EXHIBIT NO. ___(JAU-1T)
DOCKET NO. UE-072300/UG-072301
2007 PSE GENERAL RATE CASE
WITNESS: JAN A. UMBAUGH

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY, INC.,** **Respondent.**	**Docket No. UE-072300** **Docket No. UG-072301**

PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF
JAN A. UMBAUGH
ON BEHALF OF PUGET SOUND ENERGY, INC.

JULY 3, 2008

PUGET SOUND ENERGY, INC.

PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF JAN A. UMBAUGH

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PUGET SOUND ENERGY, INC.

PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF JAN A. UMBAUGH

I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Jan A. Umbaugh. My business address is Suite 900, 1645 Palm Beach Lakes Blvd., West Palm Beach, Florida 33401. Please note, however, that my business address will change on July 13, 2008, to Suite 200, 1800 North Military Trail, Boca Raton, Florida 33431.

Q. What is your occupation and with whom are you associated?

A. I am a Certified Public Accountant ("CPA") and a partner with the international public accounting firm of Deloitte & Touche LLP ("Deloitte & Touche" or the "Firm").

Q. Please describe your background and present work responsibilities.

A. I graduated from Ball State University in Muncie, Indiana, in 1969 with a Bachelor of Science degree, majoring in accounting. Since 1969 I have been employed by Deloitte & Touche or its predecessors in several different offices. My responsibilities have been concentrated in public utilities throughout my career. I currently serve as the Firm's Industry Professional Practice Director for

the public utility industry. In this role, I serve as the Firm's lead technical accounting and auditing partner for the utility industry. My responsibilities focus on providing assistance to the Firm's personnel and its public utility clients concerning a variety of public utility accounting, tax, and regulatory matters. These responsibilities include conducting and reviewing accounting research, preparing and presenting training programs, coordinating Firm responses to accounting and regulatory rules proposals, assisting in interpreting and applying specific accounting and regulatory rules, conducting concurring review of audit reports on utility clients' financial statements, and participating in a variety of engagements, including the preparation of testimony and supporting data on utility rate and accounting matters. I have served as lead client service partner for audit clients such as Entergy Corporation, Florida Public Utilities, FPL Group, IPALCO Enterprises, MCN Energy, Progress Energy, Tucson Electric Power, and Wabash Valley Power Association.

I have presented testimony as an expert witness before the Federal Energy Regulatory Commission ("FERC") and before courts or regulatory agencies in Alabama, Arizona, California, Florida, Georgia, Indiana, Michigan, Mississippi, New Jersey, New Mexico, Ohio, Rhode Island, South Carolina, South Dakota, Texas, West Virginia, and Ontario, Canada.

My professional affiliations include the American Institute of Certified Public Accountants ("AICPA") and the Florida and Missouri state societies of Certified Public Accountants. I am a licensed CPA in the states of Florida and Missouri. I

served two terms as a member of AICPA's Public Utility Committee and am a contributing author to Accounting for Public Utilities, published by Matthew Bender (now LexisNexis).

I also prepared Deloitte & Touche's comments to FERC in Docket RM 02-7, in which FERC issued Order 631, *Accounting, Financial Reporting, and Rate Filing Requirements for Asset Retirement Obligations* ("FERC Order No. 631"). Additionally, I participated in FERC's roundtable to discuss issues that were being considered by FERC in this docket.

Q. What is the purpose of your rebuttal testimony in this proceeding?

A. I have been asked by Puget Sound Energy, Inc. ("PSE" or "the Company") to discuss the scope of Statement of Financial Accounting Standards No. 143, *Accounting for Asset Retirement Obligations* ("FAS 143") and a March 2005 interpretation of FAS 143, FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* ("FIN 47") in response to assertions made by witnesses Michael J. Majoros and Charles W. King on behalf of Public Counsel. In particular, I will discuss the original intent behind the project carried out by the Financial Accounting Standard Board ("FASB") that resulted in the implementation and guidance provided in FAS 143, and I will explain why FAS 143 accounting has no impact on ratemaking and therefore no place in this proceeding. I will also discuss FERC Order No. 631, which addresses the regulatory accounting for asset removal costs and the application of FAS 143

1 under the FERC Uniform System of Accounts. Finally, I will discuss how PSE's
2 historical depreciation accounting and its current method of recognizing costs of
3 removal through its depreciation rates are consistent with current Generally
4 Accepted Accounting Principles ("GAAP") and regulatory accounting and
5 ratemaking practices, while the FAS 143-type approach proposed by Public
6 Counsel is not.

7 **Q. Would you please summarize your testimony regarding FAS 143 and FERC**
8 **Order No. 631?**

9 A. FAS 143 is a *financial accounting* requirement that deals with the identification,
10 measurement, and recording of legal obligations associated with retirements of
11 tangible, long-lived assets. FAS 143 is designed to standardize the way that
12 companies measure and report accounting costs when there is a legal obligation to
13 remove or dispose of an asset. This intent is clearly stated in the Summary of the
14 FAS 143 publication. FAS 143 was not intended to, nor does it, address
15 *regulatory* accounting or *ratemaking* treatment for rate-regulated utilities. To the
16 contrary, FAS 143 explicitly recognizes that differences may arise for rate-
17 regulated entities and continues the requirements of Statement of Financial
18 Accounting Standards No. 71, *Accounting for the Effects of Certain Types of*
19 *Regulation* ("FAS 71").

