please explain why Staff witness Schad's negative amortization proposal is
17 inappropriate.

18 A. A number of factors all point to the inappropriateness of the proposed negative
19 amortization at this time. First of all, both this Commission's treatment and the
20 accounting profession's treatment of net salvage is in a state of flux -- a circumstance
21 that in my opinion strongly argues in favor of maintaining the status quo on this issue
22 and against Staff's efforts to take the Company further down a road that the two other
23 largest utilities in the Company's service territory have not even been required to
24 embark upon. Second, Staff's amortization proposal is premised on the retrospective
25 application of Staff's underlying treatment of net salvage expense -- a treatment that

Staff recently acknowledged is contrary to the Commission's own rules governing the proper treatment of these costs. In fact, Staff's proposal inappropriately uses depreciation accounting as a pretext for reaching back and making adjustments based on prior collections of net salvage costs even though this reconciling feature of depreciation accounting for net salvage costs has already been eliminated as a result of the Company's last rate case settlement. Finally, Staff has failed to present any substantive evidence to support the absurdly low depreciation rates that would result from such an amortization or to substantiate its apparent position that Laclede's depreciation reserve does not appropriately reflect a reasonable estimate of Laclede's removal costs.

Q. Please explain your statement that now is a particularly inappropriate time to implement Staff's proposed amortization because the Commission's ratemaking and the accounting profession's treatment of net salvage costs is in a state of flux.

A. The uncertainty of treatment exists on several levels. To put it mildly, this Commission's treatment of net salvage costs has varied significantly from case to case for Missouri utilities. For example, over the past year, the Commission has authorized the two other largest regulated utilities in Laclede's service territory to continue the traditional method of including an allowance for net salvage costs in their depreciation rates. The Commission did this in a litigated case last year involving St. Louis County Water Company and more recently in the settlement of Staff's complaint case against AmerenUE. On the other hand, in two other litigated cases, involving Laclede and Empire District Electric Company, the Commission rejected the traditional method and decided to either eliminate any allowance for net salvage costs or to exclude it entirely from the calculation of depreciation rates. The Commission has also approved several settlements in which Staff's recommended treatment of net salvage costs was

1 approved, including Laclede's last rate case in which the Company agreed to such
2 treatment pending judicial review of the Commission's earlier decision on this issue.

3 Q. Have you been able to detect any distinguishing reasons for this disparate treatment
4 from one utility to the next?

5 A. No. I have been unable to detect any apparent basis that would justify this unequal
6 treatment. The Commission has approved the traditional treatment of net salvage costs
7 as a result of both litigated cases and settlements. And it has approved Staff's
8 preferred treatment of net salvage costs as a result of both litigated cases and
9 settlements. It has authorized the traditional treatment for some electric utilities and
10 rejected it for others, said that the traditional treatment is appropriate for a water
11 company but not a gas company and, in general, simply reached widely different
12 results from one case to the next.

13 Q. Has the Commission shed any light at all on why it has arrived at these differing
14 results?

15 A. Very little. Usually, the Commission simply states that its treatment is based on the
16 specific facts and circumstances of each case without giving any real guidance as to
17 what those facts and circumstances are or why they warrant such different treatment.
18 In fact, about the only guidance that the Commission has offered is its observation in
19 the St. Louis County Water Company case that cash flow considerations warranted a
20 retention of the traditional method of treating net salvage costs.

21 Q. Does this "cash flow" consideration help to distinguish the Commission's rejection of
22 the traditional method for Laclede from its continuation of the traditional method for
23 other utilities?

24 A. Absolutely not. By almost any measure, if cash flow considerations represent the
25 critical factor in determining whether the traditional or Staff method for dealing with

1 net salvage costs should be approved, then there is absolutely no basis for applying the
2 latter to Laclede, let alone exacerbating the impact of that method as Staff has
3 proposed to do in this case with its amortization proposal.

4 Q. Please explain what you mean.

5 A. A review of Staff's own rate of return testimony in this case shows that Laclede's cash
6 flow situation is terrible compared to those of its peer companies. A primary measure
7 of cash flow health is the pre-tax interest coverage ratio which shows the relationship
8 between the amount of income available to the utility to cover its interest obligations
9 and the amount of those interest obligations. As a general rule, the higher a utility's
10 pre-tax interest coverage ratio, the better its cash flow situation will be. As Staff
11 witness McKiddy notes, however, at page 42 of her direct testimony, the Company's
12 pre-tax interest coverage ratio was 2.02 times as of December 31, 2001. By
13 comparison, the pre-tax interest coverage ratio of the gas utilities that Ms. McKiddy
14 herself identified as otherwise comparable to Laclede has pre-tax interest coverage
15 ratios ranging from 2.65 times to 5.80 times, with an average of 3.51 times. In other
16 words, Laclede is not even at the bottom of the range of its peer companies and has a
17 ratio that is less than 60% of the average of its peer companies.

