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Decision No. 45138

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Investigation into the Depreciation Reserve and Accrual practices of Coast Counties Gas and Electric Company.	Case No. 5156

J. K. Horton and Pillsbury, Madison and Sutro by Turner McBaine, for respondent, Coast Counties Gas and Electric Company; Everett C. McKeage, Chief Counsel, E. F. McNaughton, Director of Public Utilities Department, and Freyman Coleman, Financial Expert, for the Commission; Roger Arnebergh, Assistant City Attorney, K. Charles Bean, Chief Engineer and General Manager, T. M. Chubb, Assistant General Manager, Department Public Utilities and Transportation, for City of Los Angeles, interested party.

O P I N I O N

The above-entitled investigation on the Commission's own motion, instituted on October 25, 1949, was heard before Commissioner Huls and Examiner Howard at San Francisco on January 10, 11, and 19, 1950, and after oral argument on the latter date was submitted on the filing of a brief by respondent on April 5, 1950. Three witnesses testified for the Commission staff and three for the respondent. The issue involved in this proceeding is the reasonableness of respondent's depreciation reserve and accrual rate and whether any rules and practices should be prescribed with respect thereto. Subsequent to submission, a "Memorandum of Understanding" was reached between representatives of respondent and the Commission staff. The proceeding was reopened for further hearing on November 29, 1950, at which time the memorandum was received in evidence and the matter submitted.

Coast Counties Gas and Electric Company was incorporated in March, 1912. The company rendered electric and manufactured gas service until about 1929, at which time the manufactured gas was replaced with natural gas. As the result of acquisitions and sales of properties over the years, and expansion of facilities, the company now renders electric and natural gas service in an area including the cities of Santa Cruz, Watsonville, Hollister, and Gilroy, natural gas service in parts of Contra Costa, Merced, and Kern Counties, and operates a small water system at Avenal in Kern County.

Depreciation Reserve

The record shows that from about 1913 to 1920, the appropriations for depreciation were varying judgment amounts and that, while the accruals for 1921 and 1922 purported to be sinking fund annuities, no interest was credited to the depreciation reserve in those years. In 1923, in connection with an electric rate proceeding, the Commission made a study of the company's depreciation practices and prescribed 6% sinking fund depreciation accounting for the electric department. It found that the electric department's depreciation reserve of $250,735 as of December 31, 1922, closely approximated a proper 6% sinking fund reserve (Decision No. 12762, 24 CRC 69). Since that time, the company has employed sinking fund depreciation continuously, although with some variations in lives and interest rates. Since January 1, 1944, the accruals have been determined on a 5% sinking fund basis, utilizing generally longer lives proposed by the company and approved by the Commission in Decision No. 37336 (45 CRC 439).

The book depreciation reserves as of December 31, 1948, and their relationship to depreciable capital, were as follows:

	Depreciable Capital	Depreciation Reserve	Percentage
Electric Department	$ 8,420,213	$3,283,609	39.0%
Gas Department	9,991,183	2,632,260	26.3
Water Department	170,363	70,606	41.4
Common	571,078	293,080	51.3
Total	19,152,837	6,279,555	32.8

In 1923, after conferences with the Bureau of Internal Revenue, an amount of $201,186 was transferred from surplus to augment the depreciation reserve; but prior to the end of 1935, the electric department portion of this amount with compound interest, in the amount of $302,087, had been transferred back to surplus. The gas department reserve at that time was not considered adequate to permit the transfer back to surplus of the gas department portion of the 1923 surplus appropriation.

A general study of reserve requirements as of December 31, 1935, for both the electric and gas departments on the 6% sinking fund basis was made, based upon the company's lives and also upon lives proposed by the Commission staff.

Based in part on the above estimates, the sum of $162,892 was transferred from the electric department reserve to gas department reserve as of March 31, 1937. At the same time, some $596,000 of manufactured gas plant was retired, about $377,000 being charged to depreciation reserve and about $219,000 being charged to Ac. 132, Property Abandoned, with an agreement that rates, otherwise not unreasonable, would not be reduced until equity considerations of this write-off made the company whole.

In 1937, at the conclusion of these transfers and write-offs, the depreciation reserve was left somewhat in excess of the reserve requirement. The actual figures are not available as of comparable dates, but it would appear that the reserve for the total company as of March 31, 1937, was overaccrued by about $45,000 of the estimated requirement on the company lives, and by about $180,000 on the basis of the Commission staff lives.

