

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

THE PEOPLES GAS LIGHT	:	
AND COKE COMPANY	:	
	:	No. 09-_____
Proposed General Increase	:	
In Rates For Gas Service	:	

Direct Testimony of

JOHN J. SPANOS

Vice President, Valuation and Rate Division
Gannett Fleming, Inc.

On Behalf of
The Peoples Gas Light and Coke Company

February 13, 2009

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1 **I. INTRODUCTION AND BACKGROUND**

2 **A. Witness Introduction**

3 Q. Please state your name and business address.

4 A. My name is John J. Spanos, and my business address is 207 Senate Avenue, Camp Hill,
5 Pennsylvania 17011.

6 Q. By whom are you employed and in what capacity?

7 A. I am employed by Gannett Fleming, Inc. (“Gannett Fleming”), as Vice President of the
8 Valuation and Rate Division.

9 **B. Purpose of Testimony**

10 Q. What is the purpose of your testimony?

11 A. The purpose of my testimony is to submit evidence supporting the request of The Peoples
12 Gas Light and Coke Company (“Peoples Gas”) to the Illinois Commerce Commission
13 (the “ICC”) for approval of a change in depreciation rates to incorporate new service lives
14 and a net salvage (also referred to as net dismantling) component. In essence, the net
15 salvage component is an additional ratable depreciation expense from the amounts
16 established in the last rate case.

17 **C. Summary of Conclusions**

18 Q. Please summarize the conclusions of your direct testimony.

19 A. In brief, the conclusions of my direct testimony are as follows: The depreciation rates set
20 forth in the depreciation study reflect rates based on plant in service as of December 31,
21 2007, to be effective for book and ratemaking purposes, January 1, 2010. These rates are

22 based on the most appropriate average service lives, survivor curves, and net salvage
23 percents for each account as determined by statistical analysis and industry information.

24 **D. Itemized Attachments to Direct Testimony**

25 Q. Are you sponsoring any attachments to your direct testimony?

26 A. Yes. I am sponsoring Peoples Gas Exhibit (“Ex.”) JJS-1.1.

27 **E. Background and Experience**

28 Q. Please describe the firm of Gannett Fleming.

29 A. The Valuation and Rate Division of Gannett Fleming, a subsidiary of Gannett Fleming
30 Affiliates, Inc., provides consulting services to public utilities. The Division and its
31 predecessors, Gannett Fleming Valuation and Rate Consultants, Inc., and the Valuation
32 Division of Gannett Fleming Corddry and Carpenter, Inc., have a long history of
33 conducting client services encompassing public utility valuations, rate studies,
34 depreciation studies, analyses of public utility accounting systems, and acquisition
35 studies. The Gannett Fleming affiliated companies employ approximately 2,000 people
36 and maintain offices in 22 states and in Calgary, Alberta, Canada.

37 Q. Please state briefly your educational background and employment experience.

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

41 In June 1986, I was employed by Gannett Fleming Valuation and Rate
42 Consultants, Inc. as a Depreciation Analyst. During the period June 1986 through

43 December 1995, I assisted in the preparation of numerous depreciation and original cost
44 studies for utility companies in various industries. My duties were to assemble and
45 analyze historical and simulated data, perform field reviews, develop preliminary
46 estimates of service life and net salvage, calculate annual depreciation, and prepare
47 reports for submission to state public utility commissions or Federal regulatory agencies.

48 In January 1996, I was assigned to the position of Supervisor of Depreciation
49 Studies. In July 1999, I was promoted to the position of Manager, Depreciation and
50 Valuation Studies. In December 2000, I attained my current position of Vice President.

51 My additional duties include determining final life and salvage estimates,
52 conducting field reviews, presenting recommended depreciation rates to management for
53 its consideration, and supporting such rates before regulatory bodies.