18 Q. Do the other utilities who the Commission has allowed to retain the traditional
19 treatment of net salvage costs have even worse cash flow situations than Laclede?

20 A. No. For example, in the AmerenUE case, in which the traditional method was
21 retained, the evidence indicated that AmerenUE had a pre-tax interest coverage ratio
22 exceeding 5 times, or more than twice that of Laclede's ratio.

23 Q. But don't these and other utilities have a greater need than Laclede for cash in order to
24 meet future capital requirements?

1 A. No. On a relative basis, Laclede's capital requirements are just as significant when
2 compared to the income it has to fund such requirements.

3 Q. What do these considerations suggest to you?

4 A. It strongly suggests that the Commission's policy regarding the treatment of net
5 salvage expense is in a state of extreme flux, with little or nothing in the way of clear
6 standards or criteria to explain why it is being applied in one manner in one case and
7 in an entirely different manner in another case. It also suggests that by virtue of the
8 one consideration that the Commission has identified for determining when the
9 traditional or Staff method should be used -- namely cash flow considerations -- that
10 there is absolutely no basis for applying the Staff method to Laclede.

11 Q. Are there other reasons why you believe the Commission's policy in this area is in a
12 state of flux?

13 A. Yes. Since Laclede's last case, the Staff has apparently come to recognize that its
14 treatment of net salvage expense violates the Commission's own rules.

15 Q. Please explain what you mean.

16 A. In a recent case involving Citizen's Electric Corporation, the head of the
17 Commission's depreciation staff was asked whether the Staff's approach of excluding
18 net salvage from depreciation and expensing it was consistent with Commission Rule
19 4 CSR 240-20.030(3)(H) which requires electric utilities to "Charge original cost less
20 net salvage to account 108., when implementing the provisions of Part 101 Electric
21 Plant Instructions 10.F. and paragraph 15,060. 10F."

22 Q. Is there a comparable provision for gas utilities?

23 A. Yes. Commission Rule 4 CSR 240-40.040(3)(H) has an identical provision for gas
24 utilities requiring them to also "Charge original cost less net salvage to account 108.,

1 when implementing the provisions of Part 201 Gas Plant Instructions 10.D. and
2 paragraph 20.050.10A.”

3 Q. What do these Commission rules mean?

4 A. They unambiguously mean that net salvage costs are to be charged to depreciation
5 accounts and not expensed as Staff has done with its method.

6 Q. Did the Staff’s manager of depreciation acknowledge this conflict?

7 A. Yes. As shown by Rebuttal Schedule 1 to my testimony, Staff witness Paul Adam in
8 that case clearly acknowledged that Staff’s approach of expensing net salvage expense
9 was “in opposition” to these Commission rules.

10 Q. In view of these considerations, is Laclede proposing in this case that the Commission
11 revert back to its traditional treatment of net salvage costs for Laclede?

12 A. For purposes of this case, and consistent with the Stipulation and Agreement in its last
13 case, the Company has filed in accordance with the Staff method for expensing cost of
14 removal. The Company intends to adhere to that agreement in this case. However, the
15 Company did not agree in its last case and certainly does not agree today that it is
16 appropriate or reasonable to take the additional step of amortizing a huge portion of
17 the Company’s depreciation reserve based on a retroactive application of that method.
18 While it would be inappropriate to take such a step under any circumstances, it is
19 clearly unwarranted given the unsettled and widely-conflicting nature of the
20 Commission’s policy in this area and Staff’s acknowledgement that the method
21 underlying its proposal is contrary to the Commission’s own rules.

22 Q. Are there other reasons not to take this additional step?

23 A. Yes. In addition to the Commission’s policies being in a state of flux in this area, the
24 accounting profession has also recently made substantial changes in how companies
25 are to account for the net salvage or removal costs for financial reporting purposes.

1 Q. Please explain what you mean.

2 A. On the accounting front, the Financial Accounting Standards Board has issued
3 Financial Accounting Standards ("SFAS") No. 143, and it is being implemented by
4 companies in all sectors around the country. This Statement is expected to have an
5 impact on the accounting treatment of net salvage costs for all utilities, including a
6 possibly significant impact on the very accounts for which witness Schad is proposing
7 the negative amortization.

