

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-080416

DOCKET NO. UG-080417

REBUTTAL TESTIMONY OF  
ALAN D. FELSENTHAL  
ON BEHALF OF AVISTA CORPORATION

**I. INTRODUCTION**

**Q. Please state your name and address.**

A. My name is Alan Felsenthal. My business address is 550 West Van Buren Street, Chicago, Illinois 60607.

**Q. Please state your occupation and work experience.**

A. I am a managing director at Huron Consulting Group (Huron). Huron provides a variety of accounting, tax and consulting services to various industry sectors. My focus is on the regulated industry sector, primarily electric and gas utilities.

Upon graduation from the University of Illinois in 1971, I was hired by Arthur Andersen & Co, where I was an auditor, focusing on audits of financial statements of regulated entities. I supervised audits of financial statements on which the Firm issued audit opinions that were filed with the Securities and Exchange Commission (“SEC”), the Federal Communications Commission, the Federal Energy Regulatory Commission (“FERC”) and various state commissions. Arthur Andersen also consulted on a significant number of utility rate cases and I helped develop testimony for myself and others on a variety of issues, including Construction Work in Progress in rate base, projected test years, lead-lag studies, cost allocation and income tax normalization. The testimony was filed in Illinois, Indiana, Florida, Michigan, Minnesota, New Mexico, Texas, Nevada and Wisconsin. I have testified before the Florida Public Service Commission, the Arizona Corporation Commission and the Illinois Commerce Commission. I joined PricewaterhouseCoopers in 2002 and became a Managing Director in their Utilities Group and continued performing audits and rate work for regulated entities. My curriculum vitae is attached as Exhibit No. \_\_\_\_(ADF-2).

1           **Q.     Have you dealt with the unique accounting, tax and financial reporting**  
2 **issues encountered by regulated enterprises?**

3           A.     Throughout my career, I have focused on utility accounting, income tax and  
4 regulatory issues, primarily as a result of auditing regulated enterprises. The unique accounting  
5 standards applicable to regulated entities embodied in Financial Accounting Standard (“FAS”)  
6 71, FAS 90, FAS 92, FAS 101 and various Emerging Issues Task Force (“EITF”) issues all need  
7 to be understood so that auditors can determine if the company’s accounting has been applied  
8 appropriately. During my career, I have witnessed the issuance of these standards and have  
9 consulted with utilities as to how they should be applied. At both Arthur Andersen and PwC, I  
10 worked with the technical industry accounting and auditing leadership to communicate and  
11 consult on utility accounting and audit matters.

12           **Q.     Have you provided training on the application of GAAP to regulated**  
13 **enterprises?**

14           A.     Yes. At Arthur Andersen and PwC (and now at Huron), I developed and  
15 presented utility accounting seminars focusing on the unique aspects of the regulatory process  
16 and the resulting accounting consequences of the application of Generally Accepted Accounting  
17 Principles (“GAAP”). I have presented seminars, as well as delivered training on an in-house  
18 basis. Seminar participants have included utility company and regulatory commission staff  
19 accountants, utility rate departments and internal auditors, tax accountants and others. I have  
20 also conducted these seminars in-house for the FERC, several state commissions, and have  
21 presented at various Edison Electric Institute and American Gas Association ratemaking and  
22 accounting seminars.

23           **Q.     What is the purpose of your rebuttal testimony?**

1           A.     My rebuttal testimony responds to the Public Counsel Section of the Washington  
2 State Attorney General’s Office (Public Counsel) and the Industrial Customers of Northwest  
3 Utilities (ICNU) witnesses Charles W. King and Michael J. Majoros on the subject of cost of  
4 removal, as a component of depreciation.

5           My rebuttal testimony will discuss certain aspects of the Financial Accounting Standards  
6 Board’s (FASB) Statement of Financial Accounting Standard No. 143, *Accounting for Asset*  
7 *Retirement Obligations* (“FAS 143”), and FASB Interpretation 47, *Accounting for Conditional*  
8 *Asset Retirement Obligations* (“FIN 47”) relating to accounting for retirement obligations. I will  
9 discuss the objectives and requirements of FAS 143 and explain why FAS 143 accounting, while  
10 relevant for financial accounting and reporting, has no impact on ratemaking. I will also discuss  
11 FERC Order No. 631, which addresses the regulatory accounting for asset removal costs and the  
12 appropriate application of FAS 143 under the FERC Uniform System of Accounts (“USoA”).  
13 Lastly, I will discuss Avista’s historical and current method of accounting for cost of removal,  
14 whereby the costs associated with removing property, plant and equipment are estimated and  
15 recognized as a component of depreciation rates, and why this method is consistent with GAAP  
16 and regulatory accounting and ratemaking practices, and should be continued.

17           **Q.     What specific recommendations of Mr. Majoros and Mr. King are you**  
18 **addressing?**

19           A.     I address Mr. King’s proposal to modify Avista’s cost of removal calculation  
20 based on a FAS 143-type approach – i.e., discounting the estimated cost of removal and  
21 recognizing annual costs on an increasing, rather than straight-line basis as is done now, as  
22 further addressed by Company witness John. J. Spanos. I also address Mr. Majoros’ proposals to  
23 1) reclassify the accumulated cost of removal balance from accumulated depreciation to a

1 regulatory liability and 2) to offset confidential litigation costs associated with an unrelated prior  
2 claim with the accumulated cost of removal.

