

Society of Depreciation Professionals
2004 Annual Meeting
Washington DC, September 13-14, 2004

SFAS No. 143 and FERC Order No. 631
What Are Non-Legal AROs?
What Is The Separation Principle?

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Objective

To discuss how SFAS NO. 143 and
FERC Order No. 631 have
highlighted a significant and
growing *intergenerational inequity*.

Concept No. 1

Substance Over Form

If it waddles like a duck, and quacks like a duck, and looks like a duck, it's a duck.

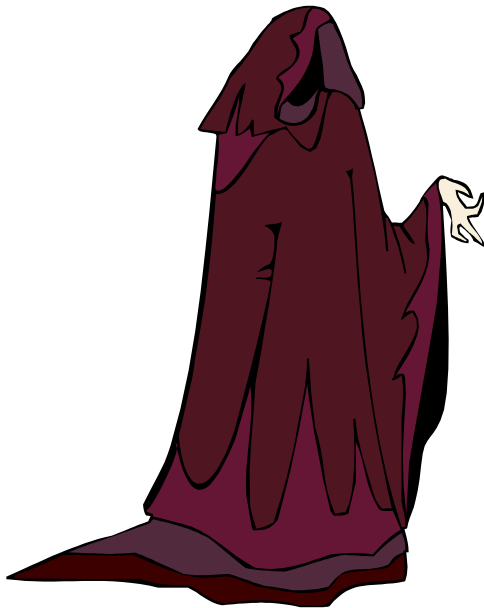
No amount of theoretical rhetoric or lobbying can turn that duck into a dog, a cat or even a dead horse.

Other Important Definitions and Concepts

- **Cost** is the amount of **money actually paid** or **to be paid** for property or services.
- Money to be paid for property or services is a **liability** (“amount owed”).
- A **legal liability** for a future asset retirement obligation is a component of the asset’s original cost.

Lynchpin Issue:

- **DEPRECIATION**



Depreciation Fundamentals: 101

- Depreciation = Cash
- Free cash inflow
- Green pieces of paper with pictures of dead presidents



Depreciation Fundamentals: 101

(Continued)

- Typically the largest non-fuel expense
- The higher the depreciation rate, the greater the revenue requirement
- The greater the revenue requirement, the higher the charges to ratepayers.
- Depreciation produces cash flow from ratepayers to utilities.



Typical Depreciation Rates Are Based on Estimates

- Service Life and Dispersion Estimates,
- Salvage Estimates, and
- Future Cost of Removal Estimates

Net Salvage

- Most estimates have assumed that COR will be greater than salvage, therefore estimated future net salvage has been negative.

Impact of Negative Net Salvage on Depreciation Rates

- Negative net salvage increases depreciation rates.



Future Cost of Removal Estimates

- Utilities usually inflate future COR estimates.
- This inflation is embedded in the method used to make the COR estimates.
- Some witnesses admit the inflation and defend it, others deny it.

Effect of Inflated COR Estimates

- Higher depreciation expense.
- Annual COR charges vastly exceed actual COR incurred each year.
- More cash flow and higher depreciation reserves.

Dirty Little Secrets About Removal Costs

- Removal costs may never be incurred at the level incorporated in current depreciation rates for mass accounts.
- Snavelly King's national studies show that steam production plants last much longer than utilities assume and there is only a limited probability of plant dismantlement.



More Dirty Little Secrets About Removal Costs

- Basic removal premise is questionable-there is no liability.
- Why would a company spend money on non-productive activities if not required?
- Therefore, most COR collections are the same as net income.



The New World Order According to GAAP

SFAS No. 143 is GAAP

- Statement of Financial Accounting Standard No. 143 is a creature of the
- Financial Accounting Standards Board (“FASB”), dealing with
- Accounting for Asset Retirement Obligations (“ARO”), and it
- Applies to all companies.

COR Under SFAS No. 143

- SFAS No. 143 says “No”.
- Can’t apply a depreciation rate designed to recover more than cost.
- Can only recognize removal costs when there is a legal liability to incur an Asset Retirement Obligation (“ARO”)

SFAS No. 143 Concepts

- An Asset Retirement Obligation (“ARO”) is a **legal** obligation (cost) associated with the retirement of an asset.
- ARO Example – end of life legal requirements for nuclear plants.
- If ARO exists, must estimate the Fair Value of the Asset Retirement Cost (“**ARC**”).
- Fair Value is net present value of estimated future expenditures.
- ARC is **capitalized** as part of the **cost** of the asset and depreciated.
- Key Concept – **zero net plant at end of life.**

Effect of SFAS No. 143

- On Telephone Industry
- On Electric, Gas and Other Utilities

FCC Response to SFAS No. 143

- FCC said “don’t change; continue to include net salvage in depreciation rates” (WCB/Pricing 02-35)

Telephone Industry Reaction to SFAS No. 143

- Industry decided that no ARO exists, took all prior collections from ratepayers into income.