Adequacy of Depreciation Reserves

Engineers of both the company and the Commission staff have estimated the theoretical reserve requirement as of December 31, 1948, on the 5% sinking fund basis, the results being as follows, compared to the book reserve:

	Reserve Requirement		Excess Reserve over Reserve Requirement	
Property	Company	Commission Staff	Company	Commission Staff
Electric	$2,219,086	$2,389,723	$1,064,523	$ 893,886
Gas	1,633,020	1,583,254	999,240	1,049,006
Water	45,007	42,748	25,599	27,858
Common	161,045	161,269	132,035	131,811
Total	4,058,158	4,176,994	2,221,397	2,102,561

The Commission staff, in presenting its studies as of December 31, 1948, stated the studies were based on available data in the company records and on certain estimates. At the same time, the staff pointed out the desirability of additional data on mortality experience and with regard to salvage, not presently available. The above estimates are based on the 5% sinking fund method, which the company has been using with Commission approval since January 1, 1944.

The staff also presented straight-line calculations on two bases of lives. For purposes of simplicity, the data herein refers only to the basis employing lives 5% longer than the sinking fund lives, since the parties recognize that, in principle, shorter equivalent lives must be used for sinking fund computations than for straight-line calculations. This is because, on a group basis, the loss of interest due to early retirements is not fully offset by the gain in interest on late retirements, and the shorter equivalent life is necessary to overcome this net loss of interest.

The book reserves and the estimated reserve requirements as of December 31, 1948, as shown by these studies, are as follows:

Department	Book Reserve	Estimated Reserve Requirement 5% Sinking Fund	Estimated Reserve Requirement Straight Line
Electric Department	$3,283,609	$2,389,723	$3,486,982
Gas Department	2,632,260	1,583,254	2,665,202
Water Department	70,606	42,748	65,405
Common	293,080	161,269	236,484
Total	6,279,555	4,176,994	6,454,073

The staff also computed depreciation accruals on both the total life and the remaining life bases, based on the December 31, 1948, depreciable property and reserves or estimated reserve requirements. The total life basis uses the estimated total life of groups of property without reference to the size of the accumulated depreciation reserve, while the remaining life basis is designed to provide accruals over the remaining life of the surviving plant just sufficient to cover the depreciable cost less existing depreciation reserve.

By the evidence of respondent's vice president and treasurer, at the reopened hearing of November 29, 1950, the results of conferences between representatives of respondent and the Commission staff, culminating in a "Memorandum of Understanding Relative to Depreciation Practices," were outlined. This memorandum, identified as the draft of November 10, 1950, having been agreed to by the company and the staff of the Commission through its counsel, was received as Exhibit No. 40 and is attached hereto as Exhibit A. No objection was voiced by any party to the proceedings to the conclusions outlined in this memorandum.

The agreement, which pertains solely to Coast Counties Gas and Electric Company and is not to be considered a precedent in relation to other utilities, was reached after considering (1) the estimated depreciation reserve requirements as of December 31, 1948, on the several studies already discussed and also the calculated 4% sinking fund reserve requirement brought forward to December 31, 1949, with certain agreed changes in lives, (2) the history of the reserve, (3) the earning history and its relationship to depreciation accruals, and (4) possible constructive purposes to which depreciation reserve excesses could be transferred. In addition, over-all equity considerations, including the consumers', the company's, and the public interest, entered heavily into the agreement, coupled with the willingness of the company to review periodically depreciation accruals on the remaining life basis, and its willingness to a showing by the staff of the Commission of a rate of return on a modified sinking fund rate base as well as the undepreciated rate base in rate cases.

A comparison of the book reserve and the calculated 4% sinking fund reserve requirement as of December 31, 1949, as shown by Exhibit No. 41, follows:

	As of December 31, 1949
Depreciation Reserve - per Books	$6,696,427
Calculated Reserve Requirement - 4% Sinking Fund Method	4,746,464

All figures pertain to Depreciation Reserve for Depreciable Plant, excluding the Reserve for Transportation and Construction Equipment which is accrued through clearing accounts.

An agreement was reached to adopt a remaining life 4% sinking fund accrual method based on the balance in reserve after adjusting the book reserve of December 31, 1949, by transfer of $999,436 from the depreciation reserve for general plant to surplus for the specific purposes as shown in detail in the memorandum of understanding (Exhibit A). These purposes were generally to restore to surplus an amount transferred from surplus in prior years, to write off one-half of acquisition adjustments presently on the books, to increase the provision for accrued taxes, to write off loss on hydro-plant lands, and to establish an insurance reserve.