20 FERC Order No. 631 is a regulatory accounting requirement that supports FAS
21 143 by amending FERC's Uniform System of Accounts ("USoA") to account for

1 asset retirement obligations ("ARO") and also to continue pre-existing accounting
2 treatment, as FAS 143 does, in allowing recognition of differences that may arise
3 for rate-regulated entities. FERC also concluded there was no reason to
4 fundamentally change regulatory accounting concepts for costs that do not qualify
5 as legal retirement obligations (i.e., non-AROs).

6 Finally, I conclude that the use of traditional depreciation accrual methodologies
7 used to recognize estimated cost of removal continues to provide the most
8 appropriate basis for recognizing these costs for *regulatory accounting and*
9 *ratemaking*. Ratemaking for cost of removal should not be changed as a result of
10 FAS 143.

11 **Q. Would you please explain the importance of the terms *financial accounting*,**
12 ***regulatory accounting*, and *ratemaking*?**

13 A. It is important to distinguish these three terms because each of them is governed
14 by different principles and requirements. Mr. Majoros and Mr. King throughout
15 their testimonies confuse these three accounting concepts and use FAS 143,
16 which is a standard used for *financial accounting*, and FERC Order No. 631,
17 which is a standard for *regulatory accounting*, to justify illogical changes to
18 traditional *ratemaking* policies. Each of these accounting concepts serves a
19 different purpose.

20 Financial accounting is used in developing financial statements for reporting
21 financial information in accordance with GAAP. The Securities and Exchange

Commission ("SEC") and Public Company Accounting Oversight Board ("PCAOB") require that companies with securities registered under the SEC rules utilize GAAP in their reporting to the public. GAAP's purpose is to establish general principles and provide consistency in accounting across all companies, which provides users comparability among the companies. The focus of the FASB in recent years has been on the balance sheet, increasing the consistency of asset and liability recognition, with less concern about the income statement's matching revenues and expenses within the same periods.

FAS 71 provides guidance on recognizing the economic effects of utility rate regulation in GAAP financial statements under certain circumstances. However, financial accounting standards do not dictate requirements for regulatory accounting, although regulatory accounting may at times adopt financial accounting standards or be modified to more closely align with financial accounting, and do not dictate ratemaking treatment.

Regulatory accounting is governed by FERC and by various state and local regulatory bodies. It is used in developing various FERC and state regulatory reports, of which FERC Form 1 is the most widely recognized for electric utilities. The purpose of regulatory accounting is to provide accounting information in a manner that assists utility regulators in their ratemaking treatment of regulated companies. As a result, certain accounting concepts and presentations under regulatory accounting may differ from those used under GAAP financial accounting. Regulatory accounting promotes reporting

comparability among rate-regulated entities where the ratemaking treatment is similar but would be substantially different from the accounting used by companies that are not subject to rate regulation.

Under ratemaking treatment for most utilities in the United States, including PSE, the utility is granted the opportunity to recover prudently incurred expenses and earn a reasonable return on its investment. In return for those privileges, the utility, including PSE, is subject to cost and price regulation by its regulatory commission. Cost and price regulation should follow the public interest goals of intergenerational equity, which, in utility regulation, essentially prescribes that ratepayers in one period should pay the costs of the service they receive and should not subsidize or be subsidized by the costs for ratepayers that receive service in another period. In order to achieve intergenerational equity in regards to capital recovery, costs associated with an asset should generally be recovered over the period that the asset provides service, not in the period the asset is retired or after the asset is retired.

II. OVERVIEW OF FAS NO. 143

Q. What is the purpose of FAS 143?

A. FAS 143 is a financial accounting pronouncement and is part of a broader focus by the Financial Accounting Standards Board ("FASB") to standardize reporting to users of financial statements to ensure the user's awareness of future legal obligations associated with the removal or disposal of tangible long-lived assets.

FASB states that the reasons for addressing the accounting and reporting of AROs is because

> Users of financial statements indicated that the diverse accounting practices that have developed for obligations associated with the retirement of tangible long-lived assets make it difficult to compare the financial position and results of operations of companies that have similar obligations but account for them differently.

Obligations that meet the definition of a liability were not being recognized when those liabilities were incurred or the recognized liability was not consistently measured or presented.

The anticipated benefits of FAS 143 include the fact that financial statements of different entities will be more comparable because all AROs that fall within the scope of FAS 143 will be accounted for consistently for financial reporting. Before the issuance of FAS 143, few companies other than regulated utilities recognized any costs of removal in their GAAP financial reporting until the costs were actually paid. Even regulated utilities usually accrued estimated nuclear decommissioning and other legal AROs over the life of the property as a component of depreciation, but used widely varying assumptions to measure those costs. Additional financial accounting benefits include the following:

- AROs will be recognized when they are incurred and will be displayed as liabilities,
- AROs will be measured on a consistent basis, and
- disclosure requirements contained in FAS 143 will provide more information about AROs.

