PUBLIC UTILITIES

November 2005

FORTNIGHTLY

Regulators Forum

SHIFTING WINDS, SHIFTING STRATEGIES

PLUS

- Our Annual ROE Survey
- Rate-Base Cleansings
- The Energy Act and Natural Gas

Rate-Base Cleansings

ROLLING OVER RATEPAYERS

State PUCs should recognize a refundable regulatory liability for past charges to ratepayers.

By Michael J. Majoros Jr.

The Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 143 (SFAS No.143) identifies an immediate need for state public utilities commissions (PUCs) to recognize a refundable regulatory liability for past charges to ratepayers for non-legal asset retirement costs.

Although these prior charges resulted in billions of dollars of regulatory liabilities on utilities' generally accepted accounting principles (GAAP) financial statements, they are almost invisible on the regulatory financial statements of the utilities. This is because of the deference shown to state PUCs by the Federal Energy Regulatory Commission (FERC) when dealing with these liabilities. Unless the state PUCs specifically recognize the liabilities, the utilities will have the opportunity to institute a rate-base "cleansing" by transferring ratepayer-fronted money into income.

Regulated public utilities rely on ratemaking hearings rather than a competitive market to establish their prices. A utility's "revenue requirement" quantifies several components summing up to the allowed revenues it will have the opportunity to collect. The "rate base" is the shareholders' investment in utility operations. A "rate of return" applied to rate base yields the "return on investment" component of the revenue requirement. Hence the phrase "rate-base, rate-of-return regulation."

Rate base includes the investment in plant and other assets, net of accumulated depreciation, and ratepayer-provided capital. Accumulated depreciation theoretically measures the amount of "investor-supplied capital" that has been returned by ratepayers. Alternatively, "ratepayer-provided capital" includes items such as accumulated deferred taxes and investment tax credits, which are charges to ratepayers for taxes the utility did not pay. In theory, ratepayers initially "front" these amounts, and then repaid in the form of lower tax expense charges in the future. The *quid pro quo* is the subtraction of this ratepayer-provided capital from rate base.

Déjà Vu All Over Again

The telephone industry has cleansed its rate base twice. Now regulated electric and other utilities are ready to cleanse their rate bases. In fact, certain electric utilities already have demonstrated their willingness to write off these ratepayer-provided capital amounts. "Write off" is a euphemism for an increase to corporate retained earnings.

To prevent these cleansings, state PUC regulators first must recognize that the utilities have collected enormous amounts for future removal costs, and then declare those amounts to be regulatory liabilities for regulatory and ratemaking purposes.

Although all companies record depreciation expense and

concomitantly increase their accumulated depreciation accounts, the process creates substantial controversy in public utility rate proceedings due to the magnitude of the numbers, stemming from the capital intensity of these regulated industries.

Depreciation rates are the vehicle for charging depreciation expense. The higher the depreciation rate, the higher the depreciation expense. Utility depreciation expense increases revenue requirements and therefore drives up utility prices. Depreciation expense is the cause, and the resulting charges to ratepayers are the effect. This article addresses regulatory liabilities resulting from depreciation-rate markups for future removal costs.

When a physical asset is no longer useful, it is retired from service. Asset-retirement costs are incidental to the retirement. Markups for estimated future retirement costs have increased public utility depreciation rates. The marked-up rates produced depreciation charges far in excess of the amount necessary to return capital to investors over the lives of utility assets.

As a rate regulator, a state PUC can impose a refundable obligation. For example, it may increase a public utility's current service rates to recover costs expected to be incurred in the future, with the understanding that if those costs are not incurred, the utility's future rates will be reduced by corresponding amounts. This obligation to pay future costs or refund the excess is a "regulatory liability."[1]

The Difference Between Legal And Non-Legal AROs

FASB's SFAS No. 143 addresses asset retirement obligations (AROs) associated with long-lived plant. It applies to both regulated and unregulated companies. Legal AROs are "legal obligations that a party is required to settle as a result of an existing or enacted law, statute, ordinance, or written or oral contract or by legal construction of a contract under the doctrine of promissory estoppel."[2]

When a company has a legal ARO, the discounted fair value of the related asset retirement cost (ARC) is capitalized and depreciated. A legal ARO results in an increased charge to depreciation expense by virtue of the higher asset cost, as long as there is a legal requirement to incur the future cost.

Many utilities do have legal AROs. The obligation associated with the retirement of nuclear plants whereby the company is legally required to perform decontamination activities when the plant ceases operations is a legal ARO. If a utility determines that it has collected too much for a legal ARO decontamination expense, it is required to report the excess collections as regulatory liabilities.

Moreover, SFAS No. 143 also addresses "non-legal" AROs. A non-legal ARO is an estimated future retirement cost for which there is no actual legal obligation or liability.[3] SFAS No. 143 requires reporting of non-legal AROs as regulatory liabilities to ratepayers because there is no legal obligation to incur these costs.[4] Thus, if a utility either collected too much for a legal ARO or has collected money for non-legal AROs, SFAS No. 143 requires it to report them as regulatory liabilities.

Since the doctrine of promissory estoppel provides substantial leeway in qualifying an ARO as legal, the threshold tests are low. The fact that an ARO is not legal under that doctrine suggests that the obligation is doubtful. By definition, non-legal AROs are not "liabilities"; they are not "probable" future sacrifices of economic benefits.[5] Non-legal AROs are ambiguous and they are not even conditional obligations.[6] Any conditional obligations, or even promises to spend the money for cost of removal, would qualify as legal AROs.