8 Q. Please explain the relevance and impact of SFAS No. 143.

9 A. This statement, issued June 2001 and effective for fiscal years beginning after June 15,
10 2002, is entitled Accounting for Asset Retirement Obligations. In brief, it specifies a
11 new method for accounting for costs associated with the retirement and replacement of
12 certain long-lived assets - those with legal obligations associated with the retirements.
13 It has not yet been determined how much of the Company's property will be subject to
14 the rules. The statement requires companies to set up the estimable fair value of a
15 liability for an asset retirement obligation as a part of the asset cost and as a liability.
16 In practice, these values may have a reasonable but not exact relationship with the
17 reserve for depreciation for such assets. The Company is now analyzing the effect of
18 this statement on Laclede. Until that analysis is complete, I believe it would be ill-
19 advised to begin amortization of any depreciation reserve difference.

20 Q. What do you recommend to the Commission given the state of flux in regulatory and
21 accounting treatment concerning net salvage costs?

22 A. Under these circumstances, I believe the appropriate thing to do is to wait until FAS
23 143 is implemented and judicial resolution is achieved before any additional steps are
24 taken to exacerbate the impact of the Commission's net salvage change for Laclede.

1 Q. You stated that approval of the negative amortization proposal would result in
2 absurdly low effective depreciation rates for the accounts involved. Please explain.

3 A. The depreciation rates proposed by Staff for these two accounts are 1.27% for Steel
4 Mains and 1.43% for Copper and Plastic Services. Using the Plant balance at
5 March 31, 2002, annual depreciation expense would amount to \$ 2,451,798 for Steel
6 Mains and \$ 2,089,713 for Copper and Plastic Services. However, effectively these
7 annual depreciation allowances would be offset by Staff's proposed negative
8 amortization amounts of (\$ 2,400,000) and (\$ 1,000,000), respectively, leaving a net
9 annual depreciation and amortization expense for these 2 accounts of a mere \$ 51,798
10 for Steel Mains and of only \$ 1,089,713 for Copper and Plastic Services. Such a net
11 annual level would result in an effective rate of less than three-quarters of a percent
12 annually for Copper and Plastic Services, and an unbelievably low rate of 0.00027 for
13 Steel Mains. For Steel Mains, such a tiny effective rate would absurdly result in an
14 implicit life of thousands of years. The attached rebuttal schedule, RLS Rebuttal - 2,
15 summarizes the relevant computations. Methodologies resulting in such ridiculous
16 results should be summarily rejected for any company, and particularly for one with
17 the cash flow condition of Laclede Gas.

18 Q. Please explain why the negative amortization proposal is inappropriate given the
19 elimination of the reconciling feature of depreciation accounting for net salvage costs?

20 A. By way of background, it is important to recognize that traditional depreciation
21 accounting for net salvage costs inherently includes a reconciliatory feature, in that the
22 depreciation reserve level can be considered in the determination of prospective
23 depreciation rates as appropriate. As a result, historical under- or over- statements of
24 net salvage costs can be corrected for through prospective adjustments that make
25 everything "come out" even in the end. This reconciling feature is an established part

1 of typical depreciation accounting, much as the Commission's Uniform System of
2 Accounts instructs.

3 Q. Is the same thing true once net salvage costs are expensed as Staff prefers?

4 A. No. Under this method, the Commission establishes a level of net salvage expense
5 that will be reflected in general rates until those rates are once again changed in a rate
6 case proceeding. In the interim, to the extent there are any increases above or
7 decreases below the net salvage costs built into rates, the Company will simply absorb
8 or benefit from the financial impact of those changes. In other words, there is no
9 longer a reconciling method to make certain that recovery perfectly matches cost.

10 Q. What implications does this have for Staff's proposal?

11 A. Staff is effectively trying to have it both ways. On the one hand, it has pressed the
12 Commission to approve a policy that jettisons traditional depreciation treatment for net
13 salvage, including the reconciling feature that ensures a matching of costs and cost
14 recovery, in favor of an approach that does not have these attributes. On the other
15 hand, however, the Staff proposes to once again use the reconciling feature for net
16 salvage costs -- a feature that it has just rejected -- to amortize a huge portion of the
17 depreciation reserve, presumably on the theory that such an action is necessary to keep
18 everything "even" when it comes to this aspect, and this aspect only, of such costs.
19 This inconsistent and selective use of traditional depreciation accounting should be
20 rejected by the Commission.

21 Q. Would other retrospective adjustments have to be made in the event the Commission
22 determined it was appropriate to adopt Staff's amortization proposal?

