

Depreciation Practices

(case study)

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Depreciation - Defined

By Uniform Systems of Accounts (USoA) - The loss in service value not restored by current maintenance, incurred in connection with the consumption or prospective retirement of plant 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. Among the causes to be given consideration are wear and tear, decay, action of the elements, inadequacy, obsolescence, changes in the art, changes in demand and requirements of public authorities.

By the Kentucky Supreme Court in the Case of the KPSC v. Dewitt Water District – “The purpose of depreciation expense as applied to nonprofit water districts does not relate to recoupment of investment, but rather, relates to renewal and replacement.”

Significance of ruling = Water Districts allowed depreciation on all property including that which was contributed.

Depreciation – Accounting

Accounting Requirements are established by USoA's.

Depreciation recognizes cost of plant over estimated service life. KPSC recognizes service life in years, not units of production.

Depreciation calculated using Straight-Line Method for accounting and rate-making purposes. Accelerated Methods are allowed for income tax purposes. Deferred taxes result.

Depreciable Basis = Original Cost

Depreciation – Accounting

Original Cost defined as the cost of the property to the person first devoting it to public service.

Original Cost of Construction Projects includes all costs to bring the asset into service:

- Contract Fees
- Wages and Overheads of Employees
- Materials and Supplies
- Transportation
- Equipment Costs including Depreciation
- Shop Service
- Insurance Protection during Construction
- Permits
- Engineering and Supervision
- Legal Services
- Taxes
- Allowance for Funds Used During Construction (AFUDC) calculated using the weighted cost of capital.

Depreciation - Accounting

- Original Cost v. Historical Cost.
- The difference in original cost and historical cost is accounted for as an “acquisition adjustment.”

Rate recovery of an Acquisition Adjustment is permissible only if:

- 1) The purchase price was established upon arms-length negotiations;
- 2) The initial investment plus the cost of restoring the facilities to required standards will not adversely impact the overall costs and rates of the existing and new customers;
- 3) Operational economies can be achieved through the acquisition;
- 4) The purchase price of utility and non-utility property can be clearly identified; and
- 5) The purchase will result in overall benefits in the financial and service aspects of the utility's operation

Depreciation – Accounting

Accumulated Depreciation Reserve = Contra-Asset Account which normally has a credit balance.

Common Entries to Accumulated Depreciation

Debit Entries, Decreases Balance:

Entire Original Cost of Asset when removed from Service.

Cost of Removal

Credit Entries, Increases Balance

Charges to Depreciation Expense

Salvage Value at Time of Removal

Gains and Losses on Disposition of Assets Flow-Through the Accumulated Depreciation Account.

Depreciation – Accounting

The effects of Asset Retirement Obligations (ARO's), as required by GAAP, are removed for rate-making purposes.

Depreciation – Rates

- Governmental Water Entities and Small Water IOU's must follow standards established by the National Association of Regulatory Utility Commissioners (NARUC) in 1979.
- RECC's must follow standards established by Rural Utility Service (RUS) Bulletin 183-1.

Latest RUS update done in 1977.

RECC must obtain RUS approval to deviate from standard.

Deviation requests are supported by Depreciation Studies.

PSC is not bound by, but generally follows, RUS Standards.

Depreciation - Rates

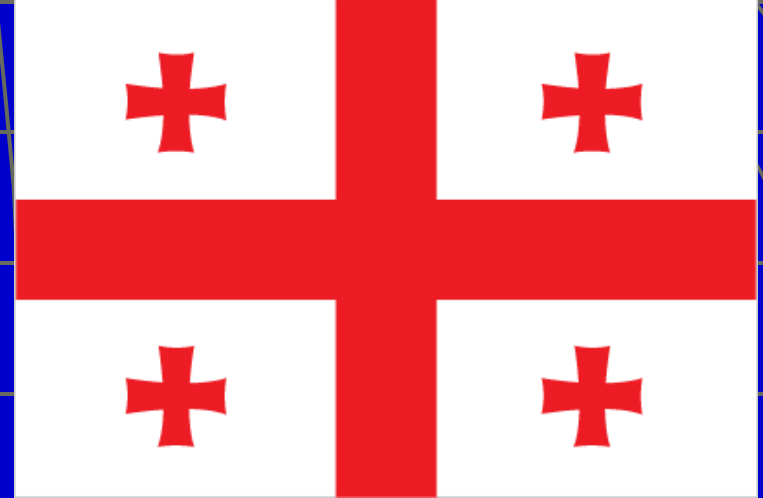
- Large IOU's establish depreciation rates using depreciation studies.
- Studies are submitted to the Commission by utilities as part of general rate filings.
- Most Studies prepared by members of the Society of Depreciation Professionals.
- No rigid time requirement for studies; Generally completed every 5 years.

Depreciation Case Study

Review of Depreciation
Study for Kentucky-
American Water Co. filed
in Case No. 2007-00143



QUESTIONS?



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THANK YOU