Yet, regardless of the low threshold, the utility industry still reports billions of dollars of regulatory liabilities resulting from non-legal AROs. The industry acknowledges that it does not have any obligation to remove its plant or to spend the money it has collected from ratepayers for that presumed purpose. Explicitly, it has not promised to spend the money for its intended purpose, and it has recognized that it is not even reasonable to assume that it will incur these future removal costs.

Given these facts, the only reasonable conclusion is that the industry likely never will incur all of the non-legal AROs that it has charged to ratepayers. That is not to say that the industry will not spend money; indeed, it will spend, but only a small portion will go for future removal costs.

Where the Problem Started

The significant magnitude of these regulatory liabilities is the product of the traditional inflated future cost approach (TIFCA), used by utilities to estimate future removal cost. TIFCA marks up depreciation rates for inflated removal-cost estimates. When applied to an ever-expanding gross plant, these marked-up rates yield enormous estimated future removal costs accruals vastly exceeding actual removal expenditures.[7]

FERC adopted most, but not all, aspects of SFAS No. 143 in its Order No. 631. Although FERC identified non-legal AROs and recognized the need for transparency, it did not require reporting of non-legal AROs as regulatory liabilities. Instead, it required specific identification and separate accounting for these amounts.

FERC Order No. 631 requires that jurisdictional entities maintain separate subsidiary records for cost of removal for non-legal retirement obligations included as specific identifiable allowances recorded in accumulated depreciation. This separately identifies such information to facilitate external

reporting as well as for regulatory analysis and rate-setting purposes. Therefore, the commission amended the instructions of accounts 108 in Parts 101 to "require jurisdictional entities to maintain separate subsidiary records for the purposes of identifying the amount of specific allowances collected in rates for non-legal retirement obligations included in the depreciation accruals."[8]

Although FERC recognized the need for segregation of the non-legal ARO amounts to facilitate external reporting, regulatory analysis, and rate-setting, it left specific recognition of the regulatory liabilities for non-legal AROs up to state PUCs.

It's Up to the PUCs

During its deliberations, FERC considered the comments of several parties. The National Association of State Utility Consumer Advocates (NASUCA) and the accounting firm of Deloitte & Touche suggested that "the commission should make certain modifications to the USOA … to include the amount of cost of removal for non-legal obligations as regulatory liabilities in account 254, other regulatory liabilities, instead of accumulated depreciation."[9] The Edison Electric Institute (EEI) and the Southern Co., however, requested, "the commission specify that any cost of removal for non-legal retirement obligations remain in accumulated depreciation."[10]

FERC followed the latter advice, but required separate subsidiary records of these accruals.[11] It concluded, "The issue of whether, and to what extent, a particular asset retirement cost must be recovered through jurisdictional [service] rates should be addressed on a case-by-case basis in the individual rate change filed by public utilities, licensees, and natural-gas companies."[12] It "declined to make policy calls concerning regulatory certainty for disposition of … adjustments to book depreciation rates…; these are matters that are not subject to a one-size-fits-all approach and are better resolved on a case-by-case basis in rate proceedings."[13]

Thus, FERC left the responsibility for recognition of the regulatory liability to state PUCs. It stated that pursuant to commission Order No. 552, "Regulatory assets and liabilities are defined as assets and liabilities that result from ratemaking actions of regulators."[14] Although FERC did not make the policy calls for FERC jurisdictional purposes, it recognized that state PUCs are able to make the calls for state jurisdictional purposes.

Therefore, the most important new issue is the need for the state PUCs specifically to recognize a refundable regulatory liability for regulatory reporting, analysis, and ratemaking purposes. While FERC's treatment provides a new transparency, it is not good enough to secure the ratepayers' interests in these amounts.

In recent rate cases, with test years subsequent to the implementation of both SFAS No. 143 and FERC Order No. 631, the existence of these regulatory liabilities has not been disclosed in the filing, notwithstanding that they were reported to the SEC. Such omissions limit the state PUCs' ability to

Magnitude of Non-Legal ARO Regulatory Liabilities

With the notable exceptions of utilities in Pennsylvania and a few other states, almost all rate-regulated public utilities have identified large regulatory liabilities resulting from non-legal asset retirement obligations (AROs) as reported in their generally accepted accounting principles financial statements and SEC Form 10Ks. The following is a list of non-legal ARO regulatory liabilities for a sample of 12 large, medium, and small electric utilities in terms of 2003 annual gross revenues. These liabilities are over and above actual expenditures.

Company	2003 Revenues $ Millions	Regulatory Liability Non-Legal ARO 2003 $ Millions	Regulatory Liability Non-Legal ARO 2004 $ Millions
	(a)	(b)	(c)
Exelon Corp.	$ 3,576	$ 973.0	$ 1,011.0
American Electric Power	3,320	1,233.0	1,290.0
Dominion Resources Inc.	3,016	572.0	595.0
Public Service Enterprise Group Inc.	2,664	395.0	418.0
Southern Co.	2,540	1,260.0	1,296.0
FirstEnergy Corp.	2,047	321.0	340.0
Cinergy Corp.	870	491.0	531.0
Ameren Corp.	847	697.0	823.0
Allegheny Energy Inc.	760	386.4	404.1
Unisource Energy Corp.	281	61.0	69.6
Nisource Inc.	261	1,034.9	1,089.8
PNM Resources Inc.	252	236.0	247.4
Total	$ 20,435.4	$ 7,660.3	$ 8,114.9

Sources: Col. (a) from *Platts Electric Utility Week*, April 19, 2004, The McGraw Hill Companies, pp. 14-15.
Cols. (b) and (c) from 2004 10K Reports.

