BEFORE THE FLORIDA
PUBLIC SERVICE COMMISSION

DOCKET NOS. 050045-EI AND 050188-EI
FLORIDA POWER & LIGHT COMPANY

JULY 28, 2005

IN RE: PETITION FOR RATE INCREASE BY FLORIDA POWER & LIGHT COMPANY
AND
IN RE: 2005 COMPREHENSIVE DEPRECIATION STUDY BY FLORIDA POWER & LIGHT COMPANY

REBUTTAL TESTIMONY OF:

WILLIAM M. STOUT

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I. QUALIFICATIONS

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is William M. Stout, and my business address is 207 Senate Avenue, Camp Hill, Pennsylvania.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am President of the Valuation and Rate Division of Gannett Fleming, Inc.

Q. PLEASE DESCRIBE THE VALUATION AND RATE DIVISION OF GANNETT FLEMIING, INC.

A. The Valuation and Rate Division of Gannett Fleming, Inc., provides consulting services to public utilities and railroads. The Gannett Fleming affiliated companies employ nearly 1,900 people in over 50 offices throughout the United States. The Valuation and Rate Division of Gannett Fleming, Inc., 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. PLEASE STATE BRIEFLY YOUR EDUCATIONAL BACKGROUND AND EMPLOYMENT EXPERIENCE.

A. I have a Bachelor of Science degree in Management Engineering from Rensselaer Polytechnic Institute. While attending Rensselaer, I was employed by the Valuation Division of Gannett Fleming Corddry and Carpenter, Inc., during the summers of 1970, 1971 and 1972. My principal assignments related to valuation studies and computer programming.

After my graduation in June 1973, I was employed by the Valuation Division as a Valuation Engineer. The scope of my activities included assembly of basic data, statistical service life analyses utilizing the retirement rate and simulated plant record methods, field surveys, preparation of preliminary estimates of service life and salvage, calculation of annual and accrued depreciation, and preparation of reports presenting the results of the studies.

In January 1980, I was assigned to the position of Manager of Depreciation and Cost Allocation Studies conducted by the Valuation Division. In June 1982, subsequent to a corporate reorganization, I became a Vice President of Gannett Fleming Valuation and Rate Consultants, Inc. I became a Senior Vice President in 1991 and attained my current position of President in 1994.

Q. ARE YOU A REGISTERED PROFESSIONAL ENGINEER?

A. Yes. I am registered in the Commonwealth of Pennsylvania.

Q. ARE YOU A MEMBER OF ANY PROFESSIONAL SOCIETIES?

A. Yes, I am a member of the National and Pennsylvania Societies of Professional Engineers, the Institute of Industrial Engineers, and the Society of Depreciation Professionals (SDP). I am a former member of both the Rates & Charges Subcommittee of the American Water Works Association and the Accounting Services Committee of the American Gas Association (AGA) and a past president of SDP.

Q. DO YOUR PROFESSIONAL ACTIVITIES INCLUDE PARTICIPATION IN CONTINUING PROFESSIONAL EDUCATIONAL PROGRAMS?

A. Yes. I have completed the "Fundamentals of Life Estimation," "Forecasting Service Life," and "Making and Administering [Depreciation] Policy" programs conducted by the Center for Depreciation Studies at Western Michigan University. In 1985 I became a member of the faculty of Depreciation Programs, Inc., lecturing on "Forecasting Service Life," "Fundamentals of Salvage Analysis", and "Managing a Depreciation Study". I also have been an instructor at the annual Advanced Accounting Seminar sponsored by AGA and the training programs offered by SDP.

Q. HAVE YOU PREVIOUSLY TESTIFIED ON THE SUBJECT OF DEPRECIATION?

A. Yes. Since January 1978, I have testified in support of depreciation studies for over 30 companies including electric, gas, telephone, and water utilities. I have testified before the California Public Utilities Commission, the Texas Public Utility Commission, the Pennsylvania Public Utility Commission, the Georgia Public Service Commission, the Public Service Commission of Indiana, the New York Public Service Commission, the Alaska Public Utilities Commission, the Alberta Energy & Utilities Board, the Newfoundland Board of Commissioners of Public Utilities, the Federal Energy Regulatory Commission, the National Energy Board of Canada, the Canadian Radio-

Television and Telecommunications Commission and the United States Tax Court on the subject of depreciation.

II. INTRODUCTION AND PURPOSE

Q. WHAT IT THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. The purpose of my testimony is to rebut the Direct Testimony of Michael J. Majoros, Jr., submitted on behalf of the Office of Public Counsel (OPC).

Q. WHAT IS THE SUBJECT OF YOUR REBUTTAL TESTIMONY?

A. The primary subject of my rebuttal testimony is net salvage. Within the overall topic of net salvage, I will discuss "excessive depreciation", depreciation concepts, the estimation of future net salvage, the alternatives to accrual accounting proposed by Mr. Majoros, and the treatment of net salvage used in other jurisdictions and recommended in authoritative texts. I also will discuss Mr. Majoros' proposal to modify a number of the survivor curve estimates proposed by Florida Power & Light Company (FPL).

Q. HAVE YOU REVIEWED THE DEPRECIATION STUDY OF FPL'S TRANSMISSION, DISTRIBUTION AND GENERAL PLANT THAT IS SPONSORED BY MR. DAVIS?

A. Yes, I have.

Q. ARE THE METHODS OF ANALYSIS AND CALCULATION OF DEPRECIATION RATES USED IN THE FPL STUDY APPROPRIATE?

A. Yes, they are.

Q. ARE THE ESTIMATES OF SERVICE LIFE AND NET SALVAGE REASONABLE?

A. Yes, they are.

III. OFFICE OF PUBLIC COUNSEL'S NET SALVAGE POSITION

Q. PLEASE SUMMARIZE THE POSITION OF OPC WITNESS MR. MAJOROS REGARDING THE RATEMAKING TREATMENT OF NET SALVAGE FOR FPL.

A. Mr. Majoros recommends the use of his "Net Present Value Approach" for the ratemaking treatment of net salvage for FPL. In his Net Present Value Approach, Mr. Majoros discounts the estimates of future net salvage used by FPL to the present using an annual rate of 5.5 percent, the same as the inflation rate that FPL used in its calculation of Asset Retirement Obligations for financial accounting purposes.