54 Q. Have you previously submitted testimony on the subject of depreciation?

55 A. Yes. I have submitted testimony to the Pennsylvania Public Utility Commission, the
56 Commonwealth of Kentucky Public Service Commission, the Public Utilities
57 Commission of Ohio, the Nevada Public Utility Commission, the Public Utilities Board
58 of New Jersey, the Missouri Public Service Commission, the Massachusetts Department
59 of Telecommunications and Energy, the Idaho Public Utility Commission, the Louisiana
60 Public Service Commission, the State Corporation Commission of Kansas, the Oklahoma
61 Corporate Commission, Delaware Public Service Commission, Tennessee Regulatory
62 Authority, the Public Service Commission of South Carolina, the Railroad Commission
63 of Texas – Gas Services Division, the New York Public Service Commission, the Illinois
64 Commerce Commission, the Indiana Utility Regulatory Commission, the California
65 Public Utilities Commission, the Arkansas Public Service Commission, the Public Utility

66 Commission of Texas, the Regulatory Commission of Alaska, and the North Carolina
67 Utilities Commission. I have also submitted testimony to the Alberta Energy & Utility
68 Board and the Federal Energy Regulatory Commission (“FERC”).

69 Q. Are you a member of any professional societies?

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

72 Q. Do your professional activities include participation in continuing professional
73 educational programs?

74 A. Yes. I have completed “Techniques of Life Analysis”, “Techniques of Salvage and
75 Depreciation Analysis”, “Forecasting Life and Salvage”, “Modeling and Life Analysis
76 Using Simulation”, “Managing a Depreciation Study”, and “Introduction to Public
77 Utility Accounting”. I also passed the exam established by the Society of Depreciation
78 Professionals and was designated a Certified Depreciation Professional in September
79 1997 and was recertified in August 2003, and February 2008.

80 **II. ILLINOIS COMMERCE COMMISSION REQUIREMENTS**

81 Q. What is your understanding of the ICC’s requirements of Peoples Gas with respect to
82 performing depreciation studies?

83 A. In its order in ICC Docket No. 95-0032, Peoples Gas’ 1995 rate case, the ICC required
84 Peoples Gas to perform depreciation studies at least every five years, commencing with
85 the date of the order, and to request ICC approval for any change in depreciation rates in
86 the future. An average service life study was performed in 1999 and 2003 to meet the

87 ICC requirements. Thus, in 2008, Peoples Gas contracted with the Valuation and Rate
88 Division of Gannett Fleming to perform a depreciation study (the “Study”) to determine
89 updated depreciation rates (based on service lives) and to estimate net salvage percents
90 based on 2007 plant accounts of Peoples Gas. The documents in this proceeding reflect
91 the results of the 2007 service life study and include an estimated net salvage percent
92 accrual element to be utilized in the annual depreciation calculation.

93 Q. Please describe what you mean by the term “depreciation”.

94 A. My use of the term “depreciation” is in accord with the definition set forth in the ICC’s
95 Uniform System of Accounts for Gas Utilities. “Depreciation” refers to the loss in
96 service value not restored by current maintenance, incurred in connection with the
97 consumption or prospective retirement of gas plant in the course of service from causes
98 which are known to be in current operation, against which the company is not protected
99 by insurance. Among the causes to be given consideration are wear and tear, decay,
100 action of the elements, inadequacy, obsolescence, changes in the art, changes in demand
101 and requirements of public authorities, and, in the case of natural gas companies, the
102 exhaustion of natural resources.

103 In the Study that I performed and that is the basis for my testimony, I used the
104 straight line remaining life method of depreciation with the average service life
105 procedure. In the remaining life method, the annual depreciation is based on a system of
106 depreciation accounting which aims to distribute the unrecovered cost of fixed capital
107 assets over the estimated remaining useful life of the unit, or group of assets, in a
108 systematic and rational manner.

109 For General Plant Accounts 391.1, 391.23, 391.3, 394, 397.1, 397.2, and 398 in
110 gas plant, I used the straight line remaining life method of amortization. The account
111 numbers identified throughout my testimony represent those in effect as of December 31,
112 2007. The annual amortization is based on amortization accounting that distributes the
113 unrecovered cost of fixed capital assets over the remaining amortization period selected
114 for each account and vintage.