Just for these 12 electric utilities, the 2003 regulatory liabilities for non-legal AROs were $7.66 billion, and the liabilities increased by $454.6 million, to $8.11 billion, in 2004. The liabilities are large and growing from continued charges to ratepayers for non-legal AROs.—***MM***

submit these regulatory liabilities to regulatory analysis and address the rate-setting implications.

Whose Money Is It?

Since accumulated depreciation theoretically measures a return of investor-supplied capital, utilities may assent that anything recorded in accumulated depreciation is "their money" because it merely represents a return of "their capital."

However, since ratepayers fronted this money for doubtful future removal expenditures, it is reasonable that they consider it as ratepayer-provided capital, not investor-supplied capital. From the ratepayers' perspective, it should be classified in account 254–Regulatory Liabilities, and recognized as a regulatory liability by regulators. Otherwise, it is at risk of loss to ratepayers.

Even classification as an "other deferred credit," as some utilities have done, is not sufficient on the ratepayers' perspective. Utilities easily can claim a deferred credit belongs to shareholders. Deferred credits defeat the purpose. This is why it must be reiterated that state PUC regulators specifically must recognize the regulatory liabilities resulting from non-legal AROs, and the utilities should report them as such.

For example, 2004 Form 10K from the Tucson Electric Power Co. (TEP) demonstrates why explicit recognition is necessary. TEP applies SFAS No. 71—Accounting for the Effects of Certain Types of Regulation—to its regulated operations. Therefore, it recorded its non-legal AROs as a regulatory liability in its Form 10K.

As of Dec. 31, 2004, TEP had accrued $67 million for the net cost of removal of the interim retirements from its transmission, distribution, and general plant. As of Dec. 31, 2003, TEP had accrued $60 million for these removal costs. The amount is recorded as a regulatory liability.[15]

However, TEP also states, "If TEP stopped applying FAS 71 to its remaining regulated operations, it would write off the related balances of its regulatory assets as an expense and its regulatory liabilities as income on its income statement."[16]

These words are hauntingly similar to the warnings uttered in Bell Company annual reports before their most recent rate-base cleansing. In 2003, the Bell Operating Companies transferred $11.5 billion of non-legal AROs from their accumulated depreciation accounts into corporate retained earnings as a result of alternative regulation and SFAS No. 143.

State PUCs specifically should recognize, as refundable regulatory liabilities, all accruals for non-legal cost of removal and dismantlement.

It also is ominous that EEI and the American Gas Association (AGA), along with individual utilities, fought so hard to avoid having either the FASB or FERC recognize or report the non-legal removal cost as regulatory liabilities.

If the utility industry is deregulated, or even if alternative forms of regulation are adopted, history suggests that billions of dollars of regulatory liabilities will be transferred into utility income. The amounts will disappear from the scene unless the state PUCs protect them on behalf of ratepayers.

The De-Reg Debacle

Setting history aside, the industry will transfer the regulatory liabilities into income because that is what GAAP requires. If deregulated, the provisions of SFAS No. 71 no longer will apply, and the regulatory liabilities will flow explicitly to GAAP income under the provisions of SFAS No. 143. If there is any doubt, consider what certain electric utilities did when their production plants were deregulated. TEP stated that:

> TEP had accrued $113 million for final decommissioning of its generating facilities. … This amount was reversed for 2002 and included as part of the cumulative effect adjustment of accounting adjustment when FAS 143 was adopted on Jan. 1, 2003.[17]

TEP already has transferred non-legal AROs into income, and if the transmission and distribution business is deregulated or if alternative regulation is adopted, TEP very well may get the rest of the money.[18]

Several American Electric Power (AEP) production plants were deregulated. AEP immediately transferred $473 million of non-legal dismantlement cost from accumulated depreciation into its income.[19]

The public utility industries will write off these amounts as soon as they are able. Recognition of the regulatory liabilities for regulatory purposes provides a certain level of protection to ratepayers.

In sum, state PUCs specifically should recognize, as refundable regulatory liabilities, all accruals for non-legal cost of removal and dismantlement. Although FERC Order No. 631 provides a new transparency, it did not establish a regulatory liability for non-legal asset retirement obligations. While it is common knowledge that ratepayers provided these prepayments, there is no regulatory recognition of the liability, and there is no provision for a refund if the utilities do not spend the amounts on their intended purpose.

Consequently, the utilities are not directly accountable for the excess collections. This is unreasonable. Inflation aspects of the TIFCA formula make it highly unlikely that utilities will incur removal costs of the magnitude collected. Nevertheless, even if this money were to be spent for cost of removal, state PUCs specifically should recognize the ratepayers' security interest in these monies until they are spent on their intended purpose. Unless they are explicitly identified as "subject to refund," they are merely hidden potential income to the public utilities, and a large potential loss to ratepayers. F

Michael Majoros is a principal with Snavely King Majoros O'Connor & Lee Inc., an economic consulting firm in Washington D.C. Margaret L. Kenney, Charles W. King, and Richard B. Lee provided assistance in the preparation of this article. Contact Majoris at mmajoros@snavely-king.com.

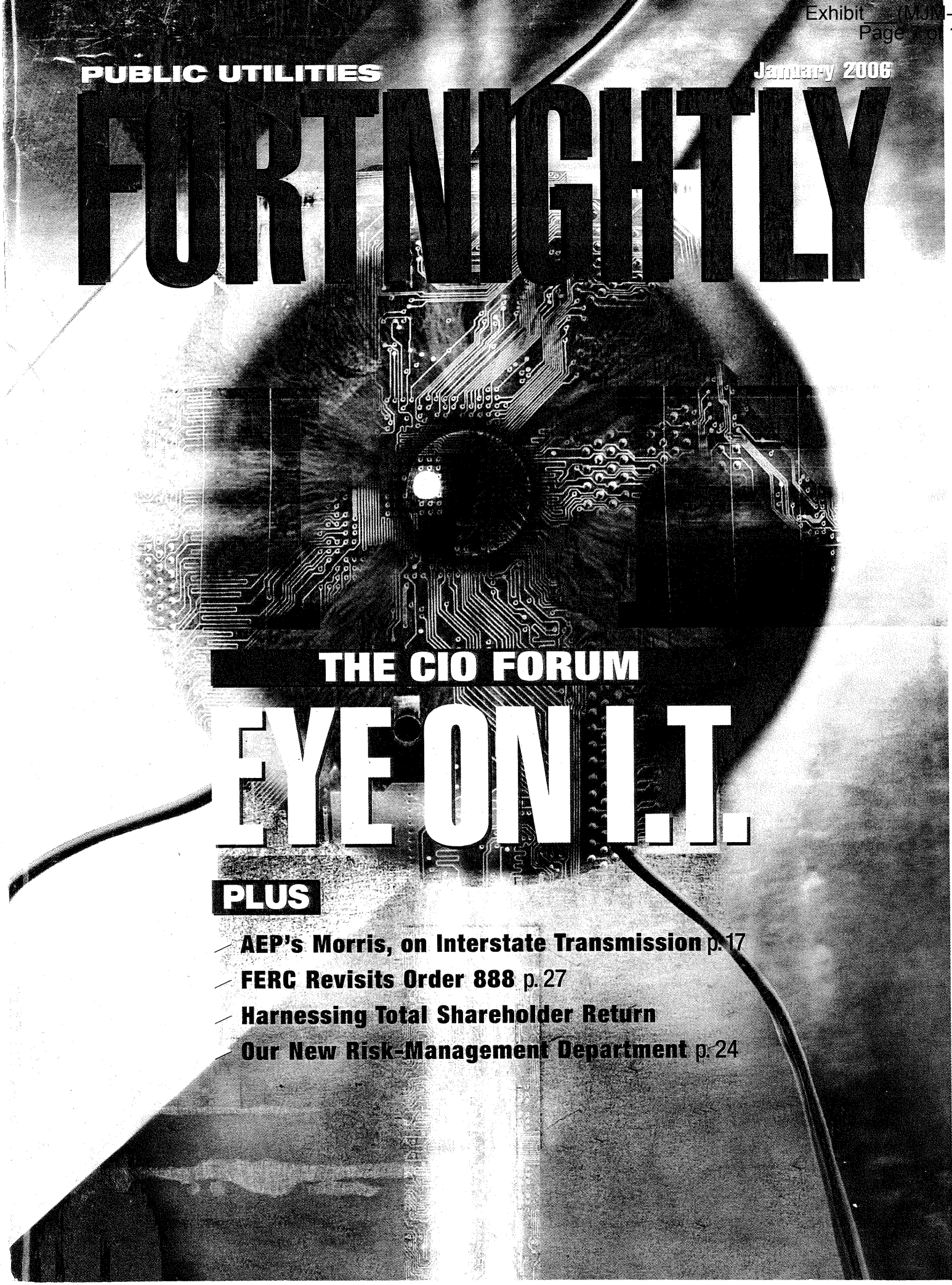
Sources

1, Statement of Financial Accounting Standards No. 71 (SFAS No. 71) – Accounting for the Effects of Certain Types of Regulation, paragraph 11.
2. Statement of Financial Accounting Standards No. 143 (SFAS 143), Accounting for Asset Retirement Obligations, paragraph 2.
3. Federal Energy Regulatory Commission, A*ccounting, Financial Reporting, and Rate Filing Requirements for Asset Retirement Obligations*, RM02-7-000, Order No. 631, Issued April 9, 2003 (Order No. 631), paragraph 36.
4. SFAS 143, paragraph B73.
5. *Id*., paragraph 4.
6. *Id*., paragraph A3.
7. James G, Campbell and Michael J. Majoros Jr., "What's 'Sunk' Ain't Stranded: Why Excessive Utility Depreciation Is Avoidable," *Public Utilities Fortnightly*, Vol. 137, No. 7, April 1, 1999, pp. 34-39.
8. Order No. 631, paragraph 38, (emphasis added).
9. *Id*., paragraph 34, footnote 28.
10. *Id*., footnote 27.
11. *Id*., paragraph 38.
12. *Id*., paragraph 62.
13. *Id*., paragraph 64.
14. *Id*., paragraph 25.
15. Unisource Energy Corp., De. 31, 2004 10K Report, page K-60.
16. *Id*., page K-59, (Emphasis added).
17. *Id.*
18. The authors understand that the Staff of the Arizona Corporation Commission objects to TEP's so-called reversal.
19. AEP 2003 Annual Report to Shareholders, p. 69.

PUBLIC UTILITIES

January 2006

FORTNIGHTLY



THE CIO FORUM

EYE ON I.T.

PLUS

To the Editor:

The article of Michael J. Majoros Jr. (*"Rate-Base Cleansings: Rolling Over Ratepayers," November 2005, p. 58*) attracted my attention, because I perceive it to propose a solution—PUCs' need to recognize refundable regulatory liabilities—for a problem that does not exist.