Q. WHAT ARE THE BASES FOR HIS PROPOSALS?

A. The bases for the proposals of Mr. Majoros as stated on page 14 of his direct testimony are his depreciation study, a review of net salvage data, FPL's responses to certain Staff and OPC data requests, prior Orders of the

Commission, and FPL's actions regarding depreciation collected from ratepayers.

Q. DO YOU AGREE WITH MR. MAJOROS' PROPOSAL AND THE CONSIDERATIONS ON WHICH IT IS BASED?

A. No, I do not. Mr. Majoros' Net Present Value Approach does not equitably allocate net salvage over the life of assets, and his estimates of service life are unreasonable because they do not properly consider the statistical analyses of FPL data and the typical range of service life estimates used in the industry. Mr. Majoros' proposal is designed to reduce rates for today's customers, but does so at the expense of tomorrow's customers. The Commission should reject this proposal and continue with more reasonable allocations of net salvage costs and typical estimates of service lives. Before addressing the Net Present Value Approach and the specific estimates, I will address the concepts and theories put forth by Mr. Majoros and also his criticisms of the traditional approach to accruing for net salvage.

IV. EXCESSIVE DEPRECIATION

Q. ON PAGE 14 AND 15 OF HIS DIRECT TESTIMONY AND IN EXHIBIT NO.___(MJM-4), MR. MAJOROS REFERS TO THE TERM "EXCESSIVE DEPRECIATION." PLEASE COMMENT.

A. Mr. Majoros expresses his concern over the possibility that the Company's depreciation rates will produce depreciation expense that is "more than

necessary to return ...capital investment over the life of an asset." He cites the 1934 decision of the U.S. Supreme Court in Lindheimer v. Illinois Bell Telephone Company in support of his concern. In Lindheimer, the Court held that the company's depreciation was excessive and, therefore, represented a contribution of capital. The court determined that the annual depreciation allowances that resulted from the "studies of the 'behavior of large groups' of items" must "meet the controlling test of experience." Mr. Majoros failed to include in his quote the very next sentence in which the controlling test used by the court was described:

> " In this instance, the evidence of expert computations of the amounts required for annual allowances does not stand alone. In striking contrast is the proof of the actual condition of the plant as maintained..."

The concept of physical depreciation referred to in this sentence is no longer used in the determination of rate base in public utility regulation. Instead, largely as a result of the 1944 decision of the U. S. Supreme Court in Federal Power Commission et al v. Hope Natural Gas Co., net investment has become the primary, if not exclusive, means of determining rate base. In this approach, the Accumulated Provision for Depreciation as recorded on the company's books is deducted from original cost. The Accumulated Provision for Depreciation reflects the past allowances for depreciation, whether they have been excessive or inadequate. Thus, these past allowances are used to limit the amount on which the utility is permitted to earn a return and, in jurisdictions such as the Florida Public Service Commission (FPSC) that adjust the annual depreciation to reflect the level

of the Accumulated Provision for Depreciation as compared to the calculated or theoretical reserve, they also are used to limit the amount that will be recovered through future depreciation expense allowances.

V. DEPRECIATION CONCEPTS

Q. IN EXHIBIT NO.___(MJM-5), MR. MAJOROS HAS PROVIDED A DISCUSSION OF DEPRECIATION CONCEPTS. DO YOU HAVE ANY DISAGREEMENTS WITH THE STATEMENTS MADE IN THIS DOCUMENT?

A. Yes, I do. Mr. Majoros' concept of public utility depreciation is at odds with the Uniform System of Accounts and authoritative texts on the subject. He states on page 1 of Exhibit No.___(MJM-5) that "public utility depreciation is straight line capital recovery" and "is accomplished by allocating the original cost of assets to expense..." He repeats this concept again at the bottom of page 2. Depreciation is not simply the allocation of original cost to expense. The Uniform System of Accounts defines depreciation as "the loss in service value not restored by current maintenance incurred in connection with the consumption or prospective retirement of property in the course of service from causes which are known to be in current operation and against which the utility is not protected by insurance." The operative words in this definition that differ markedly from Mr. Majoros' definition are *service value.* The Uniform System of Accounts goes on to define service value as "the difference between the

original cost and the net salvage value of the utility plant", not as just the original cost. The service value rendered by an asset, i.e., depreciation, must reflect both its original cost and its net salvage.

Q. DOES THE UNIFORM SYSTEM OF ACCOUNTS ALSO ADDRESS THE MANNER IN WHICH DEPRECIATION IS TO BE RECOGNIZED?

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

Q. DO YOU DISAGREE WITH ANY OTHER POINTS IN MR. MAJOROS' DISCUSSION OF DEPRECIATION CONCEPTS AS PRESENTED IN HIS EXHIBIT NO.___(MJM-5)?

A. Yes. Mr. Majoros makes several inaccurate or misleading statements throughout this exhibit. On page 1, he states that "in certain jurisdictions public utility depreciation rates incorporate net salvage factors". A more accurate statement would be "in *nearly all* jurisdictions public utility depreciation rates incorporate net salvage factors". I will discuss the policy of several state commissions on this subject later in my testimony. At the top of page 5, he states "Some utilities, such as FPL, include net salvage in the depreciation rate calculation." This statement more properly should

state that "*Nearly all* utilities, including FPL, include net salvage in the depreciation rate calculation."

On page 3, Mr. Majoros states "...but no cash flows out of the company for depreciation expense." This is a true statement, but also may leave an incorrect impression. In order for the company to record depreciation expense, it must have first experienced a cash outflow which is represented by the original cost of the asset. Depreciation allows the recovery of that cash outflow by the company.