23 A. Yes. Company witness James A. Fallert testifies in his rebuttal testimony concerning
24 what would need to be done if such retrospective adjustments are made. In addition,
25 an analysis would have to be performed to determine whether the Company, in fact,

1 collected these depreciation expenses. I am certain that if a retrospective review of the
2 Company's actual collection of these depreciation expenses were performed, it would
3 show that much of the depreciation amount that Ms. Schad claims was previously
4 collected from customers was, in fact, not collected from customers.

5 Q. Is there any other aspect of the reconciling feature of depreciation accounting that Ms.
6 Schad fails to evaluate properly.

7 A. Yes, at page 13 of her direct testimony, Ms. Schad implies that some normal costs of
8 removal for certain cast iron mains owned by the Company were offset because the
9 Company received some compensation for the use of those mains. She goes on to use
10 this as an example of why the expensing of net salvage is appropriate. Had Ms. Schad
11 checked, however, she would have found that all of the financial aspects associated
12 with the retirement of these mains, including the compensation received by the
13 Company, were reflected in its depreciation balances. In view of this, her example
14 proves just the opposite of what she contends. Specifically, it shows that with the
15 reconciling feature of the traditional method customers would have the opportunity to
16 benefit from such transactions, while under Staff's method they would not unless the
17 transaction took place in the test year.

18 Q. Do you have any other reason why the negative amortization would be inappropriate?

19 A. I would only point out that absolutely no evidence has been provided by Staff to show
20 that the depreciation reserve does not reflect a reasonable estimate of Laclede's
21 removal cost.

22 **Depreciation Rates**

23 Q. Why do you oppose the depreciation rate changes proposed by witness Schad?

24 A. I oppose the depreciation rate changes because of the pressing cash flow situation of
25 the Company. Laclede Gas already has a very low effective depreciation rate

1 compared to other companies in the industry, and I believe this to be a very poor time
2 to subject the Company to another depreciation rate reduction. In addition, I feel that
3 certain of Laclede's accounts would properly receive a much higher depreciation rate
4 if conditions beyond those included in the Staff witness' study were reflected.

5 Q. What accounts do are you referring to?

6 A. Copper and Plastic Services, account 380.02, and Data Processing Systems, account
7 391.02. The Copper and Plastic Services account should reflect the Company's
8 copper service replacement program. The Data Processing Systems account consists
9 largely of computers and appurtenant equipment such as printers. The Company's
10 recent and anticipated service life for both personal computers and mainframe
11 computers will be much shorter than the lives for such equipment which is reflected in
12 the historical retirement data used by witness Schad for her average service life
13 determination. I recommend that both of these accounts receive an increase in their
14 depreciation rate, in order to more properly reflect the anticipated lives.

15 **Accounting Instruction for Gas Holders**

16 Q. Please explain the need for accounting instruction or authority with respect to the
17 removal cost for the four gas holders.

18 A. Staff recommends that the net salvage, including removal cost for the four gas holders,
19 be charged to the depreciation reserve as under standard accounting practice, rather
20 than charging these costs to expense. I believe such treatment would be appropriate
21 for this item, when it occurs, but I also believe that the Commission should make a
22 record of the depreciation reserve as the appropriate account to charge these costs, to
23 assure that the Company would be booking those costs in accordance with the
24 Commission's orders. I am not aware that this would be a point of contention with the
25 Staff, and I view it as a necessary formality to reflect the Staff proposal for this item.

1 For the reasons stated in my direct testimony, however, I believe that additional
2 revenue requirement should be provided for these removal costs.

3 Q. Does this complete your rebuttal testimony?

4 A. Yes, it does.

Consisting of Cover and four attached pages

Transcript from Presentation

Citizens Electric Corp.

Schedule RLS Rebuttal - 1

1 year start an RFP process, looking out for 2007 to
2 give potential generators in the marketplace an
3 opportunity to put in the ground generation to meet
4 the needs of the load.

5 I think that if the corporation decided to
6 wait, let's say, until 2004 and shop, they are very
7 limited -- potential bidders are very limited on what
8 they can supply and what price they can supply power.

9 Q. So if the spot market falls under the price
10 on your contract, you really can't go out and shop
11 unless it's this particular economic development
12 customer or it's a new customer of over, you say,
13 three --

14 A. Three megawatts.

15 Q. -- three megawatts?

16 A. Yes, sir.

17 Q. But you do have stability?

18 A. We do have -- yes, we do have stability
19 which we feel has lowered our risk by having the
20 five-year contract. And, very frankly, when we went
21 to the market, the one-year and two-year contracts,
22 the prices were significantly higher than the
23 five-year cost.

