

Annual Depreciation Review: No Surprises

By Branko Terzic

Who oversees the \$64 Billion each year in U.S. electric utility costs labeled “depreciation expense”? For many electric utilities, the answer is “Maybe nobody!” as depreciation for over \$1.7 Trillion in assets is often left to review by consultants every four to six years.

The Edison Electric Institute’s **Financial Review** is a consolidated annual report of the U.S. Investor-Owned Electric utility industry. The report compiles a Consolidated Income Statement and a Balance Sheet for the 44 EEI member companies. The costs of the four components of a utility’s annual expenses are presented for: operating and maintenance expenses, depreciation, taxes, and return on investment.

The annual depreciation expense for the EEI companies in 2023 was \$64.4 Billion.

The investment in regulated assets by the EEI companies was \$1.7 Trillion ending 2023.

Depreciation expense levels are a function of 1) investment and 2) annual depreciation rates.

Most annual depreciation rates (%/year) are set by state and federal utility regulators on a 4-6 year schedule. Some companies do not have a defined period between Commission review cycles. The depreciation rates for each asset account are based on estimates of 1) future economic service life, 2) cost of removal and salvage at retirement (called “net salvage”). The required depreciation studies are prepared by specialized experts who are most often independent consultants, usually also members of the Society of Depreciation Professionals (SDP).

The factors affecting the economic service lives and net salvage costs of public utility assets are unique to each utility and subject to change at any time between regulatory prescribed depreciation rate reviews. A review every 4-6 years may not be frequent enough to capture changes in the numerous technologies, regulatory policies and other forces affecting the service lives of electricity assets.

Failure to reflect changes in economic service lives may result in stranded costs such as when assets are retired before being fully depreciated due to such factors as functional obsolescence, environmental requirements or climate change. The issue of stranded costs leads to complex rate and regulatory policy issues best avoided if possible.

An annual depreciation review would provide management with early warning as to changes required in depreciation rates ahead of or at the time of the next rate case.

“No surprises!” should be management’s motto with respect to future depreciation expense.

An annual depreciation review, as discussed here, does not propose new depreciation rates, but rather answers the question “Should a full depreciation study be done now?” The annual review would identify what factors, affecting economic service lives or net salvage, have significantly changed enough to warrant a full review for the affected accounts. As a founder of the SDP and former State PSC and FERC Commissioner, I am familiar with the regulatory requirements for depreciation rate changes. In addition, an annual, or inter-period, depreciation review can be done quickly and at a reasonable cost.