Mr. Majoros claims on page 5 that the net salvage adjustment in the numerator of the equation for the annual depreciation accrual rate is "equivalent to capitalizing or adding the estimated cost of removal to the original cost of the asset". This is only true mathematically with respect to the formula for the annual depreciation accrual. It is not true conceptually and such amounts are not capitalized for rate base purposes. He goes on to say in the concluding paragraph on page 5 that "when negative net salvage is included in the depreciation rate there will not be an equality of plant and reserve at the end of an asset's life because the Company will have charged more depreciation than it paid for the original cost of the asset." Of course they will have charged more than the original cost. The total depreciation expense must equal the sum of the original cost and the negative net salvage, not just the original cost. This is in accordance with the definition of depreciation as set forth in the Uniform System of Accounts and authoritative texts on the subject of public utility depreciation. Once the net

salvage costs are incurred, the equality of plant and reserve at the end of an asset's life is restored.

Mr. Majoros continues his assault on net salvage at the top of page 6 by implying that the equality of depreciation expense with company expenditures, original cost and negative net salvage, "will only be achieved if the Company actually spends the additional money at the end of the asset's life. However, unless the Company has a legal liability to remove the asset, it is not required to spend the money." While FPL does not have a legal obligation to remove most of its plant, it does have an obligation to provide service. In order to provide service, FPL must continually renew its plant by adding new assets and retiring old assets. FPL has been spending significant sums to retire plant for many years. I see no reason to suspect that it will not continue to do so indefinitely into the future.

Mr. Majoros then suggests that the amounts recovered from ratepayers for negative net salvage could be used to pay "salaries, dividends, etc." While it is true that dollars paid by customers are not earmarked, it is disingenuous to suggest that dollars recovered for negative net salvage are not needed for plant expenditures. Each year FPL spends significantly more on plant, both its installation and removal, than it recovers in depreciation expense.

On page 9, Mr. Majoros concludes his discussion of Depreciation Concepts with an unsupported claim that "Many of FPL's proposed depreciation rates contain negative net salvage factors which charge too

much for future cost of removal because they are too negative." On the strength of nothing but this unsupported supposition, he then concludes that "The combination of these two factors, i.e., understated lives and overstated cost of removal ratios, compounds the excessive depreciation rate problem." While that would be a true statement if the supposition were correct, in fact the supposition is belied by the overwhelming evidence in this proceeding. In my opinion, many of FPL's existing depreciation rates contain negative net salvage factors which charge too little for future cost of removal. If anything, FPL has a problem with *inadequate,* not excessive, depreciation rates.

VI. ESTIMATION OF NET SALVAGE

Q. BEGINNING ON PAGE 24 OF HIS TESTIMONY, MR. MAJOROS DESCRIBES WHAT HE REFERS TO AS THE TRADITIONAL INFLATED FUTURE COST APPROACH OR TIFCA. ARE YOU FAMILIAR WITH THE APPROACH BEING DESCRIBED BY MR. MAJOROS?

A. Yes, I am.

Q. HAVE YOU EVER HEARD OR READ OF IT REFERRED TO AS "TIFCA" BY PERSONS OTHER THAN MR. MAJOROS?

A. No, I have not. The name and related acronym were apparently made up by Mr. Majoros.

Q. ON PAGE 26 OF HIS DIRECT TESTIMONY, MR. MAJOROS

STATES THAT "TIFCA" NET SALVAGE STUDIES RELATE REMOVAL COSTS IN CURRENT DOLLARS TO RETIREMENTS IN VERY OLD HISTORICAL DOLLARS. IS THAT CORRECT?

A. Yes and no. While it is true that traditional studies of net salvage use as their statistical bases data that relate the cost of retiring an asset or group of assets to its original cost, such original costs are not usually of very old historical dollars. Instead, as I will discuss later, the average age of the retirements on a dollar weighted basis is relatively young, normally a fraction of the account's average life, and thus the original cost of the retired property reflects "young," not "old" historical dollars.

Q. IS THE EXAMPLE OF TIFCA PRESENTED BY MR. MAJOROS ON PAGES 26 THROUGH 30 OF HIS DIRECT TESTIMONY TYPICAL OF THE NET SALVAGE ANALYSIS AND APPLICATION FOR FPL?

A. No, it is not. First, the Hypothetical TIFCA Net Salvage Study on page 27 reflects retirements that occur at age 50. This is atypical. For most accounts, the average age of the retirements that are included in the analyses of net salvage is much less than 50 years. Consider the retirements for Account 365, Overhead Conductors and Devices, as shown on pages 7 and 8 in the section of the Depreciation Study titled "Average Age of Retirements." The average age of the retirements during the period 1941 through 2004 in this account was 16.79 years, less than half the estimated average life for the account of 35 years. Thus, the change in price level

between installation and removal took place over a period of approximately 17 years, not 50 years as shown by Mr. Majoros. Although inflation has occurred since those assets were originally purchased, it is not nearly the amount implied by Mr. Majoros' use of 50-year old plant retirements. Plant that is 17 years old does not represent "very old historical dollars."

Second, Mr. Majoros uses a five-year period in the example and states "FPL's TIFCA studies show figures from two bands of historical net salvage data; a ten-year band and a five-year band as a basis for its future net salvage estimates." This is an incorrect statement. I'm not sure what depreciation study Mr. Majoros was reviewing when he wrote this portion of his testimony, but the band used by FPL, as shown in the Net Salvage section of the Depreciation Study, is for the period 1986-2004, a 19-year band.

Third, Mr. Majoros suggests that the experience with the $4,000 retirement in a single year in his example would be applied to a plant balance of $100,000,000, a ratio of 25,000 to 1. Nothing could be further from the truth. Continuing with the actual data for Account 365, the amount retired during the period 1986-2004 was $111,424,685. The net salvage estimate, based on the analysis of $111 million, was applied to a plant balance of $973 million, a ratio of 9 to 1, vastly lower than the ratio implied by Mr. Majoros's exhibit and a very reasonable approach, in my opinion.