Under this plan, the adjusted balance of $5,696,991 in the depreciation reserve for general plant will come under a plan of "remaining life" accrual, wherein, by periodic reviews by the company, the depreciation accrual to be charged to expense will be determined by the gross depreciable plant per books less the then existing depreciation reserve related to the estimated remaining life of the property and estimated gross salvage, less cost of removal. Under this plan, no further adjustments through surplus for either deficient or excessive depreciation reserve balances will be made in the future, even though the accrual method adopted herein be changed. The method adopted is the 4% sinking fund method.

Interest at 4% will be accrued and charged to expense each year on the book balance in the Depreciation Reserve (excluding Reserve for Transportation and Construction Equipment). The total depreciation charge to expense will also include an annuity of such amount that, coupled with the interest charge, the total accrual would, over the remaining life, provide for the depreciation of the then existing gross depreciable plant, less the then existing depreciation reserve.

Under the agreement, the company will undertake to make reviews of depreciation charges by members of its own organization.

The company will present, by December 1, each year, its basis of depreciation accruals for the ensuing year for Commission review.

The agreement includes a stipulation that a remaining life 4% sinking fund depreciation annuity of $321,309 is reasonable for the year 1950, that interest will be $227,880, with a total provision of $549,189 for depreciation expense for 1950, and that the company will adopt this basis for its 1950 depreciation accrual and adjust its accounts accordingly. For 1951, annuity rates consistent with the 1950 calculations will be used. For the years after 1951, however, the parties are free, under the agreement, to make such representations as to remaining lives and net salvage as they feel proper after further investigation.

Proposed journal entries are shown by Exhibit No. 44, as well as actual and pro forma balance sheets as of October 31, 1950, showing the results of the journal entries. Because of the write-off of the remaining one-half of the acquisition adjustment through the surplus account, the earned surplus as of October 31, 1950, shows a decline from the actual of $1,705,994.48 to $1,404,200.48 on a pro forma basis, although it will be improved by the 1950 depreciation overaccrual, amounting to $128,766 in the first 10 months.

We find the proposed agreement to be in the public interest, and the journal entries as proposed will be approved.

Respondent and the staff are commended for their cooperation in evolving a reasonable solution to this complex problem.

O R D E R

The Commission having instituted an investigation into the depreciation reserve and accrual practices of Coast Counties Gas and Electric Company, public hearings thereon having been held, oral and documentary evidence having been received and considered together

EXHIBIT A

Draft of November 10, 1950

MEMORANDUM OF UNDERSTANDING
RELATIVE TO DEPRECIATION PRACTICES

COAST COUNTIES GAS AND ELECTRIC COMPANY

Following consideration of all aspects of the depreciation situation of the Coast Counties Gas and Electric Company as of December 31, 1949, an agreement was reached, subject to approval of the California Public Utilities Commission, which pertains solely to Coast Counties Gas and Electric Company and is not to be considered a precedent in relation to other utilities, and which is set forth herein.

The aspects of the situation considered were (1) the estimated depreciation reserve requirements as of December 31, 1948 on the several studies shown in the record in Case No. 5156 and also the calculated 4% sinking fund reserve requirement brought forward to December 31, 1949 with certain agreed changes in lives, (2) the history of the reserve, (3) the earning history and its relationship to depreciation accruals, and (4) possible constructive purposes to which depreciation reserve excesses could be transferred. In addition, over-all equity considerations, including consumers', company and public interest, entered heavily into the agreement, coupled with the willingness of the company to review periodically depreciation accruals on the remaining life basis, and its willingness to a showing by the staff of the Commission of a rate of return on a modified sinking fund rate base as well as the undepreciated rate base in rate cases.

All figures pertain to Depreciation Reserve for Depreciable Plant, excluding the Reserve for Transportation and Construction Equipment which is accrued through clearing accounts. A comparison of the book reserve and the calculated 4% sinking fund reserve requirement as of December 31, 1949 follows:

	As of December 31, 1949
Depreciation Reserve - per books	$6,696,427
Calculated Reserve Requirement - 4% Sinking Fund Method	4,746,464

An agreement was reached to adopt a remaining life 4% sinking fund accrual method based on the balance in reserve after adjusting the book reserve of December 31, 1949, by transfer of $999,436 from the depreciation reserve for general plant to surplus for the following purposes:

1. Restore to earned surplus an amount transferred from surplus to the depreciation reserve in 1923, with accumulated interest to December 31, 1949 . . . . $173,198