24 Q. You-all don't have any -- I know there's
25 been several people mention the fact that you're

47

ASSOCIATED COURT REPORTERS
(573) 636-7551 JEFFERSON CITY, MO 65101

1 member-owned and similar to the rural coops in a
2 number of ways. But you don't have any relationship
3 with any of the transmission or generation companies
4 under the coops in Missouri?

5 A. We are a member of the Missouri Electrical
6 Coops Association in the state. We are, as an
7 alternative, looking at and pursuing talks with
8 Associated, which is the large generation and
9 transmission supplier for the other 39 electric coops
10 in the state of Missouri.

11 We would love to see the price point that
12 they are delivering to our members as an opportunity
13 for our customers, but it has to be a two-way street.
14 Not only would we like to be part of that
15 organization, that organization also needs to feel
16 with its membership it's in its best interest allowing
17 Citizens to join the organization.

18 Q. So that's -- that's -- I think I got that
19 message pretty clearly, that you-all have a strong
20 interest in pursuing that if it's available?

21 A. Yes, sir.

22 Q. And it would under current circumstances
23 help your prices as far as your wholesale costs are
24 concerned?

25 A. Yes, sir.

48

ASSOCIATED COURT REPORTERS
(573) 636-7551 JEFFERSON CITY, MO 65101

1 COMMISSIONER GAW: All right. I want to
2 thank you for your time, sir. Thank you.

3 THE WITNESS: Thank you, Commissioner.

4 JUDGE DIPPELL: Thank you, Commissioner Gaw.
5 Commissioner Forbis, do you have any
6 questions?

7 COMMISSIONER FORBIS: No.

8 JUDGE DIPPELL: All right, then. Are there
9 any follow-up questions from Staff?

10 MR. MEYER: No, your Honor.

11 JUDGE DIPPELL: Public Counsel?

12 MR. COFFMAN: No. Thank you.

13 JUDGE DIPPELL: Missouri (sic) Lime?

14 MR. TURNER: No. Thank you.

15 JUDGE DIPPELL: Is there any follow-up from
16 Citizens?

17 MR. SCOTT: None, your Honor.

18 JUDGE DIPPELL: Thank you, Mr. Rodamaker.
19 You may be excused.

20 (Witness excused.)

21 JUDGE DIPPELL: I don't believe there are
22 any other Commission questions for the other Citizens
23 witness, so we'll go ahead and go to Staff's witness,
24 and we're going to begin with Mr. Adam.

25 Please raise your right hand.

49

ASSOCIATED COURT REPORTERS
(573) 636-7551 JEFFERSON CITY, MO 65101

1 (Witness sworn.)

2 JUDGE DIPPELL: Thank you.

3 PAUL WILLIAM ADAM testified as follows:

4 DIRECT EXAMINATION BY MR. ANDERSON:

5 Q. Good afternoon.

6 A. Good afternoon.

7 Q. Please give your name for the court
8 reporter.

9 A. Paul William Adam.

10 Q. Mr. Adam, who are you employed by and in
11 what capacity?

12 A. I'm a depreciation engineer for the Missouri
13 Public Service Commission Staff.

14 Q. Did you prepare the prefiled testimony in
15 this case which has previously been marked for
16 identification as Exhibit 3, Direct Testimony of Paul
17 Adam?

18 A. I did.

19 Q. Do you have any corrections or additions to
20 make to your prefiled testimony at this time?

21 A. I have no changes to make.

22 Q. Are the answers you have now provided true
23 and accurate to the best of your knowledge and belief?

24 A. To the best of my knowledge and belief.

25 Q. If I would ask you the same questions today

50

ASSOCIATED COURT REPORTERS
(573) 636-7551 JEFFERSON CITY, MO 65101

1 that are contained in your prefiled testimony, would
2 your answers be the same?

3 A. Yes.

4 MR. ANDERSON: At this time I would offer
5 Exhibit 3 into the record, and tender the witness for
6 questioning.

7 JUDGE DIPPELL: Thank you.

8 Mr. Adam, I'm going to ask you to speak up
9 just a little bit. I'm having difficulty hearing you.

10 THE WITNESS: Okay.

11 JUDGE DIPPELL: Are there Commission
12 questions for Mr. Adam from the Chair?

13 COMMISSIONER SIMMONS: No.

14 JUDGE DIPPELL: Commissioner Murray?

15 COMMISSIONER MURRAY: Thank you.

16 QUESTIONS BY COMMISSIONER MURRAY:

17 Q. Good afternoon, Mr. Adam.

18 A. Good afternoon.

19 Q. My first question, is that a flag on your
20 finger?

21 A. It is a Band-Aid, but it looks like a flag.

22 Q. Are you familiar with the testimony -- the
23 prefiled testimony of Dana Eaves for the Staff?

24 A. I'm not certain I will know what you're
25 asking about, but I'll try.

51

ASSOCIATED COURT REPORTERS
(573) 636-7551 JEFFERSON CITY, MO 65101

1 Q. All right. Since I understand that he's not
2 here today, I would like to ask you a couple of
3 questions from his testimony. And if you're unable to
4 answer them, just say so.