Finally, Mr. Majoros mentions "negative [net salvage of] 350 to 400 percent as a result of TIFCA studies" to further support the "dollar

mismatch" that he is trying to demonstrate. In response, I would simply note that the most negative estimate for FPL in the present study is negative 60 percent for Account 369, Services, Overhead. Mr. Majoros states on page 31 that amounts collected by FPL are a fiction. I disagree. Throughout his example and discussion of TIFCA, it is Mr. Majoros who engages in fiction.

Q. WHAT WERE THE STATISTICAL BASES FOR FPL'S NET SALVAGE ESTIMATES?

A. The statistical bases for FPL's estimates of net salvage were the historical net salvage costs as a percent of the original cost of the retired assets that produced the gross salvage or required the costs to remove during the period 1986-2004.

Q. DOES THE USE OF THIS STATISTICAL BASIS RESULT IN THE COLLECTION FROM CURRENT CUSTOMERS OF REMOVAL COSTS AT THE PRICE LEVEL THAT WILL BE IN EFFECT WHEN THE PLANT IN SERVICE IS RETIRED?

A. No, it does not. Although the reliance on historical indications of net salvage as a percent of the original cost retired results in the collection of net salvage costs at a future price level, it is a price level that is less than the price level that will be in effect when the plant in service is retired. Reliance on the historical indications will result in removal costs at the price level at the time of retirement only if there are substantial improvements in technology, comparable or lesser environmental regulations and a significant reduction in inflation.

Q. HOW DOES USE OF NET SALVAGE PERCENTS THAT ARE COMPARABLE TO THE HISTORICAL INDICATIONS ASSUME THESE EVENTS?

A. The net salvage percents, that is the net salvage costs divided by the original costs of the assets that have been retired and expressed as percents, are related to the retirement of plant that on average is significantly younger than the average service life of the plant in service, on an original cost dollar weighted basis. For example, the average age of retirements of Account 365, Overhead Conductor and Devices during the period 1986 through 2004 was 18.8 years. This amount is approximately half of the average life of 35 years estimated for this account.

The average cost of removal percent related to the retirements from this account during this same period of 1986-2004 was negative 50 percent. Thus, after 19 years in service, the plant was retired and the cost to remove the plant, as a result of inflation, technological changes and other factors, was 50 percent of the cost to install the same plant.

The future retirements of the total current overhead conductors in service will have an average age that actually exceeds the average life. Thus, future retirements will be of plant that has been in service nearly twice as long as the retired plant. For retirements at such ages to experience net salvage that is 50 percent of the cost to install, which is the estimate used in FPL's depreciation study, there will have to be a reduction in the rate of inflation adjusted for technological improvements over the time that passes

before the property for which removal costs are currently being collected is retired. In fact, because those future retirements are going to have an average age approximately twice as long as the average age of the property presently being retired, the rate of inflation adjusted for technological improvements will need to be less than half of the rate that occurred during the life of the plant that was retired during the period 1986-2004 for FPL to avoid under-recovering the cost of removal.

Q. DO YOU HAVE ANY CONCERN THAT THE LEVEL OF NET SALVAGE COSTS INCURRED WILL BE LESS THAN THE AMOUNTS THAT FPL HAS ESTIMATED?

A. No, I do not. Net salvage costs will be incurred. For the reason just discussed, FPL's estimates will almost certainly result in the recovery of *less*, not more, net salvage than the actual costs incurred.

Q. IS IT APPROPRIATE TO ASK CURRENT CUSTOMERS TO PAY FOR FUTURE COSTS OF REMOVAL AT A PRICE LEVEL THAT IS GREATER THAN TODAY'S PRICE LEVEL?

A. Yes, it is. The future cost to remove an item of plant is part of the service value that it renders to current customers and a ratable portion of such costs should be recovered from these customers. That is the definition of depreciation, i.e., the loss in service value during a specific period. As these future costs are recovered from current customers, they are deducted from rate base. This deduction in the amount on which the utility is entitled to earn a fair return, in effect, represents a return to customers. That is, as

customers provide for the future cost of removal, they receive a return on such amounts, in the form of a reduction in the return that they otherwise would have to pay the utility. This is fair compensation for making payment prior to the cost incurrence by the utility. Further, as already noted, by charging customers for these costs during the life of the plant; the customers that benefit from the plant, or consume its service value, are the ones that pay for such service. Customers paying today for future costs of removal and receiving a return on such payments is no different than the utility recovering today amounts that it invested many years ago, but on which it earned a return until the amount was recovered from customers.

Q. WHY ARE THE CURRENT NET SALVAGE ACCRUALS SO MUCH GREATER THAN THE CURRENT EXPERIENCE?

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

Q. IS IT APPROPRIATE FOR FPL TO COLLECT AMOUNTS FOR FUTURE NET SALVAGE COSTS THAT ARE GREATER THAN THE AMOUNTS CURRENTLY EXPENDED FOR SUCH COSTS?

A. Yes, it is. Although the amount that FPL proposes to collect from customers for future net salvage costs is greater than the amount currently expended

for such costs, the amount that FPL spends for plant is far greater than the amount that it proposes for the recovery of original cost. If net salvage accruals should be limited to current net salvage expenditures, why shouldn't the portion of depreciation expense related to the recovery of original cost be increased to the current level of plant expenditures? For example, in the year 2004, FPL's total plant expenditures were $1,394 million. Adding the net salvage costs of $27 million for that year to this amount, results in total expenditures of $1,421 million in 2004. This total expenditure is nearly twice the level of 2004 depreciation expense that includes the recovery of past original costs and future net salvage costs. When both sides of the coin are considered, the amount for recovery of costs is far less than actual expenditures. Equity considerations require that customers pay for the service value, original cost less net salvage, of the plant from which they receive service. The fact that this results in accruals for net salvage that are greater than the current experience is not unfair.

Q. WHAT IS THE IMPACT OF ACCRUALS FOR NET SALVAGE EXCEEDING THE CURRENT NET SALVAGE COSTS?

A. The impact of accruals in excess of costs is a balance in Account 108, Accumulated Provision for Depreciation, which is deducted both from rate base and from determinations of future depreciation accruals.