Majoros' basic premise is that regulated entities have no obligation to incur costs to remove or safely abandon assets in place, which he refers to as "non-legal AROs" (asset retirement obligations). Regulated entities may not have a legal obligation as is defined by Statement of Financial Accounting Standards (SFAS) 143, *Accounting for Asset Retirement Obligations*. However, this does not mean that such entities have no obligation to incur costs to remove or safely abandon assets in place. I have long observed such costs being incurred on a regular basis by regulated entities for purposes of public safety and to assure their ability to continue to provide service, even though there is no "legal obligation." An example is the Southern California Edison Co. (SCE), for which Majoros' testimony in California *Application 04-12-014* shows that during the period 1994 through 2003, SCE incurred cost-of-removal expenditures of $448 million for distribution plant alone. Contrary to Mr. Majoros' assertion, regulated entities recognize an obligation to incur removal costs and incur such costs on a regular basis.

This obligation is not trivial, as is evident for SCE and from the tabulation on p. 60 of Majoros' article of the cost of removal that has been accrued by a dozen utilities, and whether it is recorded as a component of the accumulated provision for depreciation (book reserve), as FERC dictates, or as a component of Account 254, *Regulatory Liabilities*, as Majoros suggests, does not change anything.

Majoros asserts that SFAS 143 "identifies an immediate need for state public service commissions (PUCs) to recognize a refundable regulatory liability for past charges to ratepayers for non-legal retirement costs." SFAS 143 addresses only legal obligations, and its reference to regulatory liabilities is limited to recognition that entities qualifying for SFAS 71, *Accounting for the Effects of Certain Types of Regulation*, can include such obligations in depreciation on their income statements and show the amounts therein as regulatory liabilities on their balance sheets. Therefore, Majoros' assertion about the implications of SFAS 143 is false.

Majoros asserts "the telephone industry has cleansed its rate base twice." The first event he refers to is when the telephone industry recorded asset impairments during the 1990s, which was accomplished through recording large increases to book reserves. These transactions were in response to recognition that the depreciable lives imposed by regulators were excessive and that this situation meant that the enterprises no longer qualify for the special accounting allowed by SFAS 71. The reserve increases were recorded for financial accounting purposes, but not for regulatory accounting and ratemaking purposes, so contrary to Mr. Majoros' assertion, rate base was not affected by these transactions.

The second "cleansing" event Majoros refers to is when the cost of removal that had been accumulated in the book reserves was reversed at the time SFAS 143 was adopted. This was done by all regulated entities in response to the position expressed by the Securities and Exchange Commission (SEC) that generally accepted accounting principles (GAAP) dictates cost of removal be expensed at the time incurred, rather than accrued as a component of depreciation. This was done for financial accounting purposes, but not for regulatory accounting and ratemaking purposes, because Uniform Systems of Accounts specify that cost of removal be recorded as a component of depreciation. Majoros notes similar transactions by electric utilities at the time industry restructuring caused certain power plants to no longer qualify for SFAS 71. Contrary to Majoros' assertion, rate base was not affected by these transac-

tions. I am convinced that the SEC's interpretation of GAAP is incorrect, for reasons that are beyond the scope of these comments. However, regulated entities are forced to reverse for financial accounting purposes any previously accrued cost of removal for operations no longer qualifying for SFAS 71 for as long as the SEC's current interpretation of GAAP remains.

The fact that rate base was not affected by these telephone industry actions is demonstrated by a recent proceeding in the state of Washington in which one of Mr. Majoros' partners testified on depreciation. The proceeding involved the intrastate business of Verizon, and all parties incorporated cost of removal into their proposed depreciation rates and recognized that Verizon's book reserve for regulatory accounting and ratemaking purposes includes cost of removal. Verizon's interstate business is subject to Federal Communications Commission (FCC) jurisdiction. The FCC allows depreciation rates to be based on specified ranges of lives and net salvage ratios without question, but allows departure from the ranges upon proof of need. The FCC's net salvage ranges recognize cost of removal.

Majoros uses a phrase he has coined "Traditional Inflated Future Cost Approach," which I interpret as implying there is something amiss with how the cost of removal component of depreciation rates is determined. This is an accurate phrase, but the implications Majoros seems to be drawing from it are not correct.

"Inflated" means nothing more than, when past experience is considered in determining the cost of removal expected to be incurred upon the retirement of surviving assets, it is typical to relate the recorded cost of removal to the recorded original cost of the retired assets. This relationship reflects the cost of removal at the price level when incurred and the retired assets at the price level when placed in service. Therefore, labor cost escalation over the asset lifetime is inherent in the relationship.

"Future" means nothing more than depreciation rates being required to reflect future cost of removal, *i.e.*, the expected amount at the price level at the time incurred.

The terminology typically utilized by depreciation analysts and regulators to recognize this situation is "Traditional Method" or "Traditional Approach."

Majoros notes that increases in depreciation expense cause increases to revenue requirements, but fails to mention that this is a short-term phenomenon. He notes that depreciation expense accumulates in the book reserve, but ignores its influence on revenue requirements. Rate-base regulation causes the initial revenue-requirement impact of any change in depreciation to reverse in the long-term, and it does not take very long for this to occur.

Majoros notes that accrual accounting for cost of removal can result in controversy in regulatory proceedings. This situation is due to accrual accounting, whereby estimated cost of removal expenditures are recorded as an expense ratably over the estimated life of the related assets. This typically results in annual cost of removal accrual amounts in excess of the current annual expenditure amounts, thereby causing some to assert there is something wrong and to propose deferral mechanisms for the recording and recovery of cost of removal. Such mechanisms conflict with commission accounting rules, and have the effect of increasing revenue requirements in the long term and shifting costs to future generations of ratepayers. Cost of removal having the effect of increasing depreciation rates is viewed negatively by those interested only in the short term, and may end up influencing regulators to emphasize the near term. Near-term emphasis is unfortunate for the ratepayers and the economic viability of the service territory, because inadequate depreciation rates causes inadequate book reserves that inflate rate base.