2. Increase Accrued Taxes in respect to estimated tax accrual deficiency for years prior to 1951 with the understanding that any difference, upon actual determination, will be disposed of through surplus 125,000
3. Write off one-half of Acquisition Adjustments, with the understanding that the balance will be written off directly out of surplus 461,867
4. Establish a Reserve for Insurance, with the understanding that the company will not make accruals to increase said reserve, but will charge to expense all insurance premiums and accruals to maintain the reserve at approximately the level established (until such time in the future as conditions may change) and with the understanding that balances in this reserve will be specifically reserved and used for insurance reserve purposes 200,000
5. Write off loss on hydro plant lands $52,495
   Less tax saving on long-term loss (25%) . . . 13,124   39,371
   Total $999,436

Under this plan, the adjusted balance of $5,696,991 of the depreciation reserve for general plant will come under a plan of "remaining life" accrual, wherein, by periodic reviews by the company, the depreciation accrual to be charged to expense will be determined by the gross depreciable plant per books less the then existing depreciation reserve related to the estimated remaining life of the property and estimated gross salvage, less cost of removal. Under this plan, no further adjustments through surplus for either deficient or excessive depreciation reserve balances will be made in the future, even though the accrual method adopted herein be changed. The method adopted is the 4% sinking fund method.

Interest at 4% will be accrued and charged to expense each year on the book balance in the Depreciation Reserve (excluding Reserve for Transportation and Construction Equipment). The total depreciation charge to expense will also include an annuity of such amount that, coupled with the interest charge, the total accrual would, over the remaining life, provide for the depreciation of the then existing gross depreciable plant, less the then existing depreciation reserve.

It is further understood that the company will under take to make reviews of depreciation charges by members of its own organization. The company will present, by December 1 each year, its basis of depreciation accruals for the ensuing year for Commission review.

The calculated reserve requirement represents recomputation, on a 4% sinking fund basis, of the 5% sinking fund reserve requirement as of December 31, 1948, testified to by the Commission staff in Case No. 5156 (with certain changes in equivalent lives), brought forward to December 31, 1949. This calculated reserve requirement is accepted as information for the purposes of this agreement. In the interest of disposing of the depreciation proceeding now pending, it is stipulated that a remaining life 4% sinking fund depreciation annuity of $321,309 is reasonable for the year 1950 and that interest will be $227,880, with a total provision of $549,189 for depreciation expense for 1950, and that the company will adopt this basis for its 1950 depreciation accrual and adjust its accounts accordingly. For 1951, annuity rates consistent with the 1950 calculations will be used. For years after 1951, however, the parties are free to make such representations as to remaining lives and net salvage as they feel proper after further investigation. It is also understood that this memorandum does not purport to cover the detail mechanics of adjusting the reserve by departments and computing the annuities for the future, which will be the subject of further conferences.

Reserve for Depreciation (Excluding Reserve for Transportation and Construction Equipment) - December 31, 1949	$6,696,427
Reserve Requirement on 4% Sinking Fund Basis	4,746,464
Excess in Reserve	$1,949,963
Transfer from Depreciation Reserve	999,436
Balance of Excess to Remain in Reserve	$ 950,527
Reserve after Adjustments	$5,696,991

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Disposition of Transfer from Depreciation Reserve

1. Transfer to Earned Surplus	$173,198	
2. Transfer to Tax Reserve*	125,000	
3. Write off one-half of Acquisition Adjustments (balance to be written off to surplus)	461,867	
4. Transfer to Insurance Reserve*	200,000	
5. Write off loss on hydro plant lands (net)	39,371	
		$ 999,436

* These reserves shall be noninterest bearing.

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Estimated Depreciation Expense - Year 1950

Interest - 4% on $5,696,991		$ 227,880
4% Sinking Fund Annuity - Total Life Basis	$391,249	
Less - Annual Rent of 20-year Annuity Created by Excess Retained in Reserve - 7.358% of $950,527	69,940	
Net Remaining Life 4% Sinking Fund Annuity		321,309
Depreciation Requirement for 1950		$ 549,189

with the brief and oral arguments pertaining thereto, the proceeding having been submitted and now being ready for decision,

IT IS HEREBY ORDERED that Coast Counties Gas and Electric Company is authorized and directed, respectively,

(1) To carry out the terms of the memorandum of understanding relative to depreciation practices dated November 10, 1950, received in this proceeding as Exhibit 40, and attached hereto as Exhibit A, and to place on its books the proposed journal entries which are included in Exhibit 44 filed in this proceeding.

(2) To file with the Commission a copy of each journal entry actually recorded on its books in accordance with this order.

The effective date of this order shall be twenty (20) days after the date hereof.

Dated at San Francisco, California, this 19th day of December, 1950

R. E. Mittelstaedt
Justus F. Craemer
Ray Powell
Harold P. Huls
Kenneth Potter
COMMISSIONERS