5 On -- do you have a copy with you?

6 A. No.

7 Q. On page 4 he says that he doesn't agree with
8 the Company's accounting method for accumulated
9 depreciation transmission and distribution plant
10 accounts 108.5 and 108.6. That's at lines 16 and 17.

11 A. I think I can address this.

12 Q. All right. He recommends that the Company
13 maintain its depreciation reserve accounts in
14 accordance with Commission Rule 4 CSR
15 240-20.030(3)(k).

16 Now, my first question is, under the
17 Stipulation and Agreement, are they going to do that?

18 A. No.

19 Q. All right. I'll come back to that, but my
20 second question is, does Staff also -- or would at the
21 time that this testimony was prefiled, would Staff
22 also have recommended that the Company keep its
23 accounts in accordance with 4 CSR 240-20.030(3)(h)?

24 A. Can I try to answer your question? I think
25 I know what we're talking about here, and I'm not

52

ASSOCIATED COURT REPORTERS
(573) 636-7551 JEFFERSON CITY, MO 65101

1 familiar with those rules fully.

2 But in the rules, companies that are
3 regulated by the Commission are required to keep
4 vintage data account by account of retirements. In
5 other words, as you would retire plant over time, you
6 would retire it per vintage. And what -- and the RUS
7 does not require that of companies. RUS not only
8 allows them to bring all vintages together as a single
9 dollar amount, but RUS also suggests that when they
10 retire, they retire on an average cost.

11 So in other words, if a company were to buy
12 more plant in the current year, and its unit cost
13 would simply get put in the large number of dollars,
14 then at the time they went to retire a unit of plant,
15 no knowledge of which vintage that plant came from,
16 they would retire an average of what the total bucket
17 has. In other words, if you had 100 units of plant
18 and \$100,000, you would retire \$1,000. It's an
19 average cost retirement.

20 Our other regulated companies that I've
21 seen -- this is the first one I've run into with this,
22 and this is the first RUS one I've run into that's in
23 the power industry. The other companies retire FI/FO
24 and keep data by vintage.

25 The records are established with this

53

ASSOCIATED COURT REPORTERS
(573) 636-7551 JEFFERSON CITY, MO 65101

1 company. They've been doing it, and they've been
2 successfully meeting RUS requirements. There is a
3 chart that RUS requires them to fall between two lines
4 on that chart as far as calculation of reserves versus
5 plant, and I was able to get the past five years of
6 data for that plant. So it appears to me they are
7 meeting RUS guidelines.

8 So in our proposal, in Staff's proposal, and
9 true in the Stipulation, too, we did not request that
10 the Company go through the project of breaking all of
11 their data out vintage by vintage.

12 Q. And is that because under the Stipulation
13 and Agreement it doesn't matter vintage by vintage
14 other than the fact that as plant is retired, it will
15 be expensed at that time, so there is no need to
16 really keep a vintage by vintage record of --

17 A. This really gets confusing now. RUS gives
18 ranges of depreciation rates. They don't designate a
19 life or a net salvage to go with those depreciation
20 rates.

21 Their concept is -- in speaking with their
22 specialist out of Washington, DC, is that overall, for
23 a whole company, all accounts, is that net salvage is
24 positive. In other words, gross salvage exceeds cost
25 of removal. And this concept goes back for years and

54

ASSOCIATED COURT REPORTERS
(573) 636-7551 JEFFERSON CITY, MO 65101

1 years, and they haven't updated that. He admitted
2 that it probably needed to be updated.

3 But they work on a-- kind of a conceptual
4 basis that they have some beliefs, but then they come
5 up with a range of depreciation rates. You might have
6 seen that in one of the attachments where for
7 different accounts they show a high and low for what
8 they expect companies to use for various accounts --
9 electric companies to use for various accounts.

10 It's difficult to -- it's difficult to
11 analyze this company in the way the PSC works and the
12 rules and regs that relate to the PSC and the rules
13 and regs that relate to the RUS and how the RUS works,
14 and it's a difficulty the Company has to contend with.

15 Q. Okay. In terms of the rule, and the purpose
16 of this subsection (k) of -- (3)(k) of the rule in
17 requiring maintenance of subsidiary records which
18 separate account 108, what is the purpose of that
19 under the rule?