Q. WHAT DOES THIS BALANCE REPRESENT?

A. The balance in the Accumulated Provision for Depreciation of past net salvage accruals in excess of past net salvage costs represents the amount

accrued toward the future net salvage costs of the plant in service. It represents the portion of the service value that these assets have already rendered.

Q. HOW IS THIS BALANCE RECORDED FOR FINANCIAL REPORTING PURPOSES?

A. In accordance with Financial Accounting Standard No. 143, Accounting for Asset Retirement Obligations, and subsequent guidance from the Securities and Exchange Commission, the balance in the Accumulated Provision for Depreciation of past net salvage accruals in excess of past net salvage costs for assets for which FPL does not have a legal obligation to remove the asset is recorded as a regulatory liability for financial reporting purposes.

Q. ON PAGE 25 OF HIS TESTIMONY, MR. MAJOROS STATES THAT THIS REGULATORY LIABILITY REPRESENTS "AN AMOUNT OWED TO RATEPAYERS UNTIL IT IS SPENT ON ITS INTENDED PURPOSE." DO YOU AGREE?

A. No, I do not. The amounts paid by customers were for services rendered by FPL in accordance with the tariffs approved by the Florida Public Service Commission. Recording these amounts to the Accumulated Provision for Depreciation account affords the ratepayer the protection of not having to pay for such amounts a second time and provides the assurance that FPL will use such amounts for their intended purpose unless ordered to do otherwise by the Commission. These amounts will continue to be deducted from rate base and from determinations of future depreciation accruals until

they are spent on cost of removal. Periodic depreciation studies and Commission oversight will not permit such amounts to mysteriously disappear into income as Mr. Majoros fears.

Q. DOES THE ABSENCE OF A LEGAL OBLIGATION TO REMOVE THESE ASSETS RAISE A CONCERN AS TO WHETHER FPL WILL ACTUAL REMOVE THEM?

A. No, it does not. The legal obligation standard of FAS No. 143 for recognizing a liability to retire plant does not recognize the reality of ongoing utility operations. Although the utility may not have a legal obligation to remove plant, it nevertheless does so on a regular basis and will continue to do so in the future.

VII. THE MAJOROS ALTERNATIVES

Q. ON PAGES 31 THROUGH 34 OF HIS DIRECT TESTIMONY, MR. MAJOROS PROVIDES THE COMMISSION WITH THREE ALTERNATIVES TO THE TRADITIONAL ESTIMATION AND ACCRUAL FOR NET SALVAGE. PLEASE COMMENT ON HIS FIRST APPROACH: "EXPENSING".

A. The first alternative offered by Mr. Majoros is the cash basis or expensing approach. Expensing does not charge the appropriate customers for the cost of retiring an asset and should be rejected. It defers the recovery of costs and imposes it on customers who are no longer, or never were, served by the asset. Mr. Majoros also suggests, both on pages 30 and 31, that a portion of

the cost of retiring assets be charged to the cost of the replacement asset. This is worse, as it further defers the recovery of a cost properly attributable to the customers served by the asset. Mr. Majoros states that the allocation of costs between installation and removal is "somewhat arbitrary." This is not the case. The allocations are based on analyses of the effort required to do the several tasks related to the installation and removal of the asset. The resultant allocations are reasonable for both accounting and ratemaking purposes.

Q. PLEASE COMMENT ON HIS SECOND APPROACH: "NORMALIZED NET SALVAGE ALLOWANCE."

A. Mr. Majoros characterizes his normalized net salvage approach as representing an accrual basis. This is not true. The addition to depreciation expenses of an amount based on historical average net salvage amounts does not represent an accrual for the future cost of retiring assets. He states it is "similar" to the cash basis. This is disingenuous: this proposal *is* the cash basis. The only difference is that he has called it depreciation expense and charged it the Accumulated Provision for Depreciation rather than calling it an operating expense. For ratemaking purposes, this is the same approach and should be rejected for all the reasons that I discussed above for expensing.

Q. PLEASE COMMENT ON HIS THIRD APPROACH: "NET PRESENT VALUE."

A. The net present value accrual, the approach recommended by Mr. Majoros in this proceeding, is his attempt to remove inflation from the estimated future net salvage. The sum of the accruals based on the net present value of future net salvage will be significantly less than the amount required to retire assets at the end of their lives. Mr. Majoros makes no provision for this shortfall. Thus, there is an inherent flaw in this approach. Further, if the service value of the asset is to be adjusted to current price levels, then the future net salvage and the historical original cost should both be adjusted. I suspect Mr. Majoros would reject this modification to his net present value approach. I recommend that the Commission reject this alternative as well.

Q. YOU STATED THAT THIS APPROACH IS MR. MAJOROS' ATTEMPT AT REMOVING INFLATION. DOES HE ACHIEVE HIS INTENDED PURPOSE?

A. He more than achieves it, thus exposing the fundamental flaw of his "net present value" approach. Mr. Majoros removes far more inflation than is reflected in FPL's estimates of future net salvage. For example, continuing to use Account 365, Overhead Conductors and Devices, Mr. Majoros has reduced the estimated future net salvage percent by a factor of 3.43 from negative 50 percent to negative 14.59 percent by removing 23 years of inflation at 5.5 percent per year. The results of this calculation are presented in Exhibit No.___(MJM-9) and 23 years is used because it is the average remaining life of Account 365. However, the estimate of negative 50

percent does not reflect an inflation factor of 3.43. Instead, the inflation factor reflected in this estimate is the inflation during the past 19 years, the average age of retirements. According to the Handy Whitman Index of Public Utility Construction Costs, overhead conductors have experienced an inflation factor of 1.74 during the past 19 years in the South Atlantic Region. Thus, the level of inflation reflected in both the retirement data and the FPL estimate based on such data is only half the amount of inflation that Mr. Majoros has removed.

Q WOULD THE REDUCTION OF FPL'S ESTIMATES OF NET SALVAGE BASED ON THE LEVEL OF INFLATION REFLECTED IN THE ESTIMATE BE APPROPRIATE?

A. No, it would not. In fact, as I discussed earlier a more appropriate adjustment would be to *increase* the estimates of net salvage to reflect the additional inflation that will occur between installation and removal for the plant in service as compared to the plant that has been retired. The plant presently in service will be retired at its average probable life. The average probable life is equal to the average remaining life plus the average age of the plant and is always greater than the average life of the account. The average life of overhead conductors is 35 years. The average probable life of overhead conductors is greater than 35 years and is the period between installation and retirement for the plant in service. Thus, there will be at least 16 years of additional inflation reflected in the removal cost of the plant in service by the time it is retired as compared to the 19 years of

inflation reflected in the removal cost for the plant already retired. Using a conservative rate of 3 percent inflation for this additional period of 16 years would suggest that we increase the negative 50 percent estimate by a factor of 1.6 to negative 80 percent. It is this correct analysis of the impacts of inflation on the analysis and the estimate that led me earlier to conclude that FPL's estimates likely understate future net salvage costs.

Q. ON PAGE 33, MR. MAJOROS STATES THAT HIS NET PRESENT VALUE APPROACH IS "TOTALLY CONSISTENT WITH THE COMMISSION'S DEPRECIATION RULES." DO YOU AGREE?

A. No, I do not. The Commission rule that is cited by Mr. Majoros applies specifically to the dismantlement of fossil fuel power stations, not to the mass properties included in Transmission, Distribution and General Plant to which he has applied the rule. The only rules that the Commission has related to this issue for Transmission, Distribution and General Plant are those in the Uniform System of Accounts (USOA) that it has adopted and regulatory precedent. The USOA requires that the net salvage costs be accrued over the service life of the asset. Regulatory precedent for these assets has required that the accrual be on a straight line basis. Both the Commission's rules for fossil fuel power stations and its regulatory precedent for Transmission, Distribution and General Plant result in accruals that equal future net salvage. Mr. Majoros' proposal is not consistent with these rules as it will not result in accruals that equal the future net salvage costs.

VIII. DEPRECIATION TEXTS AND REGULATORY PRECEDENTS

Q. DO AUTHORITATIVE TEXTS ON DEPRECIATION SUPPORT MR. MAJOROS' PROPOSALS RELATED TO NET SALVAGE?

A. I am not aware of any authoritative texts on the subject of depreciation that support these alternative proposals related to net salvage costs. The two depreciation texts most often cited by depreciation experts as being authoritative support the traditional approach that I have proposed. Public Utility Depreciation Practices, published in 1996 by the National Association of Regulatory Utility Commissioners states:

> Closely associated with this reasoning are the accounting principle that revenues be matched with costs and the regulatory principle that utility customers who benefit from the consumption of plant pay for the cost of that plant, no more, no less. The application of the latter principle also requires that the estimated cost of removal of plant be recovered over its life.[1]

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

> The matching principle specifies that all costs incurred to produce a service should be matched against the revenue produced. Estimated future costs of retiring of an asset currently in service must be accrued and allocated as part of the current expenses.[2]

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[1] Public Utility Depreciation Practices. Page 157. National Association of Regulatory Utility Commissioners. 1996.

[2] Depreciation Systems, Wolf, Frank K. and W. Chester Fitch. Page 7. Iowa State University Press. 1994.

Q. WHAT OTHER STATE COMMISSIONS HAVE ALLOWED HIS 5-YEAR NET SALVAGE APPROACH?

A. I have testified extensively about depreciation around the country and have seen this approach approved in only four jurisdictions. The Pennsylvania Public Utility Commission uses the 5-year net salvage amortization pursuant to a 1962 court order interpreting and applying unique Pennsylvania law. The Kentucky Public Service Commission used it for two small electric cooperatives that did not maintain detailed records of cost of removal and gross salvage by account. In other Kentucky cases, where the utility maintains detailed records of net salvage as FPL does, the traditional methodology that I have used is adopted. The Board of Public Utilities of the State of New Jersey and the Georgia Public Service Commission have also used the expensing or five-year amortization approach.

Q. WHAT IS THE TREATMENT GIVEN TO NEGATIVE NET SALVAGE IN THE DETERMINATION OF THE ANNUAL DEPRECIATION RATES IN THE VAST MAJORITY OF STATE COMMISSIONS?

A. To the best of my knowledge, the 46 state utility commissions not mentioned above each use the traditional treatment of incorporating negative net salvage in the determination of an appropriate depreciation rate, which is consistent with FPL's approach in this case.

Q. HAVE ANY OF THESE COMMISSIONS RECENTLY DEALT WITH THIS ISSUE?

A. Yes, the Missouri Public Service Commission and the Indiana Utility Regulatory Commission both recently affirmed the use of the traditional straight line accrual of net salvage during the life of the related property.

Q. PLEASE DESCRIBE THE MANNER IN WHICH THE MISSOURI COMMISSION DEALT WITH THE ISSUE OF NET SALVAGE?

A. The Missouri Public Service Commission has been dealing with the issue of net salvage for a number of years. It had originally adopted the expensing approach in a few cases while continuing to adopt the traditional straight line accrual method in another case. Laclede Gas Company appealed its case in which the Commission effectively adopted the expensing approach. The order was remanded to the Commission by the courts. During the remand proceeding the Commission accepted additional evidence on the subject of net salvage. In its final order, the Commission concluded:

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

Q. WHAT CONCLUSIONS DID THE INDIANA COMMISSION REACH IN ITS RECENT RULINGS ON THIS SUBJECT?

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

> "The next issue is the timing of the collection of such costs. The parties did not disagree that dismantling costs are a part of the cost of current facilities providing current service. They disagreed as to the timing of the collection of such costs and their amount. This Commission can either find that current customers should pay a share of dismantling costs, which will not be incurred for a number of years, or, in the alternative, conclude that these costs should be passed on to a future generation of customers. This Commission does not believe that the latter alternative constitutes sound regulatory policy, or is based on sound ratemaking principles. Current customers are receiving service from PSI's generation facilities. A part of the costs of those facilities is dismantlement upon retirement. Therefore, we do not believe it would be appropriate for the Company to backload the dismantlement costs for future ratepayers to pay when the facilities associated with these costs are providing service to current customers. Rather, we find it is appropriate that these costs be shared by all customers that received service from PSI's generation facilities. Accordingly, this Commission finds that dismantlement costs are properly included in determining the depreciation rates approved in this cause.
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> ...
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> We believe that there is a sound basis for the traditional approach on this issue that is utilized by a majority of states. Utilizing historical averages as an item to be expensed to current customers means that these customers will be paying for salvage costs at levels that may not be sufficient. That means that the next generation of customers will be paying for salvage costs related to facilities from which they may never have received service. The use of best estimates of future salvage costs addresses this

inequity. Moreover, use of historical averages for dismantling costs does not take into account the current configuration of PSI's system with regard to its production, transmission, distribution and general facilities. Facilities in service 40-50 years ago did not take into account the significantly enhanced customer base that PSI now serves, nor the current configuration of PSI's facilities that serve these customers. It seems appropriate to utilize best cost estimates for net salvage values taking into account specific facilities now serving PSI's customers in developing depreciation rates that today's customers should pay. Accordingly, we find that the use of historical averages for net salvage values with regard to transmission, distribution and general plant for the purpose of expensing them outside the context of the depreciation determination should be, and hereby is, rejected.

IX. SPECIFIC SERVICE LIFE ESTIMATES

Q. WHAT ARE THE SPECIFIC ACCOUNTS FOR WHICH MR. MAJOROS HAS ESTIMATED A SERVICE LIFE THAT IS DIFFERENT FROM THE ESTIMATE OF FPL?

A. Mr. Majoros has revised FPL's estimates of service life for Accounts 350.2, Easements; 352, Structures and Improvements; 357, Underground Conduit; 358, Underground Conductors and Devices; 359, Roads and Trails; 361, Structures and Improvements; 366.6, Underground Conduit – Ducts; 366.7, Underground Conduit – Direct Buried; 369.7, Underground Services; and 397.8, Communication Equipment – Fiber Optics.

Q. PLEASE DISCUSS THE SERVICE LIFE ESTIMATE FOR ACCOUNT 350.2, EASEMENTS.

A. The rights of way in this account relate to easements for certain transmission lines. The statistical analysis for this account is indeterminate with

insignificant information available beyond age 50. FPL retained the 50-S4 and Mr. Majoros has increased the life to an average life of 99 years, also with the S4 type curve. This suggests the use of certain rights for a period of 170 years. Although the industry limits for this account may be 25 to 100 years, the estimates at the outer limits should not be considered for this purpose. Instead, I have selected the values that comprise 80 percent of the estimates. This typical range of lives for this account is from 50 to 80 years. Mr. Majoros' estimate is well beyond this typical range and his maximum life is beyond credulity.

Mr. Majoros' estimate of 99 years is beyond the upper end of the typical range for this account and produces a maximum life that is not consistent with the maximum life of the related transmission lines and should be rejected.

Q. PLEASE DISCUSS THE SERVICE LIFE ESTIMATE FOR ACCOUNT 352, STRUCTURES AND IMPROVEMENTS.

A. The current and FPL proposed estimate for this account is the 47-S4. It is a good fit of the significant portion of the original survivor curve as shown on page 13 of the Transmission Plant section of the Depreciation Study. The portion of the original survivor curve beyond approximately age 45 is not significant because the amount of plant exposed to retirement is small and the retirements are sporadic. Mr. Majoros has increased the estimate of service life and modified the type curve by proposing the 63-L2. His primary justification is that it is the best fit of all the data points, regardless

of whether the plant exposed at older ages is sufficient for purposes of forecasting future rates of retirement. This reminds me of his concern regarding the use of a net salvage percent derived from a $4,000 retirement and its application to $100,000,000. Relying on a statistical fit of all data points for life estimation is no different. Although his estimate of 63 years is within the outer limits of service lives estimated for this account, it is outside the typical range of 40 to 60 years that 80 percent of the estimates are within. In contrast, FPL's estimate of 47 years is near the midpoint of this typical range. Finally, Mr. Majoros' estimate of the 63-L2 forecasts that structures could live as long as 177 years, the maximum age of the 63-L2. This is not reasonable and should be rejected.

Q. PLEASE DISCUSS THE SERVICE LIFE ESTIMATE FOR ACCOUNT 357, UNDERGROUND CONDUIT.

A. Mr. Majoros has once again relied entirely on statistics rather than use them with common sense. His 74-S2 projects an average life that is nearly twice the oldest significant survivor for this account and a maximum life of 144 years. These are both unreasonably long. The 46-S3 that FPL estimated for underground conduit projects a more reasonable maximum life. This is confirmed by a review of other estimates used in the industry. Although the outer limits are 6 to 80 years, the more typical range is 40 to 60 years. Mr. Majoros' estimate of 74-S2 is outside this range, relies on insignificant statistics at older ages, and should be rejected.

Q. PLEASE DISCUSS THE SERVICE LIFE ESTIMATE FOR ACCOUNT 358, UNDERGROUND CONDUCTORS AND DEVICES.

A. For this account, Mr. Majoros modifies his best fit curve, 65-R2.5, to the 60-R3. The basis for the modification is the upper limit of the industry range of estimates and the type curve that, in conjunction with a 60-year life, provides the best fit of the entire original survivor curve. Neither curve is reasonable for underground conductor. Although the outer limits of life estimates in the industry are 4 to 60 years, a life of 60 for this account is no more reasonable than the life of 4 years. 80 percent of the industry estimates are within the range of 35 to 45 years. FPL's estimate of 35-S3 is far more reasonable for this account.

