



Rebuttal Testimony
Dane A. Watson

Before the North Dakota Public Service Commission
State of North Dakota

In the Matter of the Application of
Northern States Power Company, a Minnesota Corporation

For Authority to Increase Rates for
Electric Service in North Dakota

Case No. PU-07-776
Exhibit 19

**Depreciation
Retirement Costs and ARO**

June 13, 2008

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1 **I. INTRODUCTION**

2

3 Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

4 A. My name is Dane A. Watson. My business address is 1410 Avenue K, Suite
5 1105B, Plano, Texas 75074.

6

7 Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT POSITION?

8 A. I am a Partner in Alliance Consulting Group. Alliance Consulting Group
9 provides consulting and expert services regarding depreciation, valuation and
10 accounting-related issues to the utility industry.

11

12 Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND.

13 A. I hold a Bachelor of Science degree in Electrical Engineering from the
14 University of Arkansas at Fayetteville and a Master's Degree in Business
15 Administration from Amberton University.

16

17 Q. PLEASE DESCRIBE YOUR PROFESSIONAL EXPERIENCE.

18 A. Since graduation from college in 1985, I have worked in the area of
19 depreciation and valuation. I co-founded Alliance Consulting Group in 2004
20 and am responsible for conducting depreciation, valuation, and certain
21 accounting-related studies for clients in various industries. My duties related
22 to depreciation studies include the assembly and analysis of historical and
23 simulated data, conducting field reviews, determining service life and net
24 salvage estimates, calculating annual depreciation, presenting recommended
25 depreciation rates to utility management for their consideration, and
26 supporting such rates before regulatory bodies.

27

1 My prior employment from 1985 to 2004 was with Texas Utilities Electric
2 Company and successor companies ("TXU"). During my tenure with TXU, I
3 was responsible for, among other things, conducting valuation and
4 depreciation studies for the domestic TXU companies. During that time I
5 served as Manager of Property Accounting Services and Records
6 Management in addition to my depreciation responsibilities.

7
8 I have twice been Chair of the Edison Electric Institute ("EEI") Property
9 Accounting and Valuation Committee and have also served as Chairman of
10 EEI's Depreciation and Economic Issues Subcommittee. I am a Registered
11 Professional Engineer in the State of Texas and a Certified Depreciation
12 Professional. I am a Senior Member of the Institute of Electrical and
13 Electronics Engineers ("IEEE") and served for several years as an officer of
14 the Executive Board of the Dallas Section of IEEE. I am also currently Past-
15 President of the Society of Depreciation Professionals.

16
17 Q. DO YOU HOLD ANY SPECIAL CERTIFICATION AS A DEPRECIATION EXPERT?

18 A. Yes. The Society of Depreciation Professionals ("SDP") has established
19 national standards for depreciation professionals. The SDP administers an
20 examination and has certain required qualifications to become certified in this
21 field. I have met all of these requirements and hold a Certified Depreciation
22 Professional certification.

23
24 Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE ANY REGULATORY COMMISSION?

25 A. Yes. I conducted depreciation studies and filed testimony regarding
26 depreciation and valuation issues before the Public Utility Commission of
27 Texas in Docket Nos. 11735, 12160, 15195, 16650, 18490, 20285, 22350,

1 23640, 24040, 32766, and 34040, before the Railroad Commission of Texas in
2 Gas Utility Docket Nos. 8976, 9145-9148, 9225, 9313, 9400, 9670, and 9762,
3 before the Arkansas Public Service Commission in Docket No. 06-161-U,
4 before the Public Utilities Commission of the State of Colorado in Docket
5 06S-656G, and before the New Mexico Public Regulation Commission in
6 Case No. 07-00319-UT. I also appeared in Federal Energy Regulatory
7 Commission (“FERC”) Docket No. 02-7-00 as an industry panelist on Asset
8 Retirement Obligations (“ARO”).
9

10 Q. FOR WHOM ARE YOU TESTIFYING?

11 A. I am testifying on behalf of Northern States Power Company, (“Xcel Energy”
12 or the “Company”) a Minnesota corporation operating as a public utility in
13 North Dakota.
14

15 Q. HAVE YOU PREVIOUSLY PROVIDED TESTIMONY IN THIS PROCEEDING?

16 A. No.
17

18 Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY IN THIS
19 PROCEEDING?

20 A. The purpose of my Rebuttal Testimony is to respond to statements made by
21 Mr. Charles King and Mr. Michael Majoros in their Direct Testimonies
22 presented on behalf of the Advocacy Staff of the North Dakota Public
23 Service Commission (the “Commission”) and related to Xcel Energy’s
24 depreciation study and retirement practices. More specifically, I will address
25 Mr. King’s proposal for determining retirement costs and Mr. Majoros’
26 proposal for refunding amounts paid by past ratepayers toward future
27 retirement costs. The other depreciation-related issues raised by Mr. King

1 regarding changes to a remaining life methodology, life extensions, and the
2 development of a North Dakota-specific depreciation study will be addressed
3 by Mr. Jeffrey Robinson.
4

5 II. SUMMARY AND ORGANIZATION 6

7 Q. PLEASE PROVIDE A SUMMARY OF YOUR REBUTTAL TESTIMONY.

8 A. To summarize where the issues are, the main difference between the
9 Company's recommendations regarding depreciation and Mr. King's
10 recommendations are the choice of the depreciable life (which is addressed by
11 Mr. Robinson in his Rebuttal Testimony), and the amount of retirement costs
12 to be included in rates. The other major adjustment presented by Mr.
13 Majoros relates to the treatment of "non-legal asset retirement obligations"
14 ("non-legal cost of removal" or "non-legal ARO"). Both Mr. King and Mr.
15 Majoros' retirement cost proposals cause significant intergenerational
16 inequities and are not in the ratepayers' interest. In the case of Mr. King's
17 proposal, retirement costs would be based on current costs, when it is beyond
18 debate that future actual retirement costs will be substantially higher. Current
19 ratepayers should be required to pay their proportionate share of the costs
20 related to the assets used to provide them with utility service, rather than
21 shifting those costs to future ratepayers. Similarly, under Mr. Majoros'
22 proposal, amounts paid by past ratepayers would be refunded to current
23 ratepayers, only to be recollected from future ratepayers, creating yet another
24 intergenerational disparity. I will also explain the inappropriateness of using
25 the accounting pronouncements that Mr. Majoros relies upon to support his
26 ARO adjustment and show the lack of relevance they have on utility
27 ratemaking in general, and on and this case in particular.