1 **Q. What is the background of FAS 143?**

2 A. The project that resulted in the issuance of FAS 143 was launched in order to
3 address concerns originally raised by the SEC about "accounting for the costs of
4 nuclear decommissioning" and "similar closure or removal-type costs in other
5 industries." FAS 143, Appendix B at ¶ B3. This issue was first raised by the
6 SEC staff in the early 1990s due to diversity in practice regarding the recognition
7 of nuclear decommissioning liabilities (most companies only recognized whatever
8 amounts had been recovered in rates) and because of concerns that if nuclear
9 plants were shut down prematurely the full liability would not have been
10 recognized. As a result of the concerns raised by the SEC, the Edison Electric
11 Institute (an electric utility trade association) asked the FASB to address the issue
12 of asset retirement obligations on a broader basis. The scope of the project
13 widened during its development to incorporate other "legal" asset retirement
14 obligations and to specifically exclude non-AROs. However, the overall intent
15 was (and still is) to help standardize financial reporting of legal obligations for the
16 benefit of the financial community.

17 **Q. Would you please summarize FAS 143?**

18 A. FAS 143 addresses required financial accounting and reporting under GAAP for
19 costs of "legal obligations associated with the retirement of a tangible long-lived
20 asset." FAS 143 applies to all entities, including rate-regulated entities, that may
21 have AROs. Furthermore, the statement only applies to costs related to the

1 retirement of a tangible long-lived asset that results from "acquisition,
2 construction, or development and (or) normal operation of a long-lived asset."
3 FAS 143 at ¶ 2. (This means that FAS 143 does not apply to temporary removal
4 or maintenance activities.) The most common AROs in the electric utility
5 industry include such obligations as the decommissioning of nuclear and some
6 coal plants at the end of or after their useful lives. Most of the costs associated
7 with these AROs were already recognized by regulated utilities in advance of
8 actually settling the removal obligation through cost of removal components
9 included in depreciation or through separate accruals for estimated removal costs.
10 The limitation of the FAS 143 ARO scope to legal obligations should not to be
11 taken to mean, as Mr. Majoros and Mr. King imply, that the accounting
12 community does not believe that there are no other long-lived assets for which it
13 is probable that removal and disposal costs will be incurred. For example, the
14 retirement obligations for the majority of the industry's transmission and
15 distribution assets have not been classified as AROs. Although non-AROs do not
16 meet the accounting requirements established by SFAS 143 for recognizing ARO
17 liabilities, it does not mean that these removal costs will not be incurred. The
18 historical recorded costs of removal reflected in PSE's accounting records, and
19 that were used in the preparation of PSE's proposed depreciation rates by
20 Mr. Clarke, support that removal costs are incurred for non-ARO's. Even
21 Mr. King acknowledges that significant removal costs are incurred each year
22 where he compares actual costs of removal for the past 5 years.

1 **Q. Would you please explain the initial recognition and measurement of the**
2 **liability for an ARO in accordance with FAS 143?**

3 A. The initial part of the FAS 143 process is essentially the same as the process used
4 to estimate the costs of removal to be included in depreciation rates under
5 traditional regulatory accounting and ratemaking. In both instances an estimate of
6 the ultimate future cost must be determined.

7 For financial accounting purposes, FAS 143 required changes in the historical
8 practice for estimating the ultimate cost of legal obligations in that it required
9 some additional assumptions (e.g., an assumption of a third party profit margin as
10 required by paragraph A20 even if the entity expected to perform the removal cost
11 itself) that actually increased the ultimate cost estimate. FAS 143 then required
12 that the estimated ultimate cost be discounted using a "credit-adjusted risk-free
13 rate" (equivalent to the entity's debt borrowing rate). Under FAS 143 this full
14 discounted future obligation is recorded on the balance sheet with an equal
15 increase in the fixed asset/property balance for the Asset Retirement Cost
16 ("ARC") at the time the property is placed in service rather than only recording
17 the undiscounted amount of the obligation that had been recovered to date.

18 This ARC amount is then subject to straight-line depreciation, generally over the
19 same depreciation life of the underlying asset, so that a portion of the FAS 143
20 ARO continues to be recognized through depreciation expense. The discounted
21 ARO liability is also accreted or increased each year with additional charges to

1 expense so that the initial ARO liability amount will increase to the estimated
2 ultimate cost to remove the asset by the estimated removal date (which may be
3 several years after the related asset is retired). This results in this accretion
4 (interest) portion of the cost of removal being recognized for financial accounting
5 purposes on a backloaded basis and possibly some of the expense being
6 recognized after the asset has ceased providing service to any customers. In
7 addition, the FAS 143 liability is displayed for financial accounting purposes as a
8 separate liability on the balance sheet (not included in accumulated depreciation
9 as was often the case before FAS 143).

10 **Q. What is the impact on regulated entities resulting from FAS 143?**

11 A. The impact on regulated entities resulting from FAS 143 is generally net income
12 neutral because regulatory assets or regulatory liabilities will be reflected on the
13 balance sheet, as long as the recovery of the regulatory assets and regulatory
14 liabilities are probable under FAS 71. Timing differences between ratemaking
15 and financial accounting for cumulative effects of initially implementing FAS 143
16 and the ongoing net expenses that would have occurred in an unregulated
17 environment would be reflected as regulatory assets or regulatory liabilities in a
18 regulatory environment.

19 **Q. Is the accounting for regulatory liabilities and assets a new requirement**
20 **resulting from the issuance of FAS 143?**

21 A. No. Recognition of regulatory liabilities and assets is not new and is not specific

1 to issues raised by FAS 143. Regulatory liabilities and assets are accounted for
2 under the auspices of FAS 71, which was issued in December 1982, predating
3 FAS 143 by nearly 20 years. In fact, accounting literature that predated even FAS
4 71 provided for the recognition of regulatory assets and liabilities. If the
5 conditions of FAS 71 are met, regulated entities will recognize a regulatory
6 liability or asset whenever expenses or revenues are recognized in one period for
7 regulated ratemaking but would have been recognized in another period under
8 GAAP for an unregulated entity.

9 A common example in the industry is a regulatory asset for PURPA electric
10 energy supply contract buyout costs. Unregulated entities would have to report
11 such contract buyout costs as expenses in the period of the buyout. FAS 71
12 requires regulated entities to record a regulatory asset that defers these costs when
13 incurred and recognizes the expense over time to match the rate recovery of the
14 costs. PSE's GAAP financial statements show the regulatory asset for such
15 buyout costs of approximately $141 million on December 31, 2007. PSE expects
16 to recover this amount in the future.

17 **Q. Under what conditions are regulatory liabilities recorded under FAS 71?**

18 A. Paragraph 11 of FAS 71 states that regulators can impose liabilities on regulated
19 enterprises and identifies three usual ways that such liabilities are imposed.

Q. Do all regulatory liabilities obligate the regulated enterprise to make refunds to customers?

A. No. Paragraph 11 of FAS 71 provides three usual ways that regulatory liabilities can be imposed upon regulated entities by regulators. Only the first example (paragraph 11a) is of a regulatory liability that results from a situation in which a regulator requires refunds to customers. The third example (paragraph 11c) provides that the regulator may require amounts that would be recognized as a gain or other reduction of costs by unregulated entities be given to customers over future periods. That requirement could be accomplished by deferring such amounts as a regulatory liability and amortizing those amounts as reduction of cost of service over future periods to reduce future rates to customers.

Under the second example (paragraph 11b),

> A regulator can provide current rates intended to recover costs that are expected to be incurred in the future with the understanding that if those costs are not incurred future rates will be reduced by corresponding amounts.

In this circumstance, if the amounts recovered in rates are incurred at some point in the future as expected, there would be no future refund or adjustment of future rates. It is this example in FAS 71 that is applicable to non-ARO costs of removal.

1 **Q. Does FERC's USoA[1] similarly provide for recording of regulatory assets and**
2 **liabilities for regulatory reporting purposes?**

3 A. Yes. Definition 31 in the FERC USoA provides:

4 *Regulatory Assets and Liabilities* are assets and liabilities that result
5 from rate actions of regulatory agencies. Regulatory assets and
6 liabilities arise from specific revenues, expenses, gains, or losses
7 that would have been included in net income determination in one
8 period under the general requirements of the Uniform System of
9 Accounts but for it being probable:

10 A. that such items will be included in a different
11 period(s) for purposes of developing the rates the
12 utility is authorized to charge for its utility services;
13 or

14 B. in the case of regulatory liabilities, that refunds
15 to customers, not provided for in other accounts,
16 will be required.

17 Thus, the main focus of recording regulatory assets and liabilities is to assure that
18 the economic effects of ratemaking are reflected in the financial statements when
19 the recognition of revenues or costs for ratemaking purposes occurs in a different
20 period than the period they would be recognized in under GAAP by an
21 unregulated entity. Only in limited circumstances do regulatory liabilities result
22 from a requirement to provide refunds to customers. FERC Order No. 631 thus
23 recognized that utilities subject to its accounting jurisdiction should simply keep
24 subsidiary records of the amounts of removal costs recovered and incurred rather
25 than establish a separate refundable regulatory liability.

[1] *See* 18 CFR 101.

1 **Q. Does FAS 143 address ratemaking for AROs or other costs of removal?**

2 A. No. FAS 143 does not address ratemaking treatment at all. The manner in which
3 removal and disposal costs are treated for financial reporting purposes and the
4 way in which they traditionally have been treated for ratemaking purposes are
5 different. There is nothing in FAS 143 that precludes PSE and other utilities from
6 continuing to recover property removal costs in the approved depreciation rates in
7 the same manner they always have, whether or not those costs fall within the
8 scope of FAS 143. In fact, the guidelines of FAS 143 explicitly recognize that:

> 9 Many rate-regulated entities currently provide for the costs related
> 10 to the retirement of certain long-lived assets in their financial
> 11 statements and recover those amounts in rates charged to their
> 12 customers. Some of those costs result from asset retirement
> 13 obligations within the scope of this Statement; others result from
> 14 costs that are not within the scope of this Statement. The amounts
> 15 charged to customers for the costs related to the retirement of
> 16 long-lived assets may differ from the period costs recognized in
> 17 accordance with this Statement, and, therefore, *may result in a*
> 18 *difference in the timing of recognition of period costs for financial*
> 19 *reporting and rate-making purposes*.