3 **Q. Can you please summarize your rebuttal testimony?**

4 A. Yes. My testimony concludes that Public Counsel/ICNU's proposals should be  
5 rejected in their entirety:

- 6 • **Cost of Removal Calculation** - The traditional and widely-accepted regulatory  
7 approach to recover cost of removal on a straight-line basis through depreciation  
8 charges is the appropriate methodology for such costs. This method  
9 appropriately matches the recovery of such costs with the customers who benefit  
10 from the use of the fixed asset that causes the retirement obligation. As such,  
11 this approach supports intergenerational equity. Mr. King's methodology, based  
12 on a FAS 143-type approach, produces an ever-increasing annual charge that  
13 requires annual rate cases and increases the risk that the actual cost of removal  
14 will not be recovered. In addition, this method burdens future customers simply  
15 to reduce rates for today's customers.
- 16 • **Reclassification to Regulatory Liability** – Mr. Majoros' proposal to reclassify  
17 Avista's \$209.4 million of accumulated cost of removal included in accumulated  
18 depreciation to a regulatory liability is unnecessary and inappropriate. Avista  
19 maintains subsidiary records within the accumulated depreciation account that  
20 track the cost of removal costs. Further, for regulatory purposes, Avista is not  
21 permitted to remove amounts previously accrued for removal costs from  
22 accumulated depreciation and record them in income or apply them to some  
23 other account without regulatory approval.

- **Offset of Other Cost Recovery with the Accumulated Cost of Removal** - The accumulated cost of removal obligation is required to fund the future cost of removal activities and is not available to offset other costs. Therefore, Mr. Majoros’ proposal to offset the confidential litigation settlement costs with the accumulated cost of removal is not permitted.

**Q. Have you prepared a table of contents for your testimony?**

A. Yes. A table of contents for my testimony is as follows:

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**II. COST OF REMOVAL**

**Q. What are “removal costs”?**

A. When an asset is purchased or constructed, its cost is recorded in the appropriate property, plant, and equipment account. But that is not the end of the accounting. At the end of the asset’s useful life it may have salvage value, the value of scrap metal for instance. There may be costs to safely dispose of the asset or to restore the site. The salvage and costs must be accounted for as well. For example, many transformers contain polychlorinated biphenyls (“PCB’s”) and there are environmental laws that govern the removal of PCB’s when the

1 transformer is retired. Likewise, when items of property included in FERC account 365,  
2 overhead conductor and devices, are retired (such as circuit breakers, ground wires and  
3 conductors), costs are incurred to physically remove the assets from service, although there is no  
4 legal obligation to do so.

5 **Q. How are salvage and removal costs considered in the depreciation**  
6 **calculation?**

7 A. The cost of an asset is depreciated over its estimated useful life in a systematic  
8 and rational manner (generally straight-line), so at the end of its useful life, the plant asset has  
9 been fully recovered through depreciation charges. When the asset is retired, there can be a  
10 salvage value, a cost to remove or dismantle the fixed asset, or both.

11 Under GAAP, all entities need to consider salvage value when determining the annual  
12 depreciation charge. The original cost of the fixed asset is reduced by the estimated salvage  
13 value and the net original cost is used as the basis for depreciation. For example, assume a fixed  
14 asset is acquired for \$1,000 with an estimated 5 year life and an estimated salvage value of \$60.  
15 The net cost to be recovered through annual charges is \$940 or \$188 each year ( $\$940/5$ ).

16 Under the accounting followed by some entities (but by most utilities, railroads, and oil  
17 and gas entities) prior to the issuance of FAS 143, if there was also a cost associated with  
18 removing the fixed asset upon retirement, that cost would also be considered in developing  
19 annual depreciation. Say that it is estimated to cost \$160 to remove the asset in the example  
20 above. In such a case, the “net negative salvage” is \$100 (\$60 salvage less \$160 to remove).  
21 The net cost to be recovered through annual charges is \$1,100 or \$220 per year.

22 **Q. Was this approach traditionally used by regulated entities to recover removal**  
23 **costs in the ratemaking process?**

1           A.     Yes. Regulated utilities typically included the cost of the asset, salvage value and  
2 removal costs in determining the annual depreciation charge. In this manner, the ratepayer who  
3 is receiving the benefit from using the fixed asset pays for the cost of the asset as well as the net  
4 salvage (positive or negative) on a straight-line basis. Both the recovery of the asset cost itself  
5 and the net salvage (positive or negative) are considered in the development of the depreciation  
6 factors. Avista and other utilities in Washington have historically used and continue to use this  
7 methodology, as do nearly all utilities nationwide. Many non-regulated entities, however, do not  
8 record the costs of removal until the asset is retired.

9           **Q.     What is the regulatory rationale for this approach?**

10          A.     From a regulatory standpoint, it is important to match revenues with costs under  
11 the principle that utility customers who benefit from the consumption of plant pay for the cost of  
12 that plant, including its removal costs, net of salvage. The application of this principle requires  
13 that the estimated cost of removal of plant be recovered over its life.

14          This “matching principle” is an important component of the regulatory philosophy that is  
15 sometimes referred to as intergenerational equity. Intergenerational equity means that the costs  
16 generated from a resource are borne by the same group or generation of customers that benefit  
17 from the consumption of that resource. To achieve this ratemaking goal, utility revenues should  
18 match all the costs of providing service from particular property so that the customers who  
19 receive utility service and benefit from the particular property pay for that property’s  
20 depreciation costs, including costs of removal, over the life of that property.

21          By including cost of removal as part of its depreciation rates, an equitable distribution of  
22 the revenue requirement occurs to permit recovery of the removal cost over the period in which  
23 the asset that created the requirement is used to provide utility service.



1 Intergenerational equity, however, is not a factor in setting prices for non-regulated  
2 entities.

3 **Q. Mr. King proposes to use a discounting approach similar to that contained in**  
4 **FAS 143 for calculating cost of removal, rather than the traditional, straight-line approach**  
5 **discussed above. Briefly describe FAS 143 and Mr. Kings' rationale for using it.**

6 A. FAS 143 addresses the accounting and financial reporting requirements under  
7 Generally Accepted Accounting Principles (GAAP) for legal obligations to remove, dispose, or  
8 remediate a tangible, long-lived asset. This standard was implemented to ensure that all legal  
9 liabilities are recorded in the financial statements. The liability is recorded at the discounted  
10 value or estimated fair value of the ultimate cost of the legal liability at the time the asset is  
11 placed into service. The estimate of the fair value includes an estimate of the cash flows of the  
12 future retirement activities that have been discounted using the entity's appropriate interest rate.  
13 Avista implemented FAS 143 for accounting and financial reporting of legal obligations as  
14 required by the standard.

15 Mr. King has proposed that Avista adopt the FAS 143 approach to computing its cost of  
16 removal accrual for non-legal obligations for regulatory purposes. Mr. King has made several  
17 proposals with respect to Avista's cost of removal. My testimony will first discuss in detail Mr.  
18 King's specific proposals. After discussing these specific proposals, my testimony on pages 16  
19 through 29 will discuss the accounting and regulatory standards (FAS 143, FAS 71, FIN 47,  
20 FERC Order No. 631, and FERC USoA,) which support the basis for my conclusions regarding  
21 Mr. King's proposals.

1                   **III. PROPOSAL TO MODIFY COST OF REMOVAL CALCULATION**

2           **Q.     Mr. King (pages 11-12) suggests that instead of the current approach for**  
3 **calculating and allocating cost of removal, that a discounting approach similar to that**  
4 **contained in FAS 143 be used for ratemaking purposes. Do you agree with this**  
5 **methodology?**

6           A.     No. Mr. King's proposal includes two elements for cost of removal. The first  
7 element estimates the eventual cost of removal and then discounts it to the present time using a  
8 discount rate of 3% (under FAS 143, the requirement is to use the credit-adjusted risk-free rate to  
9 discount; Mr. King uses 3% for that purpose although the actual credit-adjusted risk-free rate is  
10 likely higher). The asset retirement cost (ARC) asset calculated in this manner is then  
11 depreciated on a straight-line basis. The second element is an inflation component (again 3%) to  
12 recognize annual accretion of the cost of removal obligation so that, over time, the obligation  
13 will increase to its estimated cost. This approach results in ever-increasing annual charges,  
14 ignores the principles of intergenerational equity and will require frequent (annual) rate cases to  
15 fully capture the removal costs that will increase each year to recognize accretion.

16           Because it is not practical to file annual rate cases for the sole purpose of capturing these  
17 increasing costs, this approach will result either in 1) back-loading of costs and burdening future  
18 customers (some of which may not even have been customers who used/benefited from the  
19 service of such asset) with the difference between the actual removal costs and the amount  
20 charged through rates; or 2) the utility not recover the cost. Either way, this approach increases  
21 the risk associated with cost of removal recovery and clearly decreases current cash flows, which  
22 also increases risk.

1           The current approach used by Avista and nearly all utilities nationwide, whereby the  
2 estimated cost of removal is recovered through depreciation rates on a straight-line basis,  
3 promotes current recovery of an incurred cost in the appropriate period from the appropriate  
4 customer.

5           **Q.     Are there any other reasons that the cost of removal approach proposed by**  
6 **Mr. King should not be used for ratemaking?**

7           A.     Yes. To properly implement the FAS 143 methodology, various assumptions are  
8 required, each of which will impact the result. The assumptions involve estimates of removal  
9 costs taking into account inflation, risk factors, normal profit margins, removal time periods,  
10 etc. When you combine the FAS 143 requirements with Avista's thousands of retirement units  
11 (particularly mass assets such as poles, feet of gas mains, etc.) each with different lives (some of  
12 which are indeterminate), this method would not be practical.

13           Instead of using the methodology embodied in FAS 143, Mr. King has created an  
14 approach which simply focuses on the discounting aspect of FAS 143. Discounting the  
15 estimated obligation lowers current charges when compared to the straight-line approach  
16 currently utilized for ratemaking purposes. Further, as can be seen on Schedule 3 of Mr. King's  
17 testimony, his approach results in an annual cost of removal allowance that is lower in the early  
18 years and higher in the later years of the assets' life (even with a 20 year life, charges in the last  
19 year are 28% higher than in the first year [\$88.59 vs. \$113.62]; a longer lived recovery period  
20 would produce an even more dramatic difference). Thus, in order to recover the cost of removal  
21 from customers, annual rate increases would be required.

1 His Schedule 3 also compares the straight line methodology to his FAS 143-like  
2 approach but fails to consider that the customers receive the time value benefit associated with  
3 accumulated cost of removal (via a reduction in rate base and return).

4 Mr. King's methodology results in the back-loading of the cost of removal, deferring cost  
5 recovery to the wrong generation of customers or not collecting the amounts at all. Such back-  
6 loading would not occur under the straight-line approach currently used by Avista.

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

9 A. I am only aware of one commission, the Maryland Public Service Commission,  
10 that has adopted a present value (discounting) approach to determining the annual cost of  
11 removal accrual in two rate cases decided in 2007, although it is not a true FAS 143 approach.

12 FAS 143 is not practical for regulated utilities with many plant assets with differing lives  
13 and retirement dates and is not appropriate for ratemaking purposes because of the back-loading  
14 of costs. That is why the FERC and almost all state commissions, even before FAS 143 was  
15 issued, provide for rate recovery of both legally-required and non-legally-required costs of  
16 removal as a component of depreciation expense.

17 Regulated utilities conduct depreciation studies on a periodic basis and removal costs are  
18 considered in the determination of the depreciation rates. Adjusted depreciation rates result from  
19 such studies and the regulatory commissions typically review and approve the studies to ensure  
20 that unwarranted costs are not included.

21 **IV. PROPOSAL TO ESTABLISH A REGULATORY LIABILITY**

22 **Q. In his testimony (page 10) Mr. Majoros proposes that cost of removal**  
23 **amounts be reclassified from accumulated depreciation to a regulatory liability account to**

1 **“recognize the ratepayers’ security interest in these monies until spent on their intended**  
2 **purpose.” Should this proposal be adopted?**

3 A. No. Avista has collected future cost of removal as a component of depreciation  
4 expense related to its assets in order to collect these costs from customers over the service lives  
5 of those assets. Because the costs of removal will not be incurred until after the asset ceases  
6 operations, these collections must occur prior to the costs being paid. The SEC requires utilities  
7 to report these collected costs as a regulatory liability for financial reporting. However, this is an  
8 SEC requirement for financial reporting purposes only. The Company does not make this  
9 adjustment to its regulatory financial statements and follows FERC guidance by keeping  
10 accumulated cost of removal other than legal obligations in accumulated depreciation.

11 The expenses included in rates charged to customers are appropriately accounted for in  
12 accumulated depreciation. There is no need to segregate these funds into a specific account or  
13 lock box to ensure that these funds will be spent for their intended purpose or that any unspent  
14 funds will be used to reduce customer rates in the future. Further, there is regulatory recognition  
15 of the accumulated costs of removal in ratemaking through the reduction of rate base for  
16 accumulated depreciation that includes these accumulated costs of removal.

17 Mr. Majoros believes that a regulatory liability account is necessary to capture the  
18 accumulated cost of removal. There is no FASB requirement or FERC requirement that  
19 accumulated depreciation be recorded as a regulatory liability for financial reporting and,  
20 contrary to Mr. Majoros’ proposal, the FERC USoA simply requires that separate subsidiary  
21 records be maintained to identify the accrual of removal cost in accumulated depreciation.

22 FERC Order 631 prohibits the removal of amounts from accumulated depreciation other  
23 than for their intended purposes, in this case, for the payment of costs of removal. Contrary to

1 suggestions by Mr. Majoros, Avista is not permitted to remove amounts previously accrued for  
2 removal costs from accumulated depreciation and record them in income or apply them to some  
3 other account without regulatory approval. Non-legal cost of removal asset retirement  
4 obligations (AROs) are also recognized as regulatory liabilities under FAS 71 (paragraph 11b),  
5 when it is probable that such costs will be incurred in the future and that, if not, future rates  
6 could be reduced. The treatment of any previously-recovered amounts for non-AROs for  
7 regulatory accounting purposes would normally be considered in future depreciation studies.

8 Avista is following the FERC guidance described later in my testimony. This  
9 Commission has specifically adopted the application of the FERC Uniform System of Accounts  
10 and accounting guidance. WAC 480-100-203 – Accounting System Requirements, Paragraph  
11 (1) states,

12 “Electric utilities in the state of Washington must use the uniform system of accounts  
13 applicable to major and nonmajor electric utilities as published by the Federal Energy  
14 Regulatory Commission (FERC) in Title 18 of the Code of Federal Regulations, Part  
15 101.”  
16

17 In addition, WAC 480-100-203 – Accounting System Requirements, Paragraph (3) states,

18 “Any deviation from the uniform system of accounts, as prescribed by the FERC, will  
19 be accomplished only after due notice and order of this commission.”  
20

21 They have separately identified the accumulated cost of removal within the accumulated  
22 depreciation account. There is no compelling reason to reclassify such amounts for regulatory  
23 purposes.

24 As Mr. Majoros himself recognizes (page 11) there would be no effect on revenue  
25 requirements resulting from his proposal.

1           **Q. Mr. Majoros (pages 6 - 10) refers to Avista's accumulated cost of removal**  
2 **amounts as "excess" and "over-collection for future cost of removal." Do you agree with**  
3 **this characterization?**

4           A. No. The accumulated cost of removal he is referring to represents the amounts  
5 charged to and collected from ratepayers (as a factor in determining depreciation rates) to  
6 remove transmission and distribution plant assets from service upon their retirement. The  
7 estimates are considered in the determination of depreciation rates and charged to ratepayers  
8 during the life of the asset so that the customer who benefits from the service is the same  
9 customer that pays for the removal costs. The assertion that amounts collected are excess will be  
10 tested in time as the future cost of removal is spent. To the extent that actual removal costs differ  
11 (higher or lower) than the estimates, that difference will be considered in future depreciation  
12 estimates. In the meantime, such collections are included as a component of accumulated  
13 depreciation which serves to reduce rate base, i.e., if there were to be any temporary over  
14 collection of dollars, customers would be compensated with a return on those dollars equal to  
15 Avista's overall rate of return.

16           To call the cost of removal amounts collected from customers "excess" before they are  
17 actually spent in removing the asset is a clear mischaracterization (just as characterizing it as an  
18 under collection when assets that the utility has spent money on prior to the time such amounts  
19 are recovered thru rates). Both the financial accounting and regulatory accounting processes use  
20 the accrual basis of accounting (depreciation is an estimate). To single-out one accrual and refer  
21 to it as "excess" or an "over-collection" is inappropriate.

22           **Q. Would Avista be able to transfer the costs of removal from Account 108 and**  
23 **record accumulated depreciation as a regulatory liability if it wanted to?**

1           A. No. USoA Account 108 makes it very clear that items in accumulated depreciation  
2 are prohibited from being transferred without the authority of FERC. Account 108, item E, states,  
3           “The utility is restricted in its use of the accumulated provision for depreciation to the  
4 purposes set forth above. It shall not transfer any portion of this account to retained  
5 earnings or make any other use thereof without authorization by the Commission.”  
6

7           In addition, FERC has issued several letters to utilities as well as a FERC Order prohibiting  
8 them from reallocating accumulated depreciation.<sup>1</sup>

9           **Q. Can this Commission order Avista to transfer accumulated cost of removal to a  
10 regulatory liability?**

11           A. Yes. However, FERC’s Chief Accountant still must approve any departure from  
12 USoA. If Avista cannot obtain such approval, Avista would be obligated to create a separate set of  
13 regulatory books for state regulatory accounting and rate proceedings.

14           **Q. Does FERC or its USoA provide any guidance in the event that the actual cost of  
15 removal is less than the accumulated cost of removal recovered from ratepayers through  
16 straight-line depreciation charges?**

17           A. Yes. In a letter issued to Bruder, Gentile and Marcoux on behalf of Florida Power  
18 Corporation on November 22, 1991, the Chief Accountant of FERC stated that when applying  
19 straight-line remaining life method for depreciation, the over and under accruals of depreciation  
20 recorded in past periods are corrected over the remaining life of the related property by adjusting  
21 the book depreciation rates prospectively. Thus, such amounts are considered in depreciation  
22 studies and in determining the appropriate factor to be included in depreciation rates.

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<sup>1</sup> Eastern Edison Company, Docket No. FA84-2-000, FERC, July 5, 1984; Florida Public Service Commission, Docket No. AC93-30-000, FERC, February 2, 1993; Seminole Electric Cooperative, Inc., Docket No. AC91-99-000, FERC, November 22, 1991; Tampa Electric Company, Docket No. AC-91-102-000, December 6, 1991.



1                   **V. PROPOSAL TO OFFSET ACCUMULATED COST OF REMOVAL**

2           **Q.     On page 18 of his testimony, Mr. Majoros recommends that a portion of**  
3 **Avista’s accumulated cost of removal be used to offset any of the costs of settling certain**  
4 **confidential litigation. Do you agree with this approach?**

5           A.     No. As stated above, the accumulated costs of removal are not “excess” and are  
6 required to pay for Avista’s actual removal costs. As such, they are not available to offset the  
7 recovery of other unrelated costs. The recovery of the confidential litigation costs is a separate  
8 issue and should not be confused with the recovery of cost of removal. This would be no  
9 different than diverting income tax accruals, accumulated depreciation or other legitimate  
10 reserves, credits or liabilities to offset the recovery of other costs.

11           As previously described, Account 108 of USoA accounting instructions for accumulated  
12 depreciation does not allow amounts to be transferred from Account 108 to any other classification  
13 without the authorization of FERC’s Chief Accountant. As noted previously, in FERC’s Chief  
14 Accountant letters, a transfer to a regulatory liability and amortization of such liability to reduce an  
15 unrelated operations and maintenance expense is against USoA guidance and not likely to be  
16 accepted by FERC.

17                   **VI. FAS 143 and FAS 71**

18           **Q.     What is FAS 143 and briefly describe what it requires?**

19           A.     FAS 143 established the GAAP standard to account for legal retirement  
20 obligations. It became effective in 2003 and required an entity to determine if it has a **legal**  
21 obligation to remove, dispose, or remediate an asset. If a legal obligation exists, the fair value of  
22 the legal obligation is to be recorded as an ARO with a corresponding ARC recorded as well.  
23 The entity would then depreciate the ARC and accrete, or recognize, the ARO liability so that

1 when the retirement cost is paid, the ARC would have been fully depreciated and the ARO  
2 liability would have increased to the amount of the obligation. Both depreciation expense and  
3 accretion costs are recorded on the income statement over time to recognize the estimated costs  
4 of removing the legal obligation in the periods that the related asset is being depreciated.

5 **Q. What was the reason the FASB addressed accounting for asset retirement**  
6 **obligations by issuing FAS 143?**

7 A. The project was undertaken initially to address the accounting for nuclear  
8 decommissioning obligations as well as similar “closure-type” costs in other industries. The  
9 SEC was concerned that different companies were accounting for such obligations differently.  
10 Most utilities had been recognizing as costs and liabilities only the amounts of decommissioning  
11 obligations that were being recovered in the ratemaking process. The SEC and others were  
12 concerned that if the nuclear facility was closed prematurely, the full liability to decommission  
13 the plant would not have been recognized on the balance sheet at the time of closure. The issue  
14 of recognizing the costs associated with “retirement” and “closure” eventually was broadened to  
15 incorporate the issue of asset retirement costs on a broader basis, and the final standard addressed  
16 all “legal asset retirement obligations.” Non-legal ARO’s, however, were excluded from FAS  
17 143.

18 **Q. How does FAS 143 define legal ARO’s?**

19 A. FAS 143 requires financial accounting and reporting under GAAP for costs of  
20 “legal obligations associated with the retirement of a tangible long-lived asset.” (Paragraph 2 of  
21 FAS 143) The statement only applies to costs related to the retirement of a tangible long-lived  
22 asset resulting from “acquisition, construction, or development and (or) normal operation of a  
23 long-lived asset.”(Paragraph 2 of FAS 143) Common AROs in the electric utility industry

1 include decommissioning of nuclear and some coal plants at the end of or after their useful lives,  
2 state requirements to safely dispose and restore ash ponds and costs to remove asbestos from  
3 facilities.<sup>2</sup> The estimated costs associated with these AROs were generally recognized by  
4 regulated utilities by including a factor for estimated removal costs in the determination of the  
5 depreciation rate.

6 The retirement obligations for the majority of the utility industry's transmission and  
7 distribution assets have not been classified as AROs (and do not meet the accounting  
8 requirements of FAS 143) because they are not **legal** obligations. However, this does not mean  
9 that removal costs on such assets will not be incurred. Avista's property accounting records  
10 clearly show that removal costs are incurred for non-legal ARO's and the Company's  
11 depreciation rates include a factor for removal costs based on the historical costs of such  
12 activities.

13 **Q. What is the definition of non-legal retirement obligation (cost of removal**  
14 **other than legal obligations)?**

15 A. It is retirement obligations that do not meet the definition of FAS 143 legal  
16 obligations. It does not mean that the retirement obligation does not exist, as Mr. King and Mr.  
17 Majoros define it.

18 **Q. Did FAS 143 distinguish between the accounting for legal versus non-legal**  
19 **ARO's?**

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<sup>2</sup> The Company has recorded liabilities for legal asset retirement obligations to (1) restore ponds at Colstrip, (2) cap a landfill at the Kettle Falls Plant, (3) remove plant and restore the land at the Coyote Springs 2 site at the termination of the land lease, (4) remove asbestos at the corporate office building, and (5) dispose of PCBs in certain transformers. At December 31, 2007, Avista had recorded on its financial statements a liability of \$3.99 million for these legal asset retirement obligations.

1           A.     Yes. FAS 143 addresses the accounting and financial reporting for legal ARO's  
2 and concluded that legal ARO's should be recorded in the financial statements. The FASB has  
3 paid increasing attention to being sure that all legal liabilities of an entity are recorded as  
4 liabilities. Thus, the discounted value of the legal liability to remove an asset is recorded for all  
5 entities when the asset is placed into service as described above.

6           However, the FASB concluded in FAS 143 that the financial accounting practice of  
7 including a cost of removal factor in depreciation charges for non-legal retirement obligations  
8 was no longer appropriate under GAAP. Thus, if non-regulated companies had been including a  
9 factor for cost of removal in their depreciation rates, upon adoption of FAS 143 these entities  
10 could no longer accrue such a cost of removal factor. For companies that are not regulated, the  
11 prices that they charge are based on industry and economy-wide factors and are not based on  
12 company-specific costs. Most non-regulated entities had not been recognizing these costs  
13 whether legal obligations or not.

14           As described previously, regulated utilities routinely included a cost of removal (negative  
15 salvage) factor in depreciation rates and did not make the distinction between legal and non-legal  
16 retirement obligations. Under GAAP, with the adoption of FAS 143, regulated utilities could no  
17 longer rely on GAAP to accrue a cost of removal factor in depreciation expense. However,  
18 regulated utilities could continue to accrue such costs for financial reporting purposes if the  
19 regulator continued to permit the recovery of such removal costs in the ratemaking process.  
20 Financial accounting for regulated entities (such as Avista) is governed by SFAS 71, *Accounting*  
21 *for the Effects of Certain Types of Regulation* ("FAS 71") to reflect the economic effects of  
22 regulation. I describe FAS 71 later in my rebuttal testimony.

1           **Q.     Please describe in more detail how the initial ARO liability and Asset**  
2 **Retirement Cost are determined under FAS 143?**

3           A.     The process to determine the ARO liability begins with estimating the future cost  
4 associated with the cost of the legal obligation. In this manner, it is similar to how the cost of  
5 removal component to be included in determining depreciation rates under traditional regulatory  
6 accounting and ratemaking is estimated. In both instances an estimate of the ultimate future cost  
7 must be determined.

8           While it only applies to financial accounting and reporting of legal AROs, FAS 143  
9 requires the estimate of the ultimate cost of legal obligations to be measured at fair values. The  
10 estimate of fair values generally includes an estimate of the cash flows that reflect, to the extent  
11 possible, a marketplace assessment of the cost and timing of performing the required retirement  
12 activities. The estimate should consider the costs that a third party would incur in performing the  
13 tasks necessary to retire the asset (including an inflation component, a reasonable profit margin  
14 and a factor for the risks associated with the obligation).

15           Under FAS 143, the estimated ultimate cost is discounted using a “credit-adjusted risk-  
16 free rate” equal to the entity’s debt borrowing rate. The discounted future obligation is recorded  
17 on the balance sheet (credit) with an equal increase in the fixed asset/property balance for the  
18 ARC at the time the property is placed in service (debit).

19           This ARC amount is depreciated on a straight-line basis through depreciation expense.  
20 The discounted ARO liability is increased each year through an accretion expense charge so that  
21 the initial ARO liability amount will increase to the estimated ultimate cost to remove the asset  
22 by the estimated removal date which may be at or several years after the date the asset is retired.  
23 The FAS 143 ARO liability is displayed for financial accounting purposes as a separate liability

1 on the balance sheet as opposed to being included in accumulated depreciation as was often the  
2 case before FAS 143.

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

4 A. FIN 47 required companies to record additional AROs as a result of “conditional”  
5 obligations to remove or dispose of assets, under the premise that “nothing lasts forever.” Some  
6 companies had claimed that even though there was a legal obligation to remove an asset, they  
7 had means to avoid having to physically retire an asset and avoid ARO. Thus, FIN 47 expanded  
8 the fixed assets that were required to establish AROs at the time the assets were placed in  
9 service.

10 **Q. What was Avista’s policy with respect to removal costs prior to FAS 143?**

11 A. Avista, like most utilities, had estimated the cost associated with removing and  
12 dismantling its fixed assets and included a cost of removal component in depreciation expense to  
13 build up a balance to pay the eventual cost to remove or dismantle. By including a cost of  
14 removal factor (net of salvage) in depreciation expense, the customer who is benefitting from the  
15 property, plant and equipment pays for the total plant costs—the original cost of construction  
16 plus the estimated cost of removal, net of salvage. Under this approach, the build-up of annual  
17 cost of removal charges was included in accumulated depreciation.

18 FAS 143 only addresses the accounting and financial reporting under GAAP. It does not  
19 address regulatory accounting or ratemaking. Regulatory assets and liabilities provide a vehicle  
20 to recognize the economic effects of the ratemaking process, to the extent there are differences  
21 between the financial reporting and ratemaking treatment of certain costs. This is also true for  
22 non-regulated entities - the FASB does not dictate how to determine prices.

23 **Q. How did FAS 143 impact regulated entities?**

1           A.     The financial accounting impacts of implementing FAS 143 for regulated utilities  
2 was mostly on the balance sheet, as the net income effects that non-regulated entities would face  
3 (depreciating the ARC and accreting the ARO) are recorded as regulatory assets or regulatory  
4 liabilities as long as the recovery of the regulatory assets and regulatory liabilities are probable  
5 under FAS 71.

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

8           A.     No. Neither FAS 143 nor FAS 71 requires that regulatory liabilities be recorded  
9 in separate liability accounts rather than within accumulated depreciation.

10          **Q.     What is FAS 71?**

11          A.     FAS 71 was issued by the FASB in 1982. The Statement is the principal  
12 accounting guidance for regulated entities and addresses the unique accounting for entities where  
13 there is a linkage between tariffed rates charged to its customers and the company's costs. In  
14 summary, the economic effects of regulation are required to be reflected in the financial  
15 statements of an entity, such as Avista, that meets the scope requirements of FAS 71.

16          Under FAS 71, utilities are required to defer incurred costs that non-regulated entities  
17 would otherwise charge to expense if, as a result of the regulatory process, it is probable that  
18 such costs will be recovered in future charges to ratepayers. Additionally, regulated entities are  
19 required to record regulatory liabilities when it becomes probable that a regulator will require the  
20 refund of revenues previously charged to ratepayers or for revenues collected from ratepayers in  
21 advance of cost recognition.

22          An example of a regulatory asset would be if a storm occurred and the utility incurred  
23 costs to recover the costs of the storm. Say \$20 million of storm damage expense was incurred

1 in 2008 and the utility seeks and is granted rate recovery of such costs in 2009-2012 (\$5 million  
2 per year) by the regulatory commission. The accounting would be to record a \$20 million  
3 regulatory asset in the 2008 financial statements and amortize to expense \$5 million per year in  
4 2009-2012 to match the additional revenues.

5 Thus, FAS 71 had been in effect for many years prior to FAS 143, and the concept of  
6 regulatory assets and regulatory liabilities is not a new one. If the conditions of FAS 71 are met,  
7 regulated entities will recognize a regulatory liability or asset whenever expenses or revenues are  
8 recognized in one period for regulated ratemaking, but would have been recognized in another  
9 period under GAAP for an unregulated entity.

10 **Q. Generally, which types of entities follow the accounting under FAS 71?**

11 A. Historically, regulated electric, gas, telephone and water utilities followed the  
12 accounting requirements of FAS 71. Unlike competitive entities, where the rates/prices charged  
13 for products or services are based on competition, regulated entities typically set the rates they  
14 charge their customers based on their costs. The economic effects of regulation were considered  
15 unique by the FASB when they considered the accounting that eventually resulted in FAS 71.

16 Said another way, because regulated utilities are required to set prices based on costs,  
17 their financial statements should recognize the direct linkage between costs and revenues. And,  
18 if a regulator permitted recovery (through prices) of a cost in a different accounting period than  
19 when the cost was incurred, that cost should be deferred on the balance sheet (rather than  
20 expensed in the income statement) and amortized to the income statement in the period in which  
21 the revenues to recover that cost are being reflected. This accounting matches the costs  
22 (expenses) and revenues (based on those costs).

23



1 Specifically, FAS 71 states:

2 “This Statement may require that a cost be accounted for in a  
3 different manner from that required by another authoritative  
4 pronouncement. In that case, this Statement is to be followed  
5 because it reflects the economic effects of the rate-making  
6 process—effects not considered in other authoritative  
7 pronouncements. All other provisions of that other authoritative  
8 pronouncement apply to the regulated enterprise.” (FAS 71,  
9 page 2)

10 As long as the ratemaking process provides a linkage between costs and revenues  
11 creating an economic effect, FAS 71 should be applied.

12 **Q. Does FAS 143 contain guidance on the ratemaking treatment of legal AROs  
13 or other non-legal costs of removal?**

14 **A.** No. FAS 143 and other FASB pronouncements do not address ratemaking  
15 treatment. FAS 143 does not preclude Avista and other utilities from continuing to recover ARO  
16 and other removal costs in the approved depreciation rates in the same manner they always have,  
17 whether or not those costs fall within the scope of FAS 143. In fact, FAS 143 acknowledges that  
18 many regulated entities recover removal costs over the life of the asset through depreciation  
19 rates. Discussing rate-regulated entities, FAS 143 states:

20 “The amounts charged to customers for the costs related to the  
21 retirement of long-lived assets may differ from the period costs  
22 recognized in accordance with this Statement, and, therefore, may  
23 result in a difference in the timing of recognition of period costs  
24 for financial reporting and rate-making purposes. “

25 FAS 143 further recognizes that if the requirements for FAS 71 are met, the rate-  
26 regulated entity would recognize for financial accounting purposes a regulatory asset or liability  
27 for the differences in timing inherent in depreciation and costs of removal for ratemaking and  
28 financial reporting.  
29  
30

1           **Q.    Has this Commission addressed recovery of cost of removal?**

2           A.    Yes.  This Commission, and almost all other regulatory commissions, have  
3 established ratemaking procedures to permit the recognition and recovery of cost of removal on a  
4 straight-line basis through a factor embedded in the depreciation rates.  In this manner, the  
5 customer who is using the fixed asset pays for the asset itself (through depreciation of the  
6 original cost) as well as the eventual cost associated with removing the asset.  The FASB  
7 recognizes in FAS 71 that differences may occur in the timing of cost recognition for rate-  
8 regulated industries between ratemaking and financial reporting purposes.

9           **Q.    Why is it not appropriate to use the methodology set forth in FAS 143 as a**  
10 **basis to determine the regulatory/ratemaking treatment of removal costs?**

11          A.    Financial accounting and regulatory accounting have different objectives to serve  
12 their different users.

13          Financial accounting is used to develop financial statements for reporting financial  
14 information in accordance with GAAP.  The Public Company Accounting Oversight Board  
15 (“PCAOB”) and SEC require the use of GAAP for public companies when reporting their  
16 financial results.  GAAP’s purpose is to establish general principles and provide a common  
17 accounting yardstick across companies.  As I note above, accounting oversight bodies have  
18 increasingly focused on making sure that all legal liabilities are recorded on balance sheets.

19          GAAP recognizes that the economic effects of utility rate regulation should be  
20 recognized in the financial statements of regulated entities (FAS 71).  It is important to note that  
21 there is no requirement that the same principles used to develop financial accounting standards  
22 be used for ratemaking purposes, although regulatory accounting may adopt financial accounting  
23 standards where the objectives are the same.

1 Regulatory accounting is governed by FERC and by the various state and local regulatory  
2 commissions. It is used in developing the annual report on FERC Form 1 (Electric Utilities) and  
3 Form 2 (Gas utilities) as well as various state regulatory reports. The purpose of regulatory  
4 accounting is to provide accounting information in a manner that assists utility regulators in their  
5 ratemaking treatment of regulated companies. Under traditional utility rate regulation, utilities  
6 are permitted to establish revenue requirements to recover their capital and operating costs. It is  
7 a fundamental regulatory principle that ratepayers should pay for the appropriate costs to provide  
8 service, with appropriate consideration of factors such as intergenerational equity, prudence and  
9 cost causation.

10 Thus, certain regulatory accounting concepts may differ from those used under GAAP as  
11 established for enterprises in general.

12 **Q. When determining the appropriate regulatory charge for cost of removal, is**  
13 **it only appropriate to consider legal ARO costs?**

14 A. