Summary and Analysis of SFAS No. 143 and FERC Order No. 631
As They Relate to Non-Legal Asset Retirement Obligations
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Introduction

This summary and analysis provides the background required to understand the accounting and ratemaking implications of FERC Order No. 631 Accounting, Financial Reporting and Rate Filing Requirements for Asset Retirement Obligations as it relates to assets for which asset retirement obligations *do not* exist. It was prepared by Michael J. Majoros, Jr. who has closely followed and testified about the issue. Mr. Majoros attended the FERC Commission staff's May 7, 2002 Technical Conference on the subject and in conjunction with his partner Charles W. King prepared the Comments of the National Association of State Utility Consumer Advocates ("NASUCA") in FERC Docket No. RM02-7-000 which is manifested in FERC Order No. 631.

Background

In June 1994, at the request of the Edison Electric Institute ("EEI"), the Financial Accounting Standards Board ("FASB" or "Board") added an agenda project to focus on accounting for decommissioning costs of nuclear power plants. The original scope of the project related to the legal costs of decommissioning a nuclear power plant imposed by the Nuclear Regulatory Commission. Subsequently, the scope was expanded to include (a) similar legal obligations in other industries and (b) constructive obligations. In February 1996, the Board issued an Exposure Draft, *Accounting for Certain Liabilities Related to Closure or Removal of Long-Lived Assets.*[1]

SFAS No. 143

After two Exposure Drafts and several rounds of comments, FASB issued, in June 2001, its resulting Statement of Financial Accounting Standards No. 143, *Accounting for Asset Retirement Obligations* ("SFAS No. 143"). This statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS No. 143 applies to all entities [including public utilities] and "components of transmission and distribution systems (utility poles) etc," are specifically not excluded. (SFAS No. 143, paragraph B17, footnote 22.)

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[1] FASB Accounting for Obligations Associated with the Retirement of Long-Lived Assets. Staff summary of Board decisions, http://www.rutgers.edu/Accounting/raw/fasb/project/aro

It applies to *unambiguous* legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and (or) the normal operation of a long-lived asset, except for certain obligations of lessees. As used in SFAS No. 143, a legal obligation is an obligation 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] SFAS No. 143 is effective for all financial statements issued for fiscal years beginning after June 15, 2002.

As indicated, SFAS No. 143 establishes accounting standards for recognition and measurement of a liability for an *asset retirement obligation* ("ARO") and the associated *asset retirement cost* ("ARC"). An asset retirement obligation refers to an obligation associated with the retirement of a tangible long-lived asset. The term asset retirement cost refers to the amount capitalized that increases the carrying amount of the long-lived asset <u>when a liability for an asset retirement obligation is recognized</u>.[3]

In general, SFAS No. 143 requires all entities to conduct reviews of their long-lived assets to determine whether they have AROs based on the legal standards summarized above. If an ARO exists, the entity must measure the ARC and <u>record a liability</u> for the amount and capitalize it as part of the original cost of the asset.

In explaining why it adopted this approach, the FASB stated that "paragraph 37 of [its] Statement 19 states that 'estimated dismantlement, restoration, and abandonment costs [future cost of removal]…shall be taken into account in determining amortization and depreciation rates.' Application of that paragraph has the effect of accruing an expense irrespective of the requirements for liability recognition in FASB Concepts Statements. In doing so, it results in [the anomalous] recognition of accumulated depreciation that can exceed the historical cost of a long-lived asset. The Board concluded that an entity should be precluded from including an amount for an asset retirement obligation in the depreciation base of a long-lived asset unless that amount also meets the recognition criteria in this Statement [SFAS No. 143]. When an entity recognizes a liability for an asset retirement obligation, it also will recognize an increase in the carrying amount of the related long-lived asset. Consequently, <u>depreciation of that asset will not result in the recognition of accumulated depreciation in excess of the historical cost of a long-lived asset</u>."[4]

Paragraph 37 eliminates any doubt as to the FASB's intent regarding the application of SFAS No. 143. All companies must review their long-lived assets to determine whether they have unambiguous legal asset retirement obligations associated with those assets. If they do have such obligations, then the estimated ARC (which is based on its estimated present value and updated annually following the rules in the Statement) is capitalized as part off the cost of the asset. Thus, at the end of the asset's

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[2] SFAS No. 143, Summary, and Paragraph 2, and Appendix A, Paragraph A3.
[3] Id., Paragraph 1 and Footnote 1.
[4] Id., Paragraph B22. Emphasis added.

life, the accumulated depreciation account will be equal to the historical plant balance. In no case, may entities in general, include estimated future cost of removal in depreciation rates. Although SFAS No. 143 does not specifically state what to do with removal costs for assets which are not AROs, it is intuitively well accepted that concepts in the AICPA's SOP on Property, Plant and Equipment will eventually be adopted, and at least will not be objectionable. Those concepts would support expensing as incurred, or capitalization as a cost of the replacement.

Regardless of these overall principles and concepts, SFAS No. 143 recognizes that historically, many public utility depreciation rates contained a component for future cost of removal in the rate calculation. It deals with this issue as follows. "Many rate-regulated entities currently provide for the costs related to asset retirement obligations in their financial statements and recover those amounts in rates charged to their customers. Some of those costs relate to asset retirement obligations within the scope of this Statement; others are not within the scope of this Statement and, therefore, cannot be recognized as liabilities under its provisions. The objective of including those amounts in rates currently charged to customers is to allocate costs to customers over the lives of those assets. The amount charged to customers is adjusted periodically to reflect the excess or deficiency of the amounts charged over the amounts incurred for the retirement of long-lived assets. The Board concluded that if asset retirement costs are charged to customers of rate-regulated entities but no liability is recognized, a regulatory liability should be recognized if the requirements of SFAS No. 71 are met."[5]

Thus if the utility has included future net salvage in the past for which it has no ARO, then it will recognize and record a Regulatory Liability to ratepayers for that amount on its financial books and records. Presumably, if the utility continues to include future cost of removal in its depreciation rates, the Regulatory Liability to Ratepayers will also continue to grow.

In summary, SFAS No. 143 precludes the inclusion of future net salvage in depreciation rates for all entities in general, based on the principles and concepts included therein. However, recognizing the unique aspects of rate-regulated entities, SFAS No. 143 requires that those unique aspects be accounted for in a Regulatory Liability to Ratepayers.

FERC Docket No. RM02-7-000

On March 29, 2002, the FERC Commission staff announced that it would hold a technical conference to discuss the financial accounting, reporting and ratemaking implications related to asset retirement obligations associated with the retirement of tangible long-lived assets.[6] "The main purpose for convening this technical conference is to afford an opportunity for the electric, natural gas and oil pipeline industries and other

[5] Id., Paragraph B72.
[6] Federal Energy Regulatory Commission, Docket No. RM02-7-000, Notice of Informal Technical Conference, Agenda and Request for Comments, (March 29, 2002). ("Notice".)

interested parties to discuss with the Commission staff issues related to the implementation of accounting requirements for asset retirement obligations. The goal of the conference is to identify how recognition of asset retirement obligations may affect the Commission's existing accounting and rate regulations."[7] The FERC Notice also requested comments on the subject.

Several comments were received and the Technical Conference was held at the FERC in Washington, D.C. on May 7, 2002. Several parties attended, and several panels were heard, followed by a question and answer session. The subjects of ARO's and SFAS No. 143 were intertwined through virtually all comments. Subsequently, on October 30, 2002, the FERC Issued a Notice of Proposed Rulemaking ("NOPR") in Docket RM02-7-000. The FERC proposed to revise its regulations to update the accounting and reporting requirements for liabilities for asset retirement obligations under its Uniform Systems of Accounts for public utilities, licensees, natural gas companies, and oil pipeline companies.[8]

The NOPR stated that "the proposed accounting for asset retirement obligations is consistent with the accounting and reporting requirement that jurisdictional entities will use [SFAS No. 143] in their general purpose financial statements provided to shareholders and the Securities and Exchange Commission. (e.g., companies will separately account and report the liability for asset retirement obligations, capitalize the asset costs, and charge earnings for depreciation of the asset and operating expense for the accretion of the liability)."[9]

The NOPR went on to say "the recognition and measurement of legal liabilities associated with the retirement and decommissioning of long-lived assets by various entities, including Commission jurisdictional entities, has been inconsistent over the years. The usefulness of consistently recognizing and measuring asset retirement obligations in the financial statements resulted in Financial Accounting Standards Board (FASB) issuing a new accounting pronouncement affecting the manner in which legal obligations are measured and reported in the financial statements applicable to entities in general.6" The NOPR's footnotes 6 to 12 then cited to various paragraphs and concepts contained in SFAS No. 143. The NOPR generally proposed to adopt and integrate SFAS No. 143 into its Uniform System of Accounts, and Reporting Requirements and then established certain ratemaking standards.