20 FAS 143 at ¶ 20 (emphasis added). FAS 143 guidelines provide that if the
21 requirements for FAS 71 are met, the rate-regulated entity would recognize for
22 financial accounting purposes a regulatory asset or liability for the differences in
23 timing inherent in depreciation and costs of removal for ratemaking and financial
24 reporting.

1 **Q. Does GAAP prescribe methods or procedures for cost recovery for rate-**
2 **regulated utilities?**

3 A. No. GAAP does not prescribe the method or procedures for cost recovery of rate-
4 regulated utilities. The utility is subject to regulation by this Commission
5 according to the jurisdiction granted it under state law. PSE records its costs
6 according to the Commission's decisions and rulemaking. The longstanding
7 ratemaking procedures for capital recovery that have been established by this
8 Commission to recognize costs of removal on a straight line basis through a
9 component of depreciation support intergenerational equity and are consistent
10 with the regulatory compact. As stated before, accounting authorities recognize,
11 for financial accounting purposes, the differences that may occur in the timing of
12 cost recognition for rate-regulated industries, and have established standards to
13 report that – i.e., FAS 71.

14 **Q. Do you agree with Public Counsel's characterization of the previously-**
15 **recognized non-ARO costs as being "excess"?**

16 A. No, I do not. Mr. Majoros refers to these previously recovered costs as "excess"
17 in several places throughout his testimony. He also states, "Experience indicates
18 that it is highly unlikely that these amounts will be spent for cost of removal in
19 the magnitude they have been collected". Exhibit No. ___(MJM-1TC) at page 9,
20 lines 17-18. Mr. Majoros does not support his assertion with specific instances,
21 but I believe it is extremely unlikely that there would be support for his assertion.

1 If for no other reason, under traditional ratemaking where the estimated future
2 cost of removal is recognized over the estimated life of the property and the
3 average life of all of PSE's property is likely somewhat less than half its
4 estimated life, I would expect that somewhat less than half of the estimated cost
5 of removal of PSE's existing property has been recognized to date.

6 **Q. Do you agree with Public Counsel's assumption that non-ARO costs are not**
7 **probable of being incurred and are thus excessive?**

8 A. No. Mr. Majoros incorrectly assumes that unless a removal or disposal cost
9 results from a legal obligation, then it is not probable that it will occur, and
10 therefore is excessive. It is wrong to assume that a business would expect to incur
11 removal costs only if it has a legal obligation to do so. This assumption simply
12 contradicts the recorded history, not only at PSE, but across the industry. Utilities
13 do not have a *legal* obligation in the FAS 143 context to incur many of the
14 projected costs represented in their cost of service -- and the absence of a legal
15 obligation or a "promise to spend the money" does not mean that the incurrence
16 of these costs is not probable. PSE incurs several million dollars of removal costs
17 each year. Based on prior experience, PSE expects to incur removal costs in
18 order to replace property units that wear out, become obsolete, or are removed for
19 other reasons. It is probable that such costs will be incurred in order for the utility
20 to meet its obligation to serve customers. However, the utility obligation to
21 provide service is not the type of legal obligation that creates an ARO under
22 FAS 143.

1 Public Counsel essentially concludes that non-legal AROs are not recognized as
2 liabilities because they are not probable. To support such a conclusion,
3 Mr. Majoros must apply fallacious logic. He assumes that because, according to
4 FAS 143 requirements, all legal AROs are probable, all non-AROs must not be
5 probable. The requirement of being "probable" is only one element of the
6 determination of whether a retirement obligation falls under the ARO
7 requirements of FAS 143. It should not be used to imply that all other asset
8 retirement obligations are not probable. The reality is that non-AROs are not
9 recognized as liabilities under the requirements of FAS 143 simply *because there*
10 *are no legal obligations to retire the underlying assets.* I am not aware of any
11 business that relies upon legal requirements as the sole guideline in estimating
12 likelihood of costs it will incur in a future period.

13 **Q. Does FAS 143 require the reversal of past regulatory recognition of costs of**
14 **removal or prohibit continued recognition of such costs?**

15 A. No. As I mentioned earlier, FAS 143 only addresses financial reporting under
16 GAAP and does not address regulatory accounting or ratemaking. In fact, GAAP
17 accounting provides a mechanism (the recording of regulatory assets and
18 liabilities) to recognize for financial accounting purposes the economic effects of
19 utility ratemaking that differ from GAAP accounting for unregulated enterprises.