115 **III. RESULTS OF THE DEPRECIATION STUDY**

116 Q. Have you prepared an exhibit presenting the results of your depreciation study?

117 A. Yes. Peoples Gas Ex. JJS-1.1 presents the results of the depreciation study as of
118 December 31, 2007.

119 Q. How did you determine the annual depreciation?

120 A. The determination of annual depreciation consists of two phases. In the first phase,
121 service life characteristics and net salvage percents were estimated for each plant account
122 or subaccount identified as having similar characteristics. In the second phase, the
123 composite remaining lives and annual depreciation are calculated based on the service life
124 estimates determined in the first phase. The annual depreciation amount is the result of
125 the individual twelve monthly calculations on the plant balance.

126 Q. Please describe the first phase of the study, that is, the manner in which you estimated the
127 service life characteristics for each depreciable group.

128 A. The service life study consisted of compiling historical data from records related to
129 Peoples Gas' gas plant; analyzing these data to obtain historical trends of survivor

130 characteristics; obtaining supplementary information from management and operating
131 personnel concerning Peoples Gas' practices and plans as they relate to plant operations;
132 and interpreting the above data to form judgments of average service life characteristics.
133 The service life results were not changed for purposes of incorporating the net salvage
134 component in this study.

135 Q. Would you please explain the concept of "net salvage"?

136 A. Net salvage is a component of the service value of capital assets that is recovered through
137 depreciation rates. The service value of an asset is its original cost less its net salvage.
138 Net salvage is the salvage value received for the asset upon retirement less the cost to
139 retire the asset. When the cost to retire exceeds the salvage value, the result is negative
140 net salvage.

141 Inasmuch as depreciation expense represents the loss in service value of an asset
142 during a defined period, *e.g.*, one year, it must include a ratable portion of both the
143 original cost and the net salvage component. That is, the net salvage related to an asset
144 should be incorporated in the cost of service during the same period as the corresponding
145 original cost, so that customers receiving service from the asset pay rates including
146 portions of both elements of the asset's service value: the original cost and the net
147 salvage value.

148 For example, the full recovery of the service value of a \$100 regulator will include
149 not only the \$100 of original cost, but also, on average, \$15 to remove the regulator at the
150 end of its life and \$5 in salvage value. In this example, the net salvage component is
151 negative \$10 ($\$5 - \15), and the net salvage percent is negative 10% ($(\$5 - \$15)/\$100$).

152 Q. Please describe how you estimated net salvage percentages.

153 A. I estimated the net salvage percentages based on informed judgment incorporating the
154 historical data for the period 1996 through 2007 and considered estimates for other gas
155 distribution companies.

156 Q. Please describe the second phase of the process, the calculation of composite remaining
157 lives and the determination of annual depreciation.

158 A. After I established the service life characteristics for the 2007 study, I estimated net
159 salvage percents for each depreciable group, then I calculated annual depreciation accrual
160 amounts for each group in accordance with the straight line remaining life method, using
161 remaining lives consistent with the average service life procedure.

162 Q. Please describe briefly the straight line remaining life method of depreciation that you
163 used for depreciable property.

164 A. The straight line remaining life method of depreciation allocates the original cost less
165 accumulated depreciation in equal amounts to each year of remaining service life.

166 Q. Please describe briefly the average service life procedure.

167 A. In the average service life procedure, the remaining life annual accrual for each vintage is
168 determined by dividing future book accruals (original cost less book reserve) by the
169 average remaining life of the vintage. The average remaining life is a directly weighted
170 average derived from the estimated survivor curve.

171 Q. Please describe amortization accounting.

172 A. In amortization accounting, units of property are capitalized in the same manner as they
173 are in depreciation accounting. Amortization accounting is used for accounts with a large
174 number of units, but small asset values, therefore, depreciation accounting is difficult for
175 these assets because periodic inventories are required to properly reflect plant in service.
176 Consequently, retirements are recorded when a vintage is fully amortized rather than as
177 the units are removed from service. That is, there is no dispersion of retirement. All
178 units are retired when the age of the vintage reaches the amortization period. Each plant
179 account or group of assets is assigned a fixed period which represents an anticipated life
180 which the asset will render full benefit. For example, in amortization accounting, assets
181 that have a 20-year amortization period will be fully recovered after 20 years of service
182 and taken off the company's books, but not necessarily removed from service. In
183 contrast, assets that are taken out of service before 20 years remain on the books until the
184 amortization period for that vintage has expired.

