Q. Does NP's application of the composite method of depreciation result in the full value of an asset (less any proceeds on disposal) being recovered in rates regardless of whether it remains in service?

A. Yes, depreciation is a capital recovery mechanism in which 100 per cent of an account's original cost, less net salvage, is recovered ratably over its estimated useful life. Newfoundland Power's depreciation practice is consistent with the basic definition of depreciation as set forth by the American Institute of Certified Public Accountants in their Accounting Terminology Bulletin No. 1 (1953), which states that:

> *"Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible assets, less salvage value over the estimated useful life of the unit (which may be a group of assets), in a systematic and rational manner. It is a process of allocation, not of valuation."*

Depreciation records the decline in the service capacity of property. Depreciation accounting is the measurement of this decline and the allocation of the property's original cost over its service life. At the same time a record is kept in the depreciation reserve account of the cumulative depreciation costs recovered in past accrual rates. The reserve represents the return of the investment and is an ongoing record of the deduction from gross electric plant in order to obtain net electric plant or, essentially, rate base.

Newfoundland Power records depreciation only on electric plant that is in service, and therefore benefiting customers. Every five years Newfoundland Power conducts a service life and net salvage study for purposes of determining the appropriate depreciation accrual rates to be applied in the future. Periodically, adjustments to depreciation are made based on the current standing of the book reserve in relation to the theoretical reserve. The theoretical reserve provides companies with a measure or benchmark to assess whether its past depreciation accruals were appropriate. Newfoundland Power plans to make such an adjustment for the years 2003 - 2005 by reducing annual depreciation expense by approximately $5.8 million in each of these years.

Newfoundland Power has used the straight-line equal life group method in determining composite annual depreciation rates, and to calculate annual and accrued depreciation, for many years. The Company's depreciation consultants, Gannett Fleming, Inc., recommended in their depreciation study filed with the Company's 2003 General Rate Application that Newfoundland Power continue to use this method.

The equal life group procedure provides for a better match of depreciation expense and loss in service value than the alternative average life procedure. The average life procedure treats each unit within a group as though its life were equal to the average life of the group. The equal life group procedure on the other hand treats each unit in the group as though its life was known, and therefore recognizes, in determining the composite annual depreciation rate, that some assets in the group will be retired from

service prior to the group's average life while others will remain in service beyond the average life.

When contrasted with the average life procedure, the equal life group procedure results in annual accruals that are higher during the early years of the groups service life, when a higher number of units within the group are in service, and lower in the later years when fewer units remain in service.