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III. NET SALVAGE

Q. WHAT IS NET SALVAGE?

A. Net salvage is the difference between the gross salvage (the value of a unit retired from service resulting from its sale for scrap or reuse) and the removal cost (the expense incurred to remove the unit from service including expenses necessary to return the environment to an acceptable condition, as well as disposal of the unit). Net salvage is expressed as a percentage of plant retired. That percentage is determined by dividing the net salvage by the original cost of the retired plant.¹ Some plant assets can experience significant negative removal cost percentages.

Q. PLEASE PROVIDE AN EXAMPLE.

A. Assume for example, a Distribution asset in FERC Account 364 with a removal cost of \$50 and a current installed cost of \$500 (the cost if the asset were installed in 2008). Further assume that this asset had an actual installed cost of \$63 in 1969. If one were to calculate removal cost as simply a percentage of the current installation cost, a removal cost of \$50 for the asset would only have a negative ten percent removal cost ($\$50/\500). This result would be incorrect. The correct removal cost calculation would show approximately negative 80 percent removal cost for that asset ($\$50/\63).

Q. WHY IS IT APPROPRIATE TO CALCULATE THE PERCENTAGE BASED ON INITIAL INSTALLATION COST?

A. This is because the depreciation rate, which includes the removal cost percentage, will be applied to the original installed cost of assets. The

¹ NARUC Public Utilities Depreciation Practices, August 1996, Page 18.

1 purpose of including the life-cycle net salvage in the depreciation calculation
2 is to fully recover the cost of removing an asset (minus any salvage) by the
3 end of the life of the asset. If inflation in removal costs from the time of
4 installation of the asset until the time of its removal were ignored during the
5 life of the asset, the higher removal costs would not be recovered during the
6 life of the asset and would become a cost unfairly imposed on future
7 customers.

8
9 Q. WHAT DO MR. KING AND MR. MAJOROS RECOMMEND WITH REGARD TO NET
10 SALVAGE?

11 A. Mr. King and Mr. Majoros recommend moving away from accrual
12 accounting and the normal and accepted method of calculating net salvage,
13 which is used in all but a few states, in favor of a form of "pay-as-you-go",
14 cash-basis removal cost recovery with a refund of all accrued removal cost.
15 Mr. King recommends allowing in the cost of service only the average of the
16 last five years of cost actually incurred to remove assets. Thus, instead of
17 rates reflecting cost which will necessarily be higher in the future, he
18 proposes using a below-cost historical average or, in the alternative, a below-
19 cost current value. Mr. Majoros recommends refunding all historically-
20 accrued non-legal cost of removal.

21
22 Q. PLEASE SUMMARIZE HOW THE COMPANY'S NET SALVAGE METHOD IS
23 DIFFERENT FROM WHAT MR. KING REQUESTS?

24 A. Consistent with how depreciation expense is determined, the Company is
25 requesting a straight-line accrual, over the life of the assets, of the cost to
26 remove the assets at the end of their useful lives. This accrual method is used
27 by this Commission and nearly all Commissions in the country for a good

1 reason. It ensures that customers who are provided service from an asset pay
2 equally the full cost of the asset (installation cost and removal cost). The
3 method used by the Company is supported by 73 years² of traditional and
4 accepted depreciation theory.

5
6 On the other hand, Mr. King recommends moving away from accrual
7 accounting, preferring that removal cost instead be paid by customers after it
8 is incurred. Mr. King's method is simply a variation of the "pay-as-you-go"
9 methodology (using a 5-year average instead of a single year). Mr. King's
10 alternative method would use the present value of future retirement costs
11 (that is, the projected future retirement with the cost of inflation removed).

12
13 Whereas the accrual method recovers the cost of removal equally from all of
14 the customers who benefit from use of the asset over the life of the asset, the
15 pay-as-you go/present value methods forces future customers to be burdened
16 with most of the cost associated with removing assets used by past customers.
17 The effect of Mr. King's method is to defer, or "back-load", the payment of
18 removal cost from current customers to future customers, and this would
19 require future customers to pay not only their portion of the removal costs
20 but also the portion of the removal costs that was not recovered from prior
21 customers. Mr. King's backend loaded method would create intergenerational
22 inequities, while the Company's method does not.

23
24

² Bulletin 125 by Robley Winfrey from the Engineering Research Institute of Iowa State University, titled "Statistical Analyses of Industrial Property Retirements", originally published in 1935 is the original basis for modern depreciation theory.

1 Q. ARE THE COMPANY'S NET SALVAGE RATES "EXCESSIVE"?

2 A. No. The methodology used by the Company for estimating the percentage of
3 inflation for retirement costs, which I discussed earlier, is the accepted
4 industry standard. Further, compared to the industry, Xcel Energy's net
5 salvage request is well within the norm of other utilities and is, in fact,
6 significantly less in many accounts than the average across the Country.

7

8 Q. DO YOU BELIEVE MR. KING'S RECOMMENDED METHODOLOGY IS AN
9 APPROPRIATE METHOD TO USE IN DETERMINING NET SALVAGE RATES?

10 A. No. There are a number of problems with his method. First, it contradicts
11 the recognized authoritative texts on net salvage analysis. Second, it creates
12 tremendous intergenerational inequities. Third, it contradicts the straight-line
13 depreciation methodology that this Commission has historically followed.
14 Fourth, it creates different recovery methods within a single depreciation rate
15 (the asset depreciation is recovered using a straight-line method and the net
16 salvage cost is recovered under a deferral mechanism). Fifth, using this
17 deferral mechanism will have a detrimental effect on the total cost customers
18 will pay for use of the assets over the lives of the assets.