1 **Q. Does FAS 143 require that non-AROs be removed from accumulated**
2 **depreciation?**

3 A. No. FAS 143 actually does not specifically address accounting for non-AROs.
4 Paragraph B73 of FAS 143 (which provides background information but is not
5 part of the actual standard) suggests that non-AROs should be recorded as
6 regulatory liabilities if the conditions of FAS 71 are met. Nowhere in FAS 143 or
7 FAS 71 does it require that regulatory liabilities must be recorded in separate
8 liability accounts rather than within accumulated depreciation. However, in late
9 2003 and early 2004, the SEC issued a number of comment letters requesting that
10 the non-ARO obligation be reported as a separate liability and not netted within
11 accumulated depreciation.

12 **Q. How does the subsequently-issued FIN 47 impact FAS 143?**

13 A. FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement*
14 *Obligations – an interpretation of FASB Statement No. 143* ("FIN 47"), was
15 issued in March 2005. FIN 47 required companies to record additional AROs as a
16 result of conditional obligations to remove or dispose of assets. Paragraph A15 of
17 FAS 143 had provided an example that concluded that if there was not a legal
18 obligation to remove a component of an asset but there was a legal obligation to
19 dispose of it once it was removed then the liability should be recorded when the
20 obligation occurs (i.e., when the asset is removed). The essence of FIN 47 is that
21 because there is a legal obligation to dispose of an asset (e.g., a treated wood

1 utility pole), once it wears out and is removed[2] then the legal "disposal" cost
2 obligation should be recorded when the asset is placed in service. Because there
3 is often not a legal obligation to *remove* the asset when it wears out, the
4 "removal" cost obligation would still not qualify as an ARO and would not be
5 recorded under FAS 143.

6 **Q. Did the implementation of FIN 47 require any new accounts or accounting**
7 **by the Federal Energy Regulatory Commission?**

8 A. No. FIN 47 did not require any new accounts or accounting by the Federal
9 Energy Regulatory Commission ("FERC") beyond those identified in FERC
10 Order No. 631. The accounting required under FERC Order No. 631 adequately
11 addresses all ARO regulatory accounting requirements. While FIN 47 caused
12 certain additional ARO liabilities to be recorded, it does not change any of the
13 fundamental accounting requirements of FAS 143 or FERC Order No. 631.

14 ## III. FERC ORDER NO. 631

15 **Q. Please summarize the accounting required by FERC Order No. 631.**

16 A. FERC Order No. 631 is a regulatory accounting requirement that was issued to
17 update the accounting and regulatory reporting requirements for AROs under the
18 Uniform System of Accounts ("USoA"). Specifically, FERC (1) established new
19 balance sheet and income accounts and (2) revised the definitions and general

[2] FIN 47, ¶ A4 of Appendix A, Illustrated Examples, states, "The poles will eventually need to be

1 instructions to accommodate FAS 143 for AROs. These developments are part of
2 FERC's ongoing effort to address emerging accounting developments. FERC's
3 purpose upon issuance of Order No. 631 was to improve the usefulness and
4 transparency of financial information provided to the users of the FERC Forms by
5 establishing continuity between financial and regulatory accounting and reporting
6 requirements for legal obligations associated with the retirement of tangible long-
7 lived assets.[3]

8 **Q. Does FERC Order No. 631 change the regulatory accounting for removal**
9 **costs for non-AROs?**

10 A. No. FERC Order No. 631 does not change FERC's requirements for regulatory
11 accounting for the cost of removal amounts for non-AROs[4]. Jurisdictional
12 entities continue to account for such costs, consistent with the requirements of the
13 USoA. FERC simply concludes that utilities are to maintain subsidiary records
14 for identifying the cost of removal in depreciation accruals. This is not a change
15 in regulatory accounting, just a change in record-keeping. FERC Order No. 631
16 did not adopt FAS 143 or the SEC guidance requiring reclassification of the
17 regulatory liability outside of accumulated depreciation, but simply modified
18 FERC regulatory accounting requirements and added certain regulatory disclosure
19 requirements to accommodate certain of the FAS 143 financial accounting

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disposed of using special procedures, *because the poles will not last forever."* (emphasis added)

[3] FERC, Docket RM02-7, Order No. 631, ¶¶ 4 -5.
[4] *See id.* ¶37.

presentations.

Q. Does FERC Order No. 631 prescribe ratemaking treatment for removal costs?

A. No. FERC Order No. 631 does not address ratemaking recovery of removal costs. To the contrary, rather than requiring a change in ratemaking treatment, the Order accommodates existing ratemaking treatment by supporting the recording of regulatory assets and liabilities to reflect the differences between regulatory accounting and ratemaking treatment as prescribed in FERC Order No. 552. This treatment is consistent with FAS 71 and FAS 143, as previously discussed.

IV. PUBLIC COUNSEL PROPOSAL TO ESTABLISH REGULATORY LIABILITY

Q. Should the Commission be concerned that, as Public Counsel states, "…there is no *regulatory* recognition of the liability" (referring to accumulated removal costs that are included in accumulated depreciation)?

A. No. Public Counsel's concern is unfounded. There is absolutely no reason to raise an alarm. I have reviewed PSE's accounting for depreciation, including removal costs, and PSE's accounting complies with financial reporting and regulatory accounting requirements.

There is no FERC requirement that accumulated depreciation be recorded as a

1 regulatory liability for financial reporting and, contrary to Mr. Majoros' inference, the FERC USoA simply requires that separate subsidiary records be maintained to identify the accrual of removal cost in accumulated depreciation. "Maintaining subsidiary records" is not the same as a need to be "specifically identified in separate subaccounts of depreciation expense and accumulated depreciation." FERC established this requirement to simply help facilitate external reporting and regulatory analysis if the need arises to identify the amounts.

9 There is *regulatory* recognition of the accumulated costs of removal in ratemaking through the reduction of rate base for accumulated depreciation that includes these accumulated costs of removal.

12 **Q. Do you agree with Public Counsel that this Commission must specifically recognize regulatory liability treatment for non-AROs in this proceeding?**

14 A. No, I do not believe that is necessary. As FERC recognized in its Order No. 631, USoA prohibits the removal of amounts from accumulated depreciation other than for the prescribed purposes (e.g., the payment of costs of removal). Therefore, PSE would not be permitted for regulatory accounting purposes to remove amounts previously accrued for removal costs from accumulated depreciation and record them in income or apply them to some other account without the Commission's approval as long as PSE remains subject to the Commission's regulation. The non-AROs are also recognized as regulatory

liabilities under FAS 71 (paragraph 11b), based on the expectation that those costs will be incurred in the future but with the understanding that the utility will remain accountable for those costs and that future rates could be reduced if the utility's rates remain subject to regulation. The treatment of any previously-recovered amounts for non-AROs for regulatory accounting purposes would best be considered in future PSE depreciation studies or when, and if, any of PSE's operations cease to be cost-based regulated by this Commission.

Q. Would you please address Public Counsel's proposal to amortize a portion of PSE's accumulated costs of removal to offset its net storm damages claim?

A. Yes. That proposal is based entirely on Mr. Majoros' assertion that the accumulated costs of removal are "excess". Because the accumulated costs of removal are not "excess" they should not be diverted from the purpose for which they were initially provided. The recovery of storm costs should be addressed independently from other issues. It would not be appropriate to deny the recovery of previously incurred storm costs by confusing that issue with the recovery of costs of removal. The accumulated costs of removal have not been shown to be excessive and should not be used to offset the recovery of other unrelated costs.

V. ONGOING COSTS OF REMOVAL RECOVERY

Q. Mr. King states that traditional utility accounting and ratemaking uses what he refers to as the Traditional Inflated Future Cost Approach (or TIFCA) to recognize removal costs. Do you agree with his description?

A. Yes, although what he describes as TIFCA is commonly referred to as the Straight Line depreciation method, so a new acronym is unnecessary. Depreciation accounting is defined by the American Institute of Certified Public Accountants in the following way:

> Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage value (if any), over the estimated useful life of the unit (which may be a group of units) in a systematic and rational manner. It is a process of allocation, not valuation.[5]

As Mr. King points out, the rationale underlying Straight Line method is set forth in *Public Utility Depreciation Practices*, published by the National Association of Regulatory Utility Commissioners.[6]

> Historically, most regulatory commissions have required that both gross salvage and cost of removal be reflected in depreciation rates. The theory behind this requirement is that, since most physical plant placed in service will have some residual value at the time of its retirement, the original cost recovered through depreciation should be reduced by that amount. Closely associated with this

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[5] The definition of depreciation accounting by the American Institute of Certified Public Accountants, 1961, ¶56.

[6] *See* Exhibit No. ___(CWK-1TC), 20:2, referencing the National Association of Regulatory Utility Commissioners (NARUC), *Public Utility Depreciation Practices*, (August 1996), p. 157.

1 reasoning are the accounting principle that revenues be
2 matched with costs and the regulatory principle that utility
3 customers who benefit from the consumption of plant pay
4 for the cost of that plant, no more, no less. The application
5 of the latter principle also requires that the estimated cost
6 of removal of plant be recovered over its life.

7 Depreciation accounting should – to the extent possible – reflect the consumption
8 of physical assets, including the estimated costs to remove those assets, or the
9 pattern of revenues derived from assets. The matching principle is not only
10 important for financial accounting but is also an essential element of the
11 regulatory philosophy that has become known at intergenerational equity.
12 Intergenerational equity means that the costs generated from a resource are borne
13 by the generation of customers that benefited from the consumption of that
14 resource. To achieve this ratemaking goal, utility revenues should match all the
15 costs of providing service from particular property so that the customers who
16 receive service and benefit from particular property pay for that property's
17 depreciation costs, including costs of removal, over the life of that property.

18 It is appropriate for PSE to include estimated cost of removal, as it has
19 traditionally, as part of its depreciation rates, because this results in an equitable
20 distribution of the revenue requirement for recovery of the removal cost over the
21 period in which the asset that created the requirement is used to provide utility
22 service.