20 A. Well, if we had the accounts broken out,
21 then we can follow -- we can use software that will
22 analyze life of the plant. And in using that software
23 to analyze plant life, we then move on to depreciation
24 rate, because we're saying that the Company should
25 recover an equal amount over the average service life.

55

ASSOCIATED COURT REPORTERS
(573) 636-7551 JEFFERSON CITY, MO 65101

1 That type of data is not available from
2 Citizens. The position that I took, and is Staff's
3 position in the Stipulation, is that to develop a
4 database that would be valuable to analyse that would
5 probably take 30 years of record-keeping from this
6 point forward, and that it -- it's just cumbersome and
7 unnecessary cost for this company, because RUS is
8 requiring them to meet their guidelines.

9 And it seems to me -- this was a part of my
10 decision and my position in this case, was that what
11 RUS was requiring of them was adequate to keep them
12 financially sound.

13 Q. Okay. And that same rule under (3)
14 subsection (h) says, Charge original cost less net
15 salvage to account 108.

16 And what is the purpose of that --

17 A. Okay.

18 Q. -- in the rule?

19 A. Let me look at this just a minute.

20 What lines are you on?

21 Q. I'm not in anybody's testimony.

22 A. Oh, I'm sorry.

23 Q. I'm looking at the rule itself.

24 A. Okay. I'm sorry.

25 I believe the rule says that net salvage

56

ASSOCIATED COURT REPORTERS
(573) 636-7551 JEFFERSON CITY, MO 65101

✓ 1 will come out of the accrual, but what has been
2 proposed at the direction of top management in Staff
3 is that net salvage will be proposed as an expense and
4 handled as an expense item for the companies that are
5 regulated by the PSC.

6 And that's where what's in the Stipulation
7 about the annual work that will be done by the Company
8 that Mrs. Peifer talked about that would take about
9 40 hours is to look at net salvage as an expense and
10 present that to the Commission as though that's the
11 way their books were kept, while still maintaining the
12 balance of everything they do every month in an RUS
13 format.

✓ 14 Q. And the Commission has not engaged in any
15 proceeding to change this rule; is that correct?

16 A. Not that I'm aware of, no.

17 Q. But Staff was proposing that it be done not
18 in accordance with the rule?

19 A. In the Stipulation?

20 Q. Before -- well, when you filed your prefiled
21 testimony, in your recommendation.

22 A. When I filed my testimony, I proposed that
23 they continue with RUS technique, and another member
24 of the Staff had -- unknowns to me had brought up
25 these rules which require the data to be kept account

57

ASSOCIATED COURT REPORTERS
(573) 636-7551 JEFFERSON CITY, MO 65101

1 by account.

2 In the stipulation, we fell back to the
3 position of there was no gain. There was no benefit.
4 As a matter of fact, it would incur probably consider
5 cost.

6 Q. Mr. Adam, I'm becoming confused, and I don't
7 know if it's you or me, but let's go back to my
8 question about --

9 A. Okay.

10 Q. -- subsection (3)(h) of the rule where I
11 asked you about the requirement to charge original
12 cost less net salvage to account 108. And I thought I
13 heard you say the rule says that it shall be done that
14 way, but Staff had proposed expensing it.

15 Now, what I understand you to say is that
16 Staff was proposing and the Stipulation and Agreement
17 agreed to something that is different than what is
18 required by the rule. Is that correct?

19 A. Okay. I have confused you, and I apologize.

20 The annual data that the Company will supply
21 to the Commission, or to the Staff, will be as though
22 the cost of removal was expensed.

23 Q. Okay. Now, let me stop you there, because
24 I'm going to go back to what it was the Staff proposed
25 before there was any Stipulation and Agreement.

58

ASSOCIATED COURT REPORTERS
(573) 636-7551 JEFFERSON CITY, MO 65101

1 Was Staff proposing that the Company be
2 required to expense net salvage versus doing it in
3 accordance with the Commission rule?

4 A. No. Before -- the Staff's position has been
5 for the last several cases, including this one, that
6 net salvage would be expensed.

7 Q. And is that in opposition to our Commission
8 rule?

9 A. I believe it is, yes.

10 Q. Thank you.

11 Now, I want to --

12 A. I apologize for the confusion, Commissioner.

13 Q. I'd like to go -- let's see. Where do I
14 want to go from here?

15 Let's look at the Stip and Agreement for a
16 minute, and then I want to go to your testimony.

17 The section on depreciation reserve accruals
18 which is at page 3, paragraph 10 -- and I asked
19 Ms. Peifer about this -- the RUS accounting
20 guidelines, are they in accordance with the
21 traditional whole life method?