19

20 Q. PLEASE GIVE EXAMPLES OF HOW USING A 5-YEAR HISTORICAL AVERAGE (PAY-
21 AS-YOU-GO) NET SALVAGE CONTRADICTS AUTHORITATIVE GUIDANCE.

22 A. All authoritative utility depreciation sources agree that projecting the cost to
23 remove assets at the end of their lives is a necessary factor in establishing net
24 salvage rates. The National Association of Regulatory Utility Commissioners
25 ("NARUC") "Public Utility Depreciation Practices" supports the use of
26 estimated future salvage and removal cost as part of the depreciation

1 calculation. The publication, "Public Utility Depreciation Practices" (1996
2 Edition) published by NARUC states:

3
4 Under presently accepted concepts, the amount of depreciation to
5 be accrued over the life of an asset is its original cost less net
6 salvage. **Net salvage is the difference between the gross**
7 **salvage that will be realized when the asset is disposed of**
8 **and the cost of retiring it.** Positive net salvage occurs when
9 gross salvage exceeds cost of retirement, and negative net salvage
10 occurs when cost of retirement exceeds gross salvage. **Net**
11 **salvage is expressed as a percentage of plant retired by**
12 **dividing the dollars of net salvage by the dollars of original**
13 **cost of plant retired.** The goal of accounting for net salvage is to
14 allocate the net cost of an asset to accounting periods, making due
15 allowance for the net salvage, positive or negative. This concept
16 carries with it the premise that property ownership includes the
17 responsibility for the property's ultimate abandonment or
18 removal. Hence, **if current users benefit from its use, they**
19 **should pay their pro rata share of the costs involved in the**
20 **abandonment or removal of the property** and also receive their
21 pro rata share of the benefits of the proceeds realized.

22 **This treatment of net salvage is in harmony with generally**
23 **accepted accounting principles** and tends to remove from the
24 income statement any fluctuations caused by erratic, although
25 necessary, abandonment and removal operations. It also has the
26 advantage that **current customers pay or receive a fair share of**
27 **cost associated with the property devoted to their service,**
28 **even though the costs may be estimated.**³

29
30 Also, two of the most widely regarded experts on depreciation, Frank Wolf
31 and Chester Fitch, state in their 1994 treatise Depreciation Systems:

32
33 **Effect of Inflation on the Salvage Ratio: One inherent**
34 **characteristic of the salvage ratios is that the numerator and**

³ NARUC *Public Utility Depreciation Practices*, Page 18 (emphasis added).

1 denominator are measured in different units; the numerator is
2 measured in dollars at the time of retirement while the
3 denominator is measured in dollars at the time of installation.⁴
4

5 Drs. Wolf and Fitch further explain the importance of recognizing the future
6 cost to retire current assets as follows:
7

8 Negative salvage is a common occurrence. With inflation, the cost
9 of retiring long-lived property, such as a water main, may exceed
10 the original installed cost. Decommissioning cost of nuclear power
11 plants is an example of large negative salvage. The matching
12 principle specifies that all costs incurred to produce a service
13 should be matched against the revenue produced. **Estimated**
14 **future costs of retiring of an asset currently in service must be**
15 **accrued and allocated as part of the current expenses. ... The**
16 **accounting treatment of these future costs is clear. They are**
17 **part of the current cost of using the asset and must be**
18 **matched against revenue. While the current consumers**
19 **would say they should not pay for future costs, it would be**
20 **unfair to the future users if these costs were postponed. Some**
21 **say that although the current consumers should pay for the future**
22 **cost, that the future value of the payments, calculated at some**
23 **reasonable interest rate, should equal the retirement cost. Studies**
24 **show that the salvage is often “more negative” than forecasters had**
25 **predicted.**⁵
26

27 Q. HOW DOES ONLY ALLOWING A HISTORICAL 5-YEAR AVERAGE AMOUNT,
28 INSTEAD OF CONDUCTING A NET SALVAGE ANALYSIS, SHIFT THE BURDEN OF
29 REMOVING ASSETS TO FUTURE CUSTOMERS?

30 A. The Commission has a long history of using straight-line depreciation for
31 recovering the cost of assets and their associated net salvage cost. Using a

⁴ See Depreciation Systems, page 53 (emphasis added).

⁵ See Depreciation Systems, pages 7 and 8 (emphasis added).

1 5-year historical average cost as a substitute for net salvage analysis will no
2 longer allow the recovery of removal cost on a straight-line basis. In reality,
3 Mr. King's method is extremely back-end loaded.

4

5 Q. WOULD YOU DEMONSTRATE HOW MR. KING'S METHOD SHIFTS THE BURDEN
6 OF REMOVING ASSETS TO FUTURE CUSTOMERS?

7 A. Yes. Assume a distribution asset account was placed in service ten years ago
8 with a \$1,000 investment. Each year for the next nine years the same
9 investment is made in the class (increased at a three percent inflation rate) so
10 that you have the following ten years of investment in the account.

Year 1	\$1,000
Year 2	\$1,030
Year 3	\$1,061
Year 4	\$1,093
Year 5	\$1,126
Year 6	\$1,159
Year 7	\$1,194
Year 8	\$1,230
Year 9	\$1,267
Year 10	\$1,305
Total	\$11,465

11

12 The retirement pattern for each vintage (year of investment) is a 60 R2
13 mortality curve. This means that the assets will retire, on average, at 60
14 years (with some assets retiring earlier than 60 years and some retiring older
15 than 60 years). In this example, which reasonably mimics real life, we have
16 just closed Year 10 and are calculating removal cost for use in a depreciation

1 study. At Year 10, we know that it costs 50 percent of the original cost of
2 the assets that are retiring to remove them. Using normal straight-line
3 depreciation, each asset's removal cost will be depreciated over the life of
4 that asset (e.g. an asset that will last 5 years will have its removal cost spread
5 over its five-year life and an asset that will live 100 years will have its
6 removal cost spread over 100 years). As shown in Chart 1 below, the
7 traditional method creates a recovery pattern where smaller and smaller
8 accruals occur each year as fewer and fewer assets remain in service (i.e.
9 customers only pay for the portion of the assets they are receiving benefit
10 from). Under the normal straight-line removal cost accrual, in Year 10
11 (when all assets are still in service), the accrual would be approximately \$95.
12 As assets are retired, the accrual decreases until at Year 85 (when 80 percent
13 of the assets are retired), the accrual is only \$25. In contrast, under Mr.
14 King's method, customers would be charged \$2.69 in Year 10 for removal
15 cost (when all assets are being used by customers). In Year 85 (when only
16 20 percent of the assets remain), Mr. King's method would require the
17 Company to charge \$100. Customers under Mr. King's method will pay 37
18 times as much in Year 85 in removal cost while having use of only 20
19 percent of the assets as customers in Year 10 and customers in Year 85 will
20 be paying for the removal of assets that are not providing service to them.