Q. PLEASE DISCUSS THE SERVICE LIFE ESTIMATE FOR ACCOUNT 359, ROADS AND TRAILS.

A. The roads and trails in this account relate to certain transmission lines. The statistical analysis for this account is indeterminate with insignificant information available beyond age 45. FPL retained the 50-SQ and Mr. Majoros has increased the life to an average life of 99 years with the S4 type curve. This suggests the use of certain roads for a period of 170 years. Mr. Majoros apparently ignored the outer limits of industry estimates for this account as they range from 4 to 90 years. The values that comprise 80 percent of the estimates range from 40 to 75 years. Mr. Majoros' estimate of 99 years is beyond the upper end of the typical range for this account and produces a maximum life that is not believable and should be rejected.

Q. PLEASE DISCUSS THE SERVICE LIFE ESTIMATE FOR ACCOUNT 361, STRUCTURES AND IMPROVEMENTS.

A. Mr. Majoros has estimated the 61-R2.5 based on a statistical fit of the entire original survivor curve and the industry range of 4 to 75 years. The typical range in which contains 80 percent of the values is 35 to 60 years. The 45-L3 used by FPL is more reasonable for these assets and within the typical range used in the industry.

Q. PLEASE DISCUSS THE SERVICE LIFE ESTIMATE FOR ACCOUNT 366.6, UNDERGROUND CONDUIT – DUCT SYSTEM.

A. Mr. Majoros has estimated the 68-L2 based on a statistical fit of the entire original survivor curve. The maximum life of the 68-L2 is 191 years, rather long even by the most optimistic standards. Although well within the outer limits of the industry range, his estimate is toward the upper end of the more typical range of 44 to 70 years. The estimate of FPL is the 48-S3, toward the lower end of the typical range, but with a much more reasonable maximum life of 92 years. The current estimate of 48-S3 should be retained.

Q. PLEASE DISCUSS THE SERVICE LIFE ESTIMATE FOR ACCOUNT 366.7, UNDERGROUND CONDUIT – DIRECT BURIED.

A. Conduit that is direct buried has been used on the FPL system in significant amounts for about 30 years. It is at this age that the estimates of Mr. Majoros, the 66-S1, and FPL, the 41-S3, diverge. After age 30, Mr. Majoros relies on rates of retirement from the original survivor curve that

were developed from an insufficient amount of conduit. The life estimate for this account should be somewhat, but not significantly greater, than the life of Account 367, Underground Conductors and Devices – Direct Buried. Both FPL and Mr. Majoros used the 34-R2.5 for underground conductors that are direct buried. The 66-S1 is not at all close to the 34-R2.5. Mr. Majoros' proposal should be rejected and the 41-S3 proposed by FPL should be adopted.

Q. PLEASE DISCUSS THE SERVICE LIFE ESTIMATE FOR ACCOUNT 369.7, UNDERGROUND SERVICES.

A. Mr. Majoros does not include a discussion of this account in his direct testimony. The following observations are based on a review of his exhibits. Mr. Majoros recommends an increase in the life for this account from 34 to 65 years through a slavish fitting of the entire original survivor curve using the outer limit life from his review of industry estimates. Although the outer limits for underground services are 20 to 65 years, the typical range for this group is 30 to 40 years.

It also is logical that the life of this account would be similar to both Account 367, Underground Conductors and Devices, and Account 369, Services – Overhead. Many of the forces of retirement that act on underground conductors are the same in account 367 and 369. Many of the forces of retirement that act on overhead services, e.g., changes in demand or loss of customer, are the same for underground services. The lives used

by both Mr. Majoros and FPL for these similar accounts are within the narrow range of 34 to 38 years.

The 34-R2 survivor curve, which is used for FPL's current and proposed estimates, should be retained. It is within the typical range of estimates for this account and comparable to the estimates for similar FPL accounts.

Q. PLEASE DISCUSS THE SERVICE LIFE ESTIMATE FOR ACCOUNT 397.8, COMMUNICATION EQUIPMENT – FIBER OPTICS.

A. Mr. Majoros relies on data related to plant that has since been transferred to a separate company. The current equipment is of more recent vintage and has had little retirement experience. The average age of the plant in this account is 4.83 years. If it were all retired in 2005, the account would experience a life greater than the 4 years that was estimated by Mr. Majoros. The 10-L0 proposed by FPL is more reasonable and should be adopted.

X. SUMMARY AND CONCLUSION

Q. PLEASE SUMMARIZE YOUR REBUTTAL TESTIMONY.

A. The service life and net salvage proposals of Mr. Majoros should be rejected. Depreciation, including both the original cost and net salvage, should be recognized ratably during the life of the related asset. Assets render service relatively uniformly during their service lives. The net present value approach back-end loads the recovery of such costs and is not

fair to future ratepayers. The other two alternatives proposed by Mr. Majoros also should be rejected. None of the alternatives provides for both complete capital recovery and intergenerational equity.

The traditional approach to estimating future net salvage used by FPL is appropriate and results in estimates of net salvage that actually may understate future net salvage costs. The discounting by Mr. Majoros drastically overstates the inflation that is reflected in the estimates of FPL. More importantly, FPL's net salvage estimates should not be discounted at all; it would be more appropriate to actually increase the estimates of future net salvage costs.

The estimates of service life of Mr. Majoros are the result of a slavish and unrealistic adherence to statistics in some cases, an inappropriate reliance on the outer limits of estimates used by other utilities, and an unwillingness to consider the circumstances that produced the data in other cases. The estimation of service life requires judgment that considers appropriate factors as I have described above. Mr. Majoros' estimates do not properly incorporate such factors and should be rejected.

Mr. Majoros' conclusions regarding the magnitude of the variance between the Accumulated Provision for Depreciation and the theoretical reserve are based on his net salvage proposal and his estimates of service lives. Inasmuch as his net salvage proposal and his service life estimates are without merit, his conclusions regarding the status of the Accumulated

Provision for Depreciation are also without merit and should be rejected. The depreciation rates proposed by FPL should be adopted.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes, it does.