22 A. Please ask that question again.

23 Q. The RUS accounting guidelines, are they in
24 accordance with the -- what you call the traditional
25 whole life method?

59

ASSOCIATED COURT REPORTERS
(573) 636-7551 JEFFERSON CITY, MO 65101

1 A. To a broad degree, they perhaps are.

2 Q. Okay. And are they in accordance with FERC
3 guidelines?

4 A. I'm not certain I can answer that.

5 Q. And then the rest of that paragraph 10 that
6 goes on over to page 4, I asked Ms. Peifer about the
7 agreement here to determine the net salvage/cost of
8 removal separate expense item, Citizens will total the
9 annual salvage cost and subtract the total annual cost
10 of removal.

11 That is where Citizens agreed to follow
12 Staff's proposal to expense the annual salvage cost;
13 is that right?

14 A. That's my understanding of what was agreed
15 to.

16 Q. And, basically, Citizens agreed to Staff's
17 recommendations to just accept those for their
18 Stipulation and Agreement in terms of what Staff had
19 proposed for the treatment of depreciation and net
20 salvage; is that right?

21 A. That's my understanding, yes.

22 Q. And that is truly different than what
23 Citizens has done for the Missouri jurisdiction in the
24 past; is that correct?

25 A. Yes. There is a change here, yes.

60

ASSOCIATED COURT REPORTERS
(573) 636-7551 JEFFERSON CITY, MO 65101

1 Q. Now, when I was reading the testimony in
2 preparation for this case, I was kind of struck by the
3 fact that your testimony was -- was very thick and
4 basically only dealt with depreciation, and there was
5 not a lot of testimony other than your testimony, and
6 the Company didn't even address depreciation. And it
7 appeared to me from the fact that you devoted so much
8 time and effort into proposing such lengthy testimony
9 just on depreciation that this was your most important
10 issue.

11 A. Depreciation is my only issue. That's my
12 employment.

13 Q. Let's put it this way: Staff's most
14 important issue?

15 A. I don't know about that.

16 In this particular case, I had time to
17 address depreciation more than I might normally and to
18 address the concepts which I felt it was important for
19 some of the Commission-- all of the Commissioners, as
20 a matter of fact, to be aware of some of the
21 difference between what has been vocalized as
22 traditional whole life versus what the Staff has been
23 putting forward for the past several cases, which I
24 termed full recovery, where we look at recovery of the
25 original cost of plant, be it depreciation, and we

61

ASSOCIATED COURT REPORTERS
(573) 636-7551 JEFFERSON CITY, MO 65101

1 look at coverage of net salvage via an expense item,
2 and then if there is a final removal cost of
3 life-span-type plant, then that would be looked at at
4 a future time as an amortization.

5 And I -- there's been quite a bit go on over
6 the last couple of years, and I wanted to try to bring
7 it, if not crystal clear, at least to a better
8 understanding for yourself and the other Commissioners
9 as to what's going on and what could occur that might
10 be something you need to be aware of now rather than
11 at a future date. So I spent a disproportionate
12 amount of time on this.

13 Q. And did you think that there was going to be
14 a Stipulation and Agreement in this case?

15 A. At the time I was writing my testimony? I
16 probably figured it wouldn't go to hearing.

17 Q. So is it fair to say you were using this as
18 an opportunity to elaborate on your position as to
19 depreciation, although it was not that important to
20 this particular case?

21 A. As I just said, yes. I felt as though that
22 in the recent couple of years Staff has moved toward
23 what I termed as full recovery. And then the term
24 traditional whole life has come up a lot. And we
25 don't get a chance to talk on a one-to-one basis. I

62

ASSOCIATED COURT REPORTERS
(573) 636-7551 JEFFERSON CITY, MO 65101

Laclede Gas Company
Depreciation Rate Analysis

| Account | Description | 3/31/02 Plant Balance | Depr. Rate | Annual Depreciation | Proposed Amortization | Net Annual Depreciation & Amortization | Effective Net Rate | Effective Net Life |
|---------|-----------------------------|--------------------------|---------------|------------------------|--------------------------|--|-----------------------|-----------------------|
| 376.01 | Steel Mains | 193,054,929 | 1.27% | 2,451,798 | (2,400,000) | 51,798 | 0.0268% | 3,727 |
| 380.02 | Plastic and Copper Services | 146,133,787 | 1.43% | 2,089,713 | (1,000,000) | 1,089,713 | 0.7457% | 134 |
| | Total | 339,188,716 | | 4,541,511 | (3,400,000) | 1,141,511 | | |