21

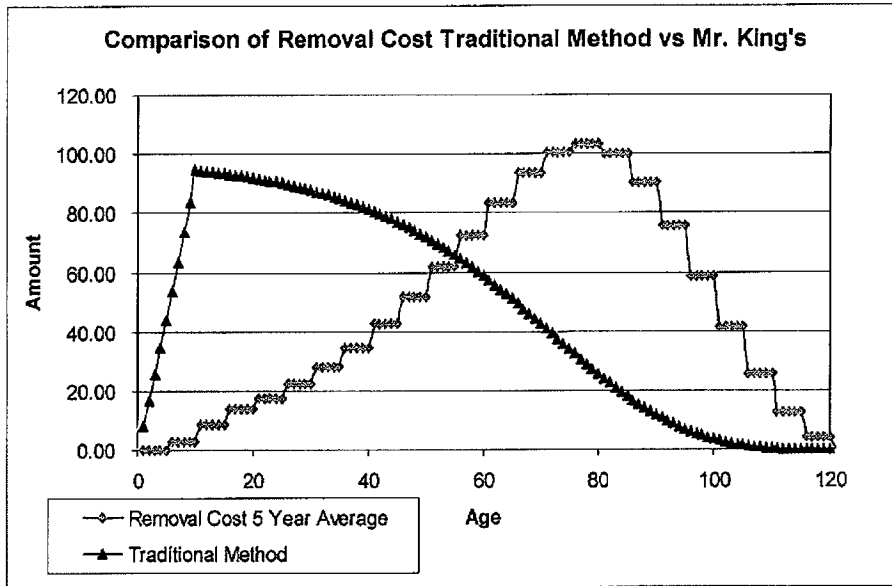
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Chart 1



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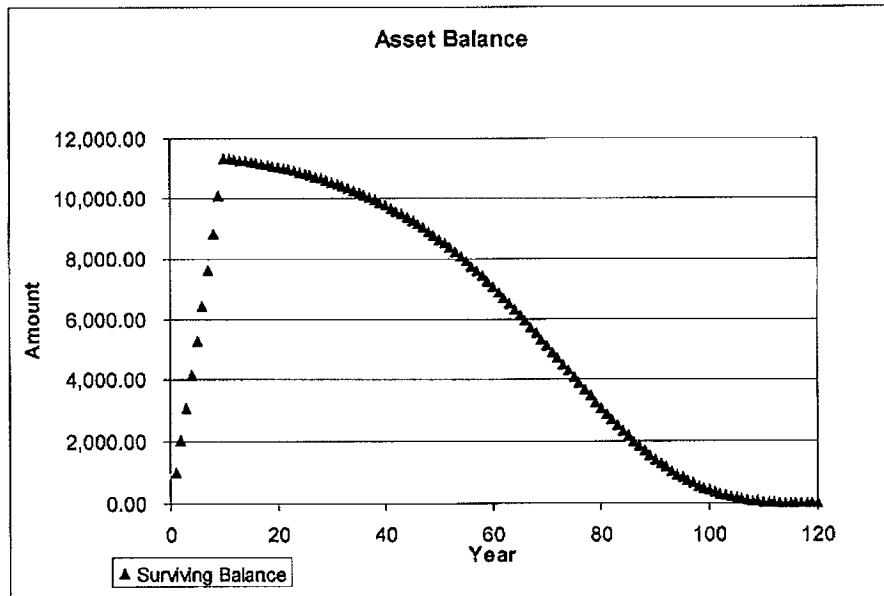
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8

Chart 2 below shows the surviving asset balance over the lives of the assets. This pattern matches very closely the pattern of the recovery of removal cost under the traditional method. In other words, customers contribute toward the removal of assets in the same pattern as their usage of the assets.

Chart 2

9



10

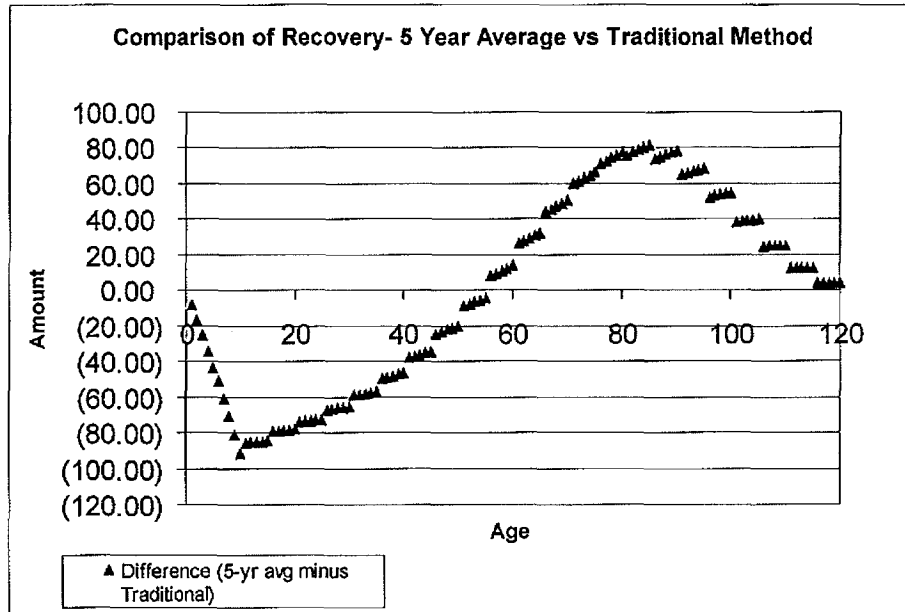
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13

1 Chart 3 below shows the difference between the accrual pattern of the
2 traditional approach and Mr. King's "pay-as-you-go" method.

3
4 Chart 3



16
17 Clearly, this pattern created by Mr. King's pay-as-you-go method shifts the
18 removal cost and creates a burden to future customers who do not have use
19 of the assets or, in regulatory parlance, creates an impermissible
20 intergenerational inequity.

21
22 Q. PLEASE EXPLAIN THE INTERGENERATIONAL EQUITY PROBLEM CAUSED BY
23 MR. KING'S PROPOSAL.

24 A. A good analogy for Mr. King's removal cost proposal, as compared to
25 Commission precedent (and the Company's practice), is a balloon mortgage
26 as opposed to a fixed rate mortgage for a homeowner. Under the existing
27 removal cost paradigm of the Commission and the Company, the recovery of

1 removal costs could be viewed as a fixed rate mortgage. In a fixed rate
2 mortgage, the total future cost of the mortgage is paid evenly over the life of
3 the loan. The current paradigm is that the estimated amount of removal cost
4 required to remove assets at the end of their lives (parallel to the total
5 mortgage cost) is accrued evenly, or on a straight-line basis, over the expected
6 life of the assets (parallel to the loan period). The effect on ratepayers of
7 adopting Mr. King's paradigm is to, in effect, move from a fixed rate
8 mortgage to a balloon mortgage. Under a balloon mortgage, a small payment
9 sufficient to cover interest is paid each year until the balloon payment for the
10 actual loaned amount is required. Paying this balloon payment will be a
11 significant problem, unless the holder of the mortgage has been saving during
12 the life of the loan for the eventual balloon payment. Mr. King's plan would
13 have the Company accrue a small amount each year that would only cover the
14 normalized average of the last five year's removal cost. Unfortunately, as with
15 the balloon mortgage, this does not allow the Company to "save" for the
16 dramatically higher cost to remove assets at future costs. The customers
17 paying these "balloon payment removal costs" will be those customers who
18 are using the asset at the end of or after its useful life. The effect that this
19 proposal has on future ratepayers is clear. Future customers will be forced to
20 pay a disproportional share of the removal costs of assets that current
21 customers are using.

22
23 Q. IS DEFERRING DEPRECIATION EXPENSE GOOD FOR CUSTOMERS?

24 A. No. The deferral of depreciation expense will cost customers more over the
25 life of an asset than contributing depreciation expense on a straight-line basis.
26 In the same way that a home buyer will pay more over the life of a loan
27 making lower principal payments (due to higher interest payments on the

1 outstanding balance), the deferral of depreciation expense increases rate base
2 (retirement payments are an offset to rate base), which causes customers to
3 pay more in return on investment. Using a 10 percent rate of return with the
4 earlier example, customers would pay approximately \$4,600 more (or an
5 additional 40 percent of the original asset cost) in return on investment over
6 the life of the asset using the deferral approach. During the first few years,
7 the pay-as-you-go approach would artificially lower rates. As seen in Chart 3
8 above, the pay-as-you-go approach is significantly more costly later in the life
9 of the asset. Deferring depreciation expense is not good for customers.

11 IV. ASSET RETIREMENT OBLIGATIONS

12
13 Q. PLEASE DESCRIBE MR. MAJOROS' TESTIMONY RELATED TO DEPRECIATION IN
14 THIS PROCEEDING.

15 A. Mr. Majoros believes that the Securities and Exchange Commission ("SEC")
16 pronouncement accepting the Statement of Financial Accounting Standards
17 No. 143 ("FAS 143") provides new information that should cause the
18 Commission to reconsider the normal accounting for retirement costs that it
19 has used for many years.⁶ He further recommends that because this
20 pronouncement recognizes that, for regulated utilities, retirement costs have
21 been accrued for the future removal of assets where there is no legal
22 obligation to remove the assets, this accrued removal cost should be
23 transferred to a regulatory liability for ratemaking purposes.⁷ Finally, he
24 recommends that the accrued removal costs where there is no legal obligation
25 should then be returned to the customers over a 10-year period.⁸

26

⁶ Direct Testimony of Mr. Majoros, page 9.

⁷ Direct Testimony of Mr. Majoros, page 12, lines 11-12.

1 Q. ARE MR. MAJOROS' RECOMMENDATIONS REASONABLE OR APPROPRIATE?

2 A No. The Commission's current process, which is used by nearly every state in
3 the country, is appropriate. As I will demonstrate, the concepts and broad
4 assumptions underlying Mr. Majoros' proposal are incorrect. Additionally,
5 the Company is not aware of any Commission that has ordered utilities to
6 refund their accumulated removal costs based on FAS 143, as proposed by
7 Mr. Majoros.

8

9 Q. WHAT IS THE STATED BASIS FOR MR. MAJOROS' RECOMMENDATION TO
10 REFUND ALL ACCRUED REMOVAL COST?

11 A Mr. Majoros states two primary reasons for this recommendation. The first is
12 that "[he] do[es] not believe NSP will ever spend all of this money on future
13 cost of removal."⁹ Secondly, he states that, "as long as the money remains in
14 the Company's hands, it will do whatever it can to convert the regulatory
15 liability to income."¹⁰ Neither of these assumptions is correct.

16

17 Q. DOES XCEL ENERGY HAVE A HISTORY OF USING ITS ACCRUED REMOVAL
18 COST?

19 A. Yes. Although Mr. Majoros states that "my experience shows that it is
20 unlikely that all of the amounts collected will be spent for future cost of
21 removal",¹¹ the reality is that Xcel Energy has a strong record of removing
22 assets and, in a number of instances, has not accrued sufficient removal cost
23 to cover the removal of those assets. Mr. Majoros has provided no evidence
24 that the amounts held for future retirement are excessive, while the Company
25 has shown that its retirement percentages are conservative. In addition, under

⁸ Direct Testimony of Mr. Majoros, page 21, lines 9-14.

⁹ Direct Testimony of Mr. Majoros, page 21, lines 4-8.

¹⁰ Direct Testimony of Mr. Majoros, page 21, lines 4-8.

1 established depreciation principals, any excess retirement amounts would
2 automatically be used to reduce the depreciation expense. It is only under his
3 extreme assumption of deregulation that the Company could even possibly
4 recognize the difference as income. Even if that were plausible, which it is
5 not, any mismatch can hardly justify eliminating all of the accumulated
6 retirement amounts.

7
8 Q. PLEASE DESCRIBE AN EXAMPLE CURRENTLY TAKING PLACE AT THE COMPANY
9 THAT DEMONSTRATES THE COMPANY NOT ONLY USES ACCRUED REMOVAL
10 COSTS BUT ALSO HAS IN SOME CASES UNDER ACCRUED FOR REMOVAL COST.

11 A. Xcel Energy is currently in the process of completely demolishing the High
12 Bridge Steam Plant, a multiple unit coal-burning facility. The portion of the
13 plant site containing the former coal-burning facility is being brought to
14 green-field conditions. A new natural gas fired combined-cycle unit is being
15 constructed on a separate portion of the original plant site.

16
17 Q. WHAT NET SALVAGE RATE WAS USED FOR THE HIGH BRIDGE GENERATING
18 PLANT?

19 A. In the early 1980s, the Minnesota Public Utilities Commission ("MPUC")
20 approved the use of an average net salvage percentage of approximately
21 negative 5 percent for High Bridge. (If the cost of removal exceeds the
22 salvage value of the retired plant components, then the net salvage value will
23 be negative.)

24
25 Q. IS THE NEGATIVE 5 PERCENT ESTIMATED NET SALVAGE SUFFICIENT TO
26 REMOVE THE HIGH BRIDGE PLANT?

¹¹ Direct Testimony of Mr. Majoros, Page 13, lines 13-14.

1 A. No. The historical use of approximately negative 5 percent net salvage for
2 High Bridge has resulted in \$5.2 million in removal costs being accrued at the
3 end of the plant's operational life. The most recent estimate of removal and
4 remediation costs for the High Bridge Steam Plant (which currently is being
5 dismantled) is \$35.9 million. The actual cost that will be incurred equates to a
6 negative 32 percent net salvage value. Future customers who did not benefit
7 from the use of the original High Bridge generating facility will now be
8 burdened with paying this cost. This is the same type of intergenerational
9 inequity that will happen to Xcel Energy's customers for all assets, if the
10 Commission accepts Mr. Majoros' recommendation. Under Mr. Morojors'
11 recommended method, the shortfall would have been \$35.9 million, since his
12 approach refunds all historically-accrued net salvage.

13

14 Q. PLEASE PROVIDE ANOTHER EXAMPLE THAT FURTHER ILLUSTRATES THE COST
15 OF REMOVAL ISSUE AND THE PRACTICE OF THE COMPANY TO REMOVE ASSETS.

16 A. The Minnesota Valley Generating Plant is owned by Xcel Energy and was
17 retired in 2004. While in-service, approximately \$906,000 in removal costs
18 was recorded. In a 2004 demolition study (conducted immediately before
19 dismantling the plant) performed by Utility Engineering and Veit Companies
20 the estimated demolition costs were \$10.1 million. This estimate equates to a
21 negative 72 percent net salvage rate. Under Mr. Majoros' recommended
22 methodology, there would have been a \$10.1 million shortfall.

23

24 Q. HOW IS THE UNDER-RECOVERY OF DEMOLITION COST FOR THE MINNESOTA
25 VALLEY GENERATING PLANT BEING ADDRESSED?

26 A. In a recent decision in Docket No. E, G002/D-05-288, the MPUC provided
27 a 12.5-year time period for NSP-Minnesota to record additional cost of

1 removal dollars through the monthly depreciation accrual process. Given that
2 the Minnesota Valley facility is not in-service, current ratepayers receive no
3 benefit in the form of generated electricity during the 12.5 years while these
4 additional costs are being recorded, and the ratepayers who received the
5 actual benefit of the generation from the plant did not pay for the full cost of
6 the generation. Accepting Mr. King's recommendation would result in a
7 similar mismatch in revenues versus expenses and intergeneration inequities
8 for all non-legal asset obligations.

9

10 Q. DOES THE COMPANY INTEND TO "TRANSFER THE REGULATORY LIABILITY
11 (I.E. ACCRUED REMOVAL COST) INTO GAAP INCOME"?

12 A. No. Mr. Majoros based his supposition on a statement in the Company's
13 SEC Form 10-K. These financial statements are conservative in nature, and
14 the statement Mr. Majoros refers to is for the entire section on regulatory
15 assets and liabilities, not just the non-legal cost of removal. Mr. Majoros'
16 supposition is further premised on a claim that future deregulation would
17 allow the Company to transfer the regulatory liability to the income statement.
18 Whereas, in reality, if deregulation were to occur (which there is no indication
19 of happening), the Company, the North Dakota legislature, and the
20 Commission could deal with all regulatory assets and liabilities as deregulation
21 was put in place.

22

23 In its recent natural gas rate case (Case No. PU-06-525), the Company
24 included the following as an Amendment to the Settlement Agreement:

25

26 Should, at any future date, there be change in regulation or other
27 event that would result in a change in the above-described
28 process [for treatment of retirement costs] the Company agrees

1 to work with the Commission to ensure that any accumulated
2 depreciation amounts for retirement purposes are considered
3 and appropriately addressed as part of that change.
4

5 The Company renews that offer in this proceeding.
6

7 Mr. Majoros raised these same issues in the most recent gas rate case for
8 Public Service Company of Colorado (“PSCo”), an affiliate of the Company,
9 in Case No 06S-656G. Mr. Majoros’ concerns were addressed in a settlement
10 in which PSCo agreed to “include a footnote in its future annual FERC Form
11 2 filings disclosing the non-legal asset retirement obligation portion of
12 accumulated depreciation for its gas utility operations.” The Company is
13 willing to make the same disclosure in its annual North Dakota Public
14 Utilities Commission Annual Report as well.
15

16 Q. WHAT IS THE PURPOSE OF FAS 143, ACCOUNTING FOR ASSET RETIREMENT
17 OBLIGATIONS?

18 A. The best response to this question is to refer to the introductory paragraphs
19 provided in the pronouncement itself, which establishes financial reporting
20 obligations related to legal retirement obligations. From FAS 143, page 4,
21

22 FAS 143 Summary

23 This Statement addresses financial accounting and reporting for
24 obligations associated with the retirement of tangible long-lived
25 assets and the associated asset retirement costs. This Statement
26 applies to all entities. It applies to legal obligations associated with
27 the retirement of long-lived assets that result from the acquisition,
28 construction, development and (or) the normal operation of a
29 long-lived asset, except for certain obligations of lessees. **As used**
30 **in this Statement, a legal obligation is an obligation that a**
31 **party is required to settle as a result of an existing or enacted**
32 **law, statute, ordinance, or written or oral contract or by legal**

1 **construction of a contract under the doctrine of promissory**
2 **estoppel. (Emphasis supplied)**

3
4 The Financial Accounting Standards Board (“FASB”) chose to standardize the
5 financial reporting process around retirement costs that are directly related to
6 legally required transactions (a “legal ARO”). Accordingly, the main impetus
7 behind the creation of FAS 143 was to increase consistency and comparability
8 in financial reporting to the financial markets and any reader of the financial
9 reports. An example of a legal-ARO is legally required asbestos removal
10 within a building. In contrast, regulatory cost recovery for removal includes
11 both the asbestos removal expense and the expense of removing all other
12 components of the building.

13
14 Q. PLEASE SUMMARIZE THE FAS 143 TREATMENT AT XCEL ENERGY FOR
15 FINANCIAL REPORTING PURPOSES.

16 A. Beginning in 2003, Xcel Energy recognized a mathematical portion of the
17 traditional accumulated depreciation as a regulatory liability (i.e. all non-ARO
18 removal cost) because of the change in financial presentation and reflected
19 this on its financial books. The FASB, in its mission to make the presentation
20 of financial information meaningful and comparable for legal obligations,
21 decided on a common method of recognition of those obligations that should
22 be utilized by all public corporations. Nothing in FAS 143 affected the
23 treatment of non-legal cost of removal, only their recognition in financial
24 reporting.

25
26 Thus, FASB touched on the minimum amount Xcel Energy could recognize
27 in its financial reports and statements regarding removal costs. In contrast,
28 state regulatory commissions have historically set rates to recover the

1 expected total amount needed for the cost of removal, because that approach
2 best protects ratepayer interests and prevents intergenerational inequities.
3 This distinction between the financial and regulatory treatment meant that the
4 difference between the lower financial reporting amount (legal-ARO) and the
5 higher amount actually recovered in rates (non-ARO cost of removal) would
6 accumulate as a regulatory liability. Basically, the change caused by FAS 143
7 with respect to removal obligations was merely “balance sheet geography”, as
8 the cost of removal amount included in accumulated depreciation was
9 reclassified to a regulatory liability at the request of the SEC for financial
10 reporting purposes.

11

12 Q. IS IT NECESSARY FOR THE COMMISSION TO CREATE A NEW REGULATORY
13 LIABILITY FOR RATE MAKING PURPOSES?

14 A. No. The Company and the Commission have long treated the accumulated
15 retirement amounts as comparable to a regulatory liability, using the funds to
16 offset rate base. Mr. Majoros recommends that the Commission require the
17 Company to set up its accumulated depreciation balance for non-legal cost of
18 removal as a regulatory liability. He states,

19

20 “As a result, nothing holds NSP specifically accountable for
21 these excess collections, even though the public accounting
22 profession and the Securities and Exchange Commission
23 recognize that they are regulatory liabilities and that the PSC
24 implicitly holds NSP accountable.”¹²

25

26

27 As was demonstrated above, the Company has already done just that for
28 financial reporting purposes for legal and non-legal obligations. For
29 regulatory purposes, removing accumulated retirement amounts from the

1 accumulated depreciation reserve would provide no additional ratepayer
2 protection.

3
4 Q. WHAT IS THE DIFFERENCE BETWEEN THE CURRENT PROCESS AND THE ONE
5 PROPOSED BY MR. MAJOROS?

6 A. The easiest way to explain the difference is to provide an example using one
7 asset. Assume, for example, that only one asset exists, the original cost of the
8 asset is \$100, the asset lasts 25 years, and it has an estimated removal cost of
9 50 percent. Under the normal ratemaking process, depreciation expense will
10 accumulate until the account is fully depreciated (i.e., the amount accrued
11 equals the sum of the original cost (\$100) plus the estimated removal cost
12 (\$50)). The Company would split the depreciation expense into two balance
13 sheet accounts for financial reporting purposes with a portion of depreciation
14 expense associated with estimated future removal cost being booked to
15 "other regulatory liabilities." For ratemaking purposes, those two accounts
16 are combined together in the accumulated depreciation account. At the end
17 of the life of the asset (before its retirement), the balance in the other
18 regulatory liability account is \$50 – which is the amount needed to remove
19 the asset. At retirement, the asset will be retired and the removal expense
20 incurred will reduce the regulatory liability account to zero.

21
22 The main difference under Mr. Majoros' proposed method is that he
23 proposes to return to customers (through an amortization) the other
24 regulatory liability account balance that has accumulated to date. If we
25 assume that we are currently half way through the life of the asset, \$25 will be
26 paid to current ratepayers. Current ratepayers, however, did not pay that \$25.

¹² Direct Testimony of Mr. Majoros, Page 13, Lines 4-7.

1 Prior ratepayers paid it. At the time of retirement of the asset, there would be
2 no accrued Other Regulatory Liability account balance against which to
3 charge the removal cost. That cost would be born completely by future
4 customers who receive service after the asset retires and who did not receive
5 any benefit from using the asset. This would be inconsistent with widely
6 accepted regulatory matching principles. As Xcel Energy will explain in its
7 post-hearing brief in this proceeding, it is also prohibited retroactive
8 ratemaking, because it refunds amounts lawfully recovered under previously
9 approved Commission rates

10
11 Q. HOW DOES THE FERC TREAT THE RETIREMENT AMOUNTS THAT ARE
12 COLLECTED WHERE THERE IS NO LEGAL OBLIGATION?

13 A. The FERC has made no change in the treatment of non-legal cost of removal
14 accruals. In FERC Order 631, Section D: Accounting for Cost of Removal
15 That Does Not Constitute a Legal Obligation, Paragraph 36, the FERC states,

16
17 Under the existing requirements of the Uniform Systems of
18 Accounts removal costs that are not asset retirement obligations
19 are included as a component of the depreciation expense and
20 recorded in accumulated depreciation.³⁰ The Commission notes
21 that certain jurisdictional entities may have been receiving specific
22 allowances for cost of removal for non-legal retirement
23 obligations as a specific component in their rates approved by
24 their regulators. The Commission did not propose any changes to
25 its existing accounting requirements for cost of removal for non-
26 legal retirement obligations. Accordingly, jurisdictional entities are
27 accounting for such costs consistent with the requirements of the
28 Uniform Systems of Accounts under Part 101 for public utilities
29 and licensees, Part 201 for natural gas companies and Part 352 for
30 oil pipeline companies.

31 ³⁰ See Definition 10 in 18 CFR Part 101 (Public Utilities and Licensees),
32 Definition 10 in 18 CFR Part 201 (Natural Gas Companies), and Definition 12
33 in 18 CFR Part 352 (Oil Pipeline Companies).

1 The FERC did not see a need to change the traditional process. Mr. Majoros
2 was a party to this rulemaking proceeding and participated by providing
3 comments (NASUCA at pp. 15-17), suggesting what he is recommending in
4 this current proceeding to FERC and was rejected by FERC (FERC Order
5 631 Paragraph 37): “However, this issue is beyond the scope of this rule and
6 we are not convinced that there is a need to fundamentally change accounting
7 concepts at this time.”

8
9 The Company believes that the FERC was attempting to 1) develop a
10 financial presentation that would be acceptable to the SEC, the FERC, and
11 the financial markets and 2) not to change long-established rate making
12 practices. Simply put, the FERC felt the rules in place were sufficient.

13
14 Q. DOES THE FAS 143 PRONOUNCEMENT OR FERC ORDER 631 OFFER “NEW
15 INFORMATION” TO THE COMMISSION AS MR. MAJOROS CLAIMS?

16 A. No. The fact that there is a regulatory liability embedded in the Accumulated
17 Provision for Depreciation is not a new fact. The SEC merely wanted
18 regulated utilities to recognize regulatory liabilities for financial reporting
19 purposes. FERC simply gave utilities the ability to report without conflicting
20 with the SEC. Mr. Majoros’ justification for significantly reducing the
21 Company’s depreciation expense because there is “new information” is
22 incorrect.¹³

23
24 Q. PLEASE SUMMARIZE THE PROBLEMS WITH MR. MAJOROS’ RECOMMENDATION
25 TO REQUIRE THE COMPANY TO REFUND ALL NON-LEGAL REMOVAL COST
26 THAT HAS BEEN ACCRUED FOR FUTURE ASSET REMOVAL.

¹³ Direct Testimony of Mr. Majoros, Page 9, lines 2-5.

1 A. Mr. Majoros' recommendation would require the Company to give back
2 funds previously authorized by this Commission and recollect those same
3 funds in the future. His recommendation is:

- 4 • Not required nor even suggested by any authoritative text and was
5 specifically rejected by the FERC, and to the best of our knowledge, it has
6 not been adopted by any State Commission.
- 7 • Not based on any "new accounting information."
- 8 • Based on unsupported premise that there are "excessive" removal costs in
9 the depreciation reserve, and that a hypothetical transfer of this reserve to
10 income would allow a windfall to the Company.
- 11 • Based on the unjustified premise that, if deregulated, utility companies
12 would use removal cost accruals to increase earnings.
- 13 • Harms (not protects) future customers.

14 Therefore, the method used consistently by the Commission should continue
15 to be used, and the Commission should deny Mr. Majoros' recommendation
16 to refund accumulated depreciation.

17
18 Q. WHAT IS THE IMPACT OF THESE DEPRECIATION ISSUES?

19 A. The Company's position is that the Commission has correctly authorized the
20 recovery of expected removal over the useful life of the asset to assure that
21 current customers pay the costs associated with the benefits. Therefore, both
22 the proposed change in determining the amount of retirement expense and
23 the requested amortization of non-legal cost of removal should be denied.
24 The total depreciation adjustment recommended by Mr. King (including
25 those addressed by Mr. Robinson) is over \$4.115 million. Mr. Majoros'

1 adjustment refunding previously collected removal cost over 10 years is
2 \$1.837 million

3

4 Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

5 A. Yes, it does.

1 STATE OF NORTH DAKOTA
2 BEFORE THE
3 PUBLIC SERVICE COMMISSION
4
5

6 In the Matter of the Application of Northern)
7 States Power Company, a Minnesota Corporation)
8 For Authority to Increase Rates for Electric Service) Case No. PU-07-776
9 in North Dakota)
10
11

12
13 AFFIDAVIT OF
14 Dane A. Watson
15

16
17 I, the undersigned, being duly sworn, depose and say that the foregoing is
18 the Rebuttal Testimony of the undersigned, and that such Rebuttal Testimony and
19 the exhibits or schedules sponsored by me to the best of my knowledge,
20 information and belief, are true, correct, accurate and complete, and I hereby adopt
21 said testimony as if given by me in formal hearing, under oath.
22

23
24 *Dane A. Watson*
25 Dane A. Watson
26
27

28
29
30 Subscribed and sworn to before me, this 12th day of June, 2008.
31

32 *Karri L. Alba*
33
34 Notary Public
35
36