Pre-Tax Gains

	<u>\$ Billions 1/</u>
– SBC	\$ 5.9
– Verizon	\$ 3.5
– Qwest	\$ 0.4
– BellSouth	\$ 1.3
– Sprint	<u>\$ 0.4</u>
– Total	\$11.5

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Telephone Industry Reaction (continued)

- Industry reduced financial book depreciation rates, and
- Is **Expensing COR.**

Electric and Gas Utilities Reaction to SFAS No. 143

- Paragraph B73 requires that all prior and future collections of non-legal future cost of removal must be reclassified from accumulated depreciation and recorded as regulatory liabilities.

Electric and Gas Utilities Reaction to SFAS No. 143 (continued)

A good example is AEP, one of the largest electric holding companies. They said:

“...our utility operating companies have collected removal costs from ratepayers...to extent of deregulation we have taken \$473 million into income...and reclassified \$1.2 billion from accumulated depreciation to Regulatory Liabilities.”

AEP 2003 Annual Report

AEP Example (continued)

- Obvious conclusion – AEP's shareholders won \$473 million, and its ratepayers lost \$473 million.
- Is this an *intergenerational inequity*?
- I think it is.

But What is Stockholder Response to Eruption of Major Regulatory Liabilities



FERC Response to SFAS No. 143

- FERC instituted Docket No. RM02-7
Notice of Proposed Rulemaking (“NOPR”)

NASUCA

Responded to the NOPR:

- Pointed out inconsistency of current practice with SFAS 143 principles
- Suggested removal costs be taken out of depreciation
- Proposed removal costs be
 - Expensed or Capitalized as part of a Replacement
 - Or
 - Treated Like AROs

FERC Order No. 631

(April 9, 2002)

- Incorporates the principles of SFAS No. 143 into USoA.
- If AROs exist, they are capitalized into special accounts and depreciated.
- Identifies **non-legal AROs**.

Non-Legal AROs

- FERC Order No. 631 characterizes collections for non-ARO future COR as non-legal AROs
- Establishes a “**Separation Principle**” in lieu of SFAS No. 143 Regulatory Liability approach to non-legal AROs.

Order No. 631 Separation Principle

- Order No. 631 paragraphs: 34, 35, 37, 38, 39, and 63 address non-legal AROs, and are in direct response to NASUCA's Comments.
- They identify the “separation principle”

Order No. 631 Paragraph 34

(Separation Principle)

Paragraph 34 states in part:

“Certain other commenters [**NASUCA**] suggest that the Commission should make certain modifications to the Uniform Systems of Accounts ... to include the amount of cost of removal for non-legal obligations as regulatory liabilities...”

Order No. 631 Paragraph 35

(Separation Principle)

Paragraph 35 states:

“One commenter [**NASUCA**] recommends that the Commission exclude the cost of removal that does not qualify as a legal retirement obligation from the depreciation accrual and instead capitalize any removal costs related to the asset replaced as part of the costs of replacing the utility plant and if no replacement of the asset occurs, the cost of removal for non-legal retirement obligations should be expensed in the income statement.”

Order No. 631 Paragraph 38

(Separation Principle)

Paragraph 38 states:

“Instead [in response to NASUCA] 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 USoA].”

Order No. 631 Paragraph 39

(Separation Principle)

Paragraph 39 further elaborates:

“ Jurisdictional entities **must** identify and quantify in separate subsidiary records the amounts, if any, of previous and current accrued accumulated removal costs for other than legal retirement obligations recorded **as part of the depreciation accrual...**”

Separation Principle and Regulatory Liability

- The Regulatory Liability required in Paragraph B73 of SFAS No.143 should be the same as the separation within accumulated depreciation required in Order No. 631.

Current Situation

- Presently substantial sums of non-legal COR is hidden in depreciation rates and accumulated depreciation.
- Intergenerational inequities-utilities are taking these amounts into income wherever possible.
- Both SFAS No. 143 and Order No. 631 highlight the amounts.

Anticipated Results

- Obvious response is to discontinue current practice and reduce depreciation expense to stem the astronomical build-up of these amounts.
- Utilities will correctly assert that Order No. 631 does not require them to reduce their depreciation rates.
- Utilities will make theoretical arguments intended to continue these huge charges to ratepayers.
- If depreciation rates do not change, at least the amounts are separately identified, and the liabilities to ratepayers will continue to grow to even greater levels.
- At some point, these amounts must be challenged, if not by regulators, perhaps by shareholders.

Conclusion

- Regardless of the rhetoric, in substance and in form we now have identified huge amounts owed to ratepayers.
- These prior collections are owed to ratepayers because the utilities do not have any legal obligation to spend the money.
- These amounts have been and are being audited!
- I wonder where the money will come from when it's time to pay-off the liabilities to ratepayers?
- Probably the social security trust fund, unless the utilities contrive a way to take these amounts into income.