John S. Ferguson
Richardson, Texas

The Author Responds: John Ferguson's response to my article is not surprising. Mr. Ferguson is a depreciation witness who always represents utilities and advocates for higher and higher depreciation rates. His response to my article attempts to defend the current practice of increasing depreciation rates for inflated future cost of removal estimates.

Excess depreciation is not the primary focus of my article. Its main thrust, as stated in the first sentence, is "the immediate need for state public utilities commissions (PUCs) to recognize a refundable regulatory liability for past charges to ratepayers for non-legal asset retirement costs." PUCs should protect collections on behalf of ratepayers until they are used for their intended purpose. What's wrong with that? It is pure common sense, but Ferguson strongly objects.

He objects because the protection I recommend precludes utilities the opportunity for exorbitant rate-base cleansings. Rate-base cleansings are rate-base increases resulting from transfers of ratepayer-provided capital into corporate equity accounts.

Ferguson is correct that the telecom industry's most recent rate-base cleansing resulted from the implementation of SFAS No. 143 (*i.e.*, excess cost of removal charges), but he is incorrect about that industry's first cleansing. The first telecom rate base cleansing was a component of the 1983 AT&T divestiture. Its operating subsidiaries transferred into their corporate equity accounts billions of dollars of ratepayer-provided capital in the form of deferred taxes and investment tax credits.

Additionally, as explained in my current article, electric utilities whose production plants have been deregulated already have cleansed that portion of their rate bases. In other words, regardless of Ferguson's claims to the contrary, the problem does exist—it is real.

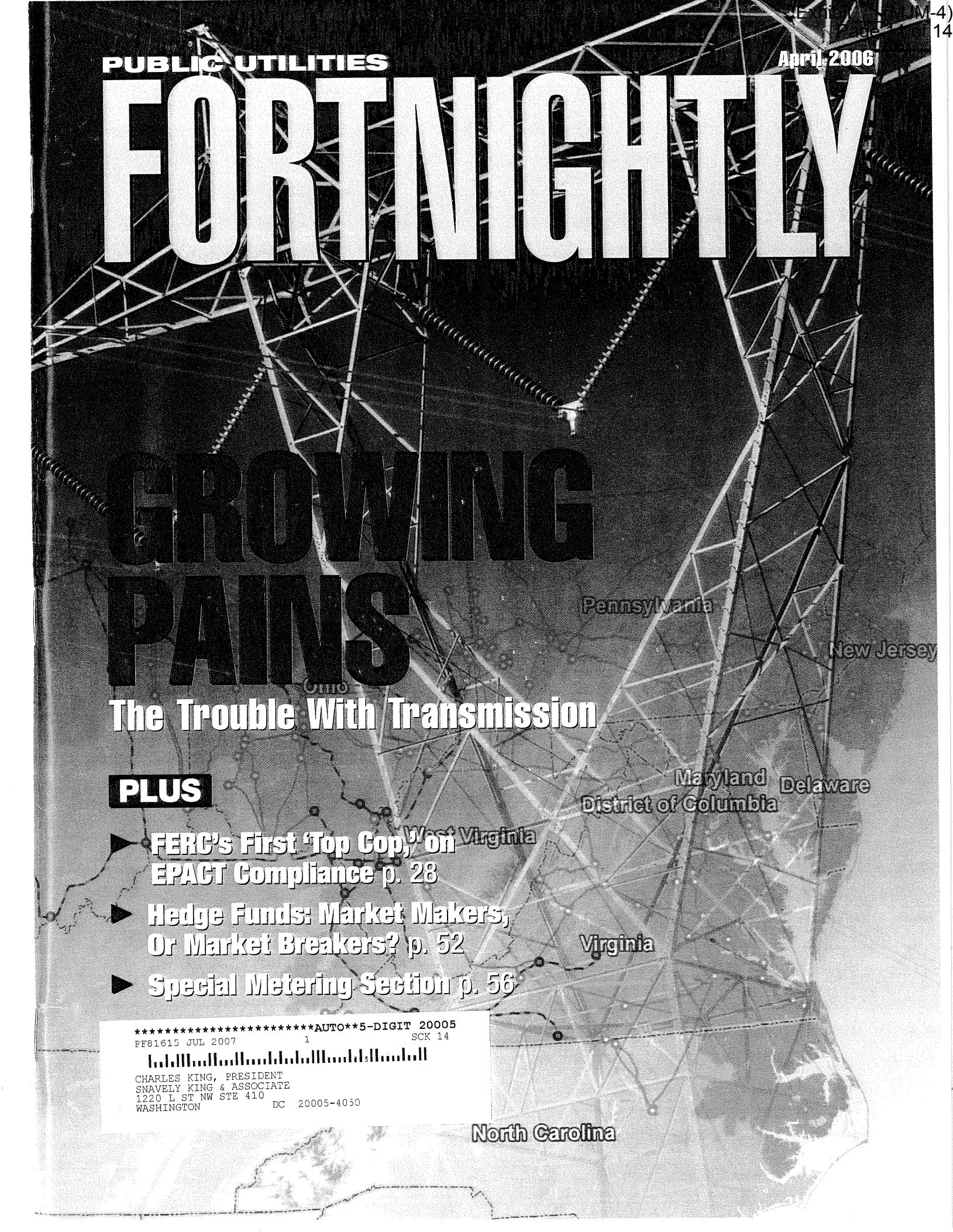
Finally, since Ferguson chose to address a recent proceeding in which I provided testimony (*A.04-12-014*), it is fair to set the record straight. First, Ferguson was not a witness in the proceeding. Second, Ferguson correctly states that my testimony showed that the company had incurred $448 million of distribution plant cost of removal for the years 1994 to 2003. He fails, however, to inform the reader that my testimony also showed that the company had charged its ratepayers $1.5 billion over and above the $448 million for distribution plant cost of removal. I seek to protect that $1.5 billion excess from a rate-base cleansing until the company actually spends the money on its intended purpose. Again, what's wrong with that?—***Michael J. Majoros Jr.***