Regarding non-legal retirement obligations the NOPR stated "the Commission is aware that a number of natural gas companies are currently collecting an allowance in jurisdictional rates to cover the future cost of retiring and removing facilities. This allowance is referred to as a negative salvage allowance. The Commission believes that these negative salvage allowances do not necessarily reflect the existence of a legal asset

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[7] Notice page 3.
[8] FERC Docket No. RM02-7-000, Notice of Proposed Rulemaking, Issued October 30, 2002, ("NOPR"), page 1.
[9] Id., Paragraph I.2.

retirement obligation. Therefore, the Commission will require that negative net salvage allowances that are not established due to an asset retirement obligation be identified for ratemaking purposes separately from asset retirement obligation allowances. The current rate change filing requirements for natural gas companies at 154.312(d), Statement D, requires that any authorized negative salvage must be maintained in a separate subaccount of account 108, Accumulated provision for depreciation of gas utility plant. The Commission proposes to amend this section to ensure that this subaccount must not include any amounts related to asset retirement obligations."[10] The NOPR did not specifically identify electric utilities in this regard. Again, comments were requested and received, and on April 9, 2003 the FERC issued its Final Rule, i.e. Docket No. RM02-7-000, Order No. 631.

Order No. 631

Order No. 631 states "instead, we will require jurisdictional entities to maintain separate subsidiary records for cost of removal for non-legal retirement obligations that are included as specific identifiable allowances recorded in accumulated depreciation in order to separately identify such information to facilitate external reporting and for regulatory analysis, and rate setting purposes. Therefore, the Commission is amending the instructions of accounts 108 and 110 in parts 101, 201 and account 31, Accrued depreciation-carrier property, in Part 352 to require jurisdictional entities to maintain separate subsidiary records for the purpose of identifying the amount of specific allowances collected in rates for non-legal retirement obligations included in the depreciation accruals.[11]

"Jurisdictional entities must identify and quantify in separate subsidiary records the amounts, if any, of previous and current accumulated removal costs for other than legal retirement obligations as part of the depreciation accrual in accounts 108 and 110 for public utilities and licensees, account 108 for natural gas companies, and account 31 for oil pipeline companies. If jurisdictional entities do not have the required records to separately identify such prior accruals for specific identifiable allowances collected in rates for non-legal asset retirement obligations recorded in accumulated depreciation, the Commission will require that the jurisdictional entities separately identify and quantify prospectively the amount of current accruals for specific allowances collected in rates for non-legal retirement obligations."[12]

Order No. 631 also states "the Commission will decline to make policy calls concerning regulatory certainty for disposition of transition costs, external funds for amounts collected in rates for asset retirement obligations, adjustments to book depreciation rates, and the exclusion of accumulated depreciation and accretion for asset retirement obligations from rate base; 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. The

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[10] Id., Paragraph III 45.
[11] FERC Docket No. RM02-7-000, Order No. 631, Issued April 9, 2003, Paragraph 39.
[12] Id., Paragraph 39.

Commission is of the view that utilities will have the opportunity to seek recovery of qualified costs for asset retirement obligations in individual rate proceedings. This rule should not be construed as pregranted authority for rate recovery in a rate proceeding."[13]

Order No. 631 goes on to say "finally this rule requires nothing new and nothing more with respect to the requirement for a detailed study. Complex depreciation and negative salvage studies are routinely filed or otherwise made available for review in rate proceedings. When utilities perform depreciation studies, a certain amount of detail is expected. It is incumbent upon the utility to provide sufficient detail to support depreciation rates, cost of removal, and salvage estimates in rates.45." [14] And footnote 45 states "when an electric utility files for a change in its jurisdictional rates, the Commission requires detailed studies in support of changes in annual depreciation rates if they are different from those supporting the utility's prior approved jurisdictional rate."[15]

Thus, it seems clear that the FERC recognizes distinctions between legal and non-legal AROs just as SFAS No. 143 recognizes those distinctions. In fact, the amount resulting from Order No. 631's requirement to identify previous amounts collected for non-legal ARO's should result in the same amount as the SFAS NO. 143 requirement to establish a regulatory liability to ratepayers for the same amounts. It is also clear, that on a going-forward basis, jurisdictional entities must be prepared to specifically identify and justify any non-legal AROs that they propose to be included in their rates.

[13] Id., Paragraph 64. (Emphasis added.)
[14] Id., Paragraph 65.
[15] Id., footnote 45.