1 **Q. What is your position regarding a change in regulatory recovery for costs of**
2 **removal?**

3 A. Specific recognition and recovery of ARO costs in rates is not necessary because
4 the recovery of removal costs are currently and appropriately provided as part of
5 the depreciation rates. FAS 71 and FERC Order No. 631 provide the basis for
6 making any necessary accounting entries for the proper balance sheet
7 classification of amounts recovered and costs incurred for financial or regulatory
8 accounting. The important point to understand is that a recovery requirement for
9 removal cost is created at the moment an asset is placed into service. While the
10 recovery or costs of removal can be achieved by recovering those costs at the time
11 using the modified FAS 143 approach proposed by Mr. King, such an approach
12 blatantly ignores the principles of intergenerational equity. Such an approach will
13 burden customers with the cost of removing an asset in the period that the
14 removal cost is incurred when service started well before such period. Use of the
15 modified FAS 143 would undoubtedly result in an extreme back-loading of costs
16 because such method recovers the present value of a portion of the cost of
17 removal rather than the straight line average of the cost that will actually be
18 incurred. This will, unfortunately, result in a deferral of the remaining cost
19 recovery to future rate-payers, after the asset is retired from service.

1 **Q. Are there any reasons that FAS 143 or the modified FAS 143-type approach**
2 **for recovery of costs of removal proposed by Mr. King should not be used for**
3 **ratemaking?**

4 A. Yes. The FAS 143 accounting method utilizes several scenarios of estimated
5 removal cost for each asset and then assigns a probability to each scenario to
6 arrive at a weighted average estimated cost. This method is complex and utilizes
7 multiple assumptions. Therefore, this method would not be practical for mass
8 property items (e.g., electric and gas distribution systems) with indeterminate
9 lives for each specific piece of equipment. Due to the complexity of the analyses
10 that would be needed, this method would not be practical even for assets other
11 than the mass property items without specific retirement dates or legal
12 requirements for the legal removal.

13 FAS 143 requires that cost estimates be based on an assumption of what a third
14 party would require to perform the work, including its required profit margin,
15 even if the company intends to perform the work internally. Therefore, it can
16 result in the recognition of liabilities and costs that are significantly different from
17 actual expectations.

18 Under FAS 143, the weighted cost estimate is then discounted based on an
19 estimated "credit-adjusted risk-free rate" (essentially the specific company's then-
20 current unsecured debt borrowing rate) and then accreted back up to the ultimate
21 estimated liability over the time period until the liability is estimated to be settled.

1 The discount rate required by FAS 143 would generally be lower than the utility's
2 weighted cost of capital and thus would result in a higher initial ARC asset (and
3 higher straight line depreciation) and less backloaded accretion than calculated by
4 Mr. King in Exhibit No. ___(CWK-4) and Exhibit No. ___(CWK-5). Whatever
5 the discount rate used, an FAS 143 approach would result in a significant portion
6 of the total cost recognition being back loaded over time, and therefore does not
7 meet the ratemaking goal of intergenerational equity.

8 Mr. King has selectively applied only some of the principles of FAS 143 in his
9 proposal. Even then he adjusts his results because he recognizes that for most
10 electric distribution plant assets his approach would result in rate recovery that is
11 less than the actual cash costs incurred for cost of removal on average in recent
12 years.

13 Because Mr. King's approach backloads the rate recognition of costs, it would
14 essentially require annual increases in customer rates to recover the ever
15 increasing costs of removal resulting from accretion. If annual increases are not
16 provided, PSE would not recover a portion of its removal costs from customers or
17 would be forced to defer the unrecovered costs related to serving customers in
18 one period and recover those costs from customers in a later period that did not
19 benefit from that service.

1 **Q. Are you aware of any utility commissions that have adopted FAS 143 for**
2 **ratemaking purposes?**

3 A. No. I am aware that the Maryland Public Service Commission adopted a present
4 value approach in two 2007 decisions, but the Maryland cases did not adopt a
5 FAS 143-type approach as recommended by Mr. King in this case. FAS 143
6 inappropriately spreads the costs of removal unevenly over generations of
7 customers. FERC and most state commissions had provided for rate recovery of
8 both legally-required and non-legally-required costs of removal as a component
9 of depreciation expense long before FAS 143 was issued. Few companies outside
10 the regulated (or previously regulated) utility industries and the oil and gas
11 industry recognized costs of removal in advance of spending funds for the
12 removal activity. Particularly since FERC and state regulatory commissions have
13 more extensively studied depreciation and removal costs and how they should be
14 treated for ratemaking purposes than the FASB, I would not expect FERC or any
15 state commission to adopt FAS 143 for ratemaking purposes.

16 ## VI. CONCLUSION

17 **Q. Would you please summarize your recommendations?**

18 A. Yes. I believe Public Counsel's proposals with respect to past and ongoing cost
19 of removal recovery are unnecessary and inappropriate. The historical Straight
20 Line recovery of estimated costs of removal as a component of depreciation rates
21 remains appropriate and should be continued by the Commission.

1 **Q. Does that conclude your prefiled rebuttal testimony?**

2 A. Yes.