185 Q. Can you explain why you recommend amortization accounting?

186 A. Amortization accounting has been implemented by almost all utility companies across the
187 United States and Canada over the past 15 to 20 years. I have presented this methodology
188 in the depreciation study in order to smooth the annual depreciation accrual rate over time
189 for the specific asset classes described in general plant as well as to improve record
190 keeping practices for a large number of assets that have relatively small utility plant in
191 service amounts.

192 Q. For which plant accounts is amortization accounting being implemented?

193 A. Amortization accounting is only appropriate for certain General Plant accounts. These
194 accounts are 391.1, 391.23, 391.3, 394, 397.1, 397.2, and 398 for gas plant which
195 represents slightly less than one percent of depreciable plant.

196 Q. Please outline the contents of Peoples Gas Ex. JJS-1.1.

197 A. Peoples Gas Ex. JJS-1.1 is presented in three parts. “Part I. Introduction” includes
198 statements related to the scope of and the basis for the depreciation study.

199 “Part II. Methods Used in the Estimation of Depreciation” includes descriptions of
200 the estimation of survivor curves, net salvage percents, and the calculation of annual and
201 accrued depreciation.

202 “Part III. Results of Study” presents a description of the results, summaries of the
203 depreciation calculations by component, graphs and tables of the recent service life study,
204 tables which relate to the net salvage estimated, and the detailed depreciation
205 calculations.

206 The table on pages III-4 through III-6 presents the estimated survivor curve, net
207 salvage percent, the original cost at December 31, 2007, and the book reserve and
208 calculated annual depreciation amount and rate for each account or subaccount of gas
209 plant.

210 The section beginning on page III-7 presents the results of the retirement rate
211 analyses prepared as the historical bases for the 2007 service life estimates. The section,
212 beginning on page III-139, presents the results of the net salvage analyses prepared as the
213 historical bases for the net salvage estimates. The section, beginning on page III-158,

214 presents the calculation of annual depreciation by vintage by account for each
215 classification of gas plant.

216 Q. What do you recommend regarding Peoples Gas' implementation of the service lives and
217 net salvage percents that you estimated?

218 A. I recommend that the service lives and net salvage percents that I have estimated be used
219 in the calculation of annual depreciation effective January 1, 2010, provided that the ICC
220 also approves the service lives and net salvage percents for ratemaking purposes.

221 Q. What was the purpose of the calculation of annual depreciation accrual rates as of
222 December 31, 2007?

223 A. The purpose of the December 31, 2007, calculation was to provide Peoples Gas and the
224 ICC with an approximation of the amount of annual depreciation by component,
225 including a net salvage element, based on the results of the Study. This methodology
226 provides a ratable recovery instead of the current cash recovery method after the asset is
227 removed from service. The ratable recovery method is more equitable to all ratepayers
228 since it spreads the complete service value in a systematic and rational manner over the
229 life of the asset while in service.

230 Q. Were there any special programs considered in the development of the depreciation rates?

231 A. Yes. Peoples Gas is proposing an accelerated main replacement program.

232 Q. Can you explain the accelerated main replacement program?

233 A. The accelerated main replacement program would relate to an effort to replace all cast
234 and ductile iron main by the end of the year 2030. The cast and ductile iron main had

235 been installed many years ago and, if the accelerated main program is adopted and
236 implemented, will be retired until completed in 2030.

237 Q. How would this affect the rate for Account 376.30?

238 A. The average service life is not affected, however, the remaining life for all vintages will
239 be less than or equal to 23 years based on a December 31, 2007, calculation date.

240 Q. Does that conclude your direct testimony?

241 A. Yes, it does.