Correction: In the 2005 financial rankings of the *Public Utilities Fortnightly 40* (*September issue, p. 28*), Progress Energy's 2002 net income was overstated because of a data-entry error by financial data provider C Three Group LLC. The net income of Progress Energy for 2002 should have been $528 million, which ties the utility for 37th place with DTE Energy on the *Fortnightly 40*. The *Fortnightly* regrets the error.

PUBLIC UTILITIES

April 2006

FORTNIGHTLY



GROWING PAINS

The Trouble With Transmission

PLUS

- FERC's First 'Top Cop,' on EPACT Compliance p. 28
- Hedge Funds: Market Makers, Or Market Breakers? p. 52
- Special Metering Section p. 56

Letters to the Editor

To the Editor:

In "Rate-Base Cleansings: Rolling Over Ratepayers" (*November 2005, p.58*), Michael Majoros urges state public utility commissions to recognize a refundable regulatory liability for past charges to ratepayers for non-legal asset retirement costs. "Unless the state PUCs specifically recognize the liabilities, the utilities will have the opportunity to institute a rate-base 'cleansing' by transferring ratepayer-fronted money into income." The author's criticism of the prescribed accounting for discontinuation of FASB Statement No. 71 (euphemistically labeled "rate–base cleansing") is grossly misplaced.

Regulatory assets and liabilities can be created either a) within the accounting framework of financial reporting required for non–regulated enterprises; or b) within the accounting framework for regulated utilities prescribed by the Uniform System of Accounts (USOA). Differences between financial accounting and regulatory accounting are permitted under generally accepted accounting principles (GAAP) provided the general-purpose financial statements of a regulated entity are prepared in conformance with the provision of FASB 71. In particular, if current recovery is provided under regulation for costs (that would not be recognized in the accounting framework for non-regulated enterprises) that are expected to be recovered in the future, FASB 71 requires a regulated entity to recognize these current receipts as liabilities.

Regulated assets and liabilities created within the framework of regulatory accounting prescribed by the USOA arise from specific revenues, expenses, gains, or losses that would have been included in net income in one period under the requirements of the USOA but for it being probable that a) such items will be included in different periods for the purpose of developing rates charged for utility services; or b) refunds to customers are not provided in other USOA accounts.

The reporting of a regulatory asset or liability is dependant upon the accounting framework in which the asset or liability arises. In the case of removal costs (or non-legal asset retirement obligations), the accounting framework for reporting a regulatory liability is GAAP for non-regulated enterprises. This liability does not create or imply an obligation to refund past charges to ratepayers. It simply means that regulation is permitting recovery of a future cost that would otherwise be reported as a current expense for a non-regulated enterprise.

Including cost of removal as a component of depreciation rates is widely recognized and accepted by a substantial majority of state regulatory commissions as a standard ratemaking principle. Net salvage is included as a component of depreciation rates to equitably distribute cost of removal (less salvage) over the periods in which the assets that created the cost are used to provide utility service. Any concern over the magnitude or timing of these charges is properly addressed in the course of conducting depreciation studies. Ratepayers are not entitled to a refund of costs recognized to provide services they have already received.

Karen G. Kissinger
Vice President, Controller & Chief Compliance Officer,
Tucson Electric Power Co.
kkissinger@tep.com

(cont. on p. 12)

To the Editor:

I would like to comment on the article by Michael J. Majoros Jr. ("*Rate-Based Cleansings: Rolling Over Ratepayers," November 2005, p. 58*).

I find it interesting that Majoros is critical of the traditional method of depreciation while overlooking an accounting standard (SFAS No.143) that could be much more devastating on the ratepayers. True, the traditional depreciation capital recovery schedule is "front-end" loaded, as illustrated in Exhibit 1 below, because the ARO is non-discounted, but it recoups no more than the ARO cost of removal by the end of the ARO's life. In Exhibit 1, the future worth (FW) of the return and depreciation of $422,500 is equal to the $422,500 ARO in 10th year. Unlike the SFAS No.143 capital recovery schedule as illustrated in Exhibit 2, the future worth of the return (or accretion) and depreciation of $643,698 exceeds the $422,500 in the 10th year by 52 percent. The situation becomes worse as illustrated in Exhibit 3, with an increase in the ARO life. In fact, ARO lives over 50 years are not uncommon, resulting in overstatements of well over 175 percent.

Common sense would show that there is something dreadfully wrong here. If Majoros is truly interested in the ratepayers' welfare, he would be advocating a capital recovery schedule such as the one shown in Exhibit 4 and help "cleanse" the flawed SFAS No.143 accounting standard and save the ratepayers billions of future dollars.

Don Bjerke
Regina, Saskatchewan, Canada
bjerke@sasktel.net

EXHIBIT 1 TRADITIONAL CAPITAL RECOVERY SCHEDULE FOR A $422,500 ARO

Year	Beginning Year Remaining Capital	10% Return	Depreciation	Return + Depreciation	$(f/p)^{10\%}$ Factor	FW (Return +Dep.)
1	$ 0	$ 0	$42,250	$42,250	2.3579	$99,623
2	(42,250)	(4,225)	42,250	38,025	2.1436	81,510
3	(84,500)	(8,450)	42,250	33,800	1.9487	65,867
4	(126,750)	(12,675)	42,250	29,575	1.7716	52,394
5	(169,000)	(16,900)	42,250	25,350	1.6105	40,826
6	(211,250)	(21,125)	42,250	21,125	1.4641	30,929
7	(253,500)	(25,350)	42,250	16,675	1.3310	22,494
8	(295,750)	(29,575)	42,250	12,675	1.2100	15,337
9	(338,000)	(33,800)	42,250	8,450	1.1000	9,295
10	(380,250)	(38,025)	42,250	4,225	1.0000	4,225
						$422,500

EXHIBIT 2 SFAS No.143 CAPITAL RECOVERY SCHEDULE FOR A $422,500 ARO

Year	Beginning Year Liability	10% Accretion	Depreciation	Accretion + Depreciation	$(f/p)^{10\%}$ Factor	FW (Return +Dep.)
1	$162,892	$16,289	$16,289	$32,578	2.3579	$76,816
2	179,181	17,918	16,289	34,207	2.1436	73,326
3	197,099	19,710	16,289	35,999	1.9487	70,151
4	216,809	21,681	16,289	37,970	1.7716	67,268
5	238,490	23,849	16,289	40,139	1.6105	64,644
6	262,339	26,234	16,289	42,523	1.4641	62,258
7	288,573	28,857	16,289	45,146	1.3310	60,089
8	317,430	31,743	16,289	48,032	1.2100	58,119
9	349,173	34,917	16,289	51,206	1.1000	56,327
10	384,090	38,410	16,289	54,700	1.0000	54,700
11	422,500	$259,608	$162,892	$422,500		$643,698

$$\text{Overstatement} = \frac{\$643{,}698 - \$422{,}500}{\$422{,}500} = 52\%$$

These exhibits were obtained from the article "Comments on Asset Retirement Obligations," by Don and Ralph Bjerke, in the *Journal of the Society of Depreciation Professionals*, Volume 11, Number 1, 2002-2003, pp. 49-55. This topic is further discussed in the article "Modeling ARO Financial Statements," by Don and Ralph Bjerke, in the *Journal of the Society of Depreciation Professionals*, Volume 12, Number 1, 2004-2005, pp. 21-28.

EXHIBIT 3 SFAS NO.143 OVERSTATEMENT FOR ASSET LIVES AND RATES OF RETURN

Asset Life	5% Return	10% Return	15% Return
10	25%	52%	81%
20	58%	124%	192%
30	94%	204%	313%
40	133%	288%	438%
50	175%	374%	565%

EXHIBIT 4 PROPOSED CAPITAL RECOVERY SCHEDULE FOR A $422,500 ARO

Year	Beginning Year Remaining Capital	10% Return	Depreciation	Return + Depreciation	$(f/p)^{10\%}$ Factor	FW (Return +Dep.)
1	$162,892	$16,289	$16,289	$32,578	2.3579	$76,818
2	146,603	14,660	16,289	30,949	2.1436	66,343
3	130,314	13,031	16,289	29,321	1.9487	57,137
4	114,024	11,402	16,289	27,692	1.7716	49,057
5	97,735	9,774	16,289	26,063	1.6105	41,974
6	81,446	8,145	16,289	24,434	1.4641	35,774
7	65,157	6,516	16,289	22,805	1.3310	30,353
8	48,868	4,887	16,289	21,176	1.2100	25,623
9	32,578	3,258	16,289	19,547	1.1000	21,502
10	16,289	1,629	16,289	17,918	1.0000	17,918
						$422,500

The Author Responds

Karen Kissinger is the vice president, controller, and chief compliance officer of Tucson Electric Power Co. (TEP), a specific company I addressed in my November 2005 article. I reported that TEP already had transferred previously collected but unspent money from its ratepayers into its income. TEP collected the money from its ratepayers to provide for production plant removal costs TEP will not incur. Instead of returning the excess collections to ratepayers, TEP gave it to its shareholders. I also predicted that TEP would do it again for its remaining regulated plant accounts if it has an opportunity to do so.

Kissinger's last sentence corroborates everything I reported. According to Kissinger, "Ratepayers are not entitled to a refund of costs recognized to provide services they have already received." To make it clear, Kissinger is saying that even though TEP charged its ratepayers substantial sums that TEP will not spend for its intended purpose, TEP intends to keep the money and transfer it to its shareholders if possible. Clearly, neither Kissinger nor TEP wants any local public service commission to protect that money on behalf of ratepayers.

Don Bjerke claims that I have "overlooked an accounting standard (SFAS No. 143) that could be much more devastating on the ratepayers." What Mr. Bjerke overlooks is that I specifically recognized SFAS No. 143 in the first sentence of my article. SFAS No. 143 highlighted the excess charges that TEP already has transferred into its corporate income and the remaining excess money that TEP's Kissinger would like to keep rather than return to ratepayers.

Bjerke's primary misunderstanding is that he focuses his attention on asset retirement obligations (ARO), which are legal obligations to spend money at the end of a plant asset's life. Although Bjerke addresses "legal AROs," my article is about "non-legal AROs" where there is no obligation, legal or otherwise, to spend any money at the end of a plant asset's life.

None of Bjerke's tables addresses non-legal AROs; he missed the point. His tables should have addressed the "consumers' discount rate" which is always higher than a public utility's cost of capital. If he had done so, he may not be so enamored with front-loaded revenue requirements. For more information on this subject, see *www.snavely-king.com/ Think Pieces/Debate on the Use of Customer Discount Rates.*—**Michael Majoros**

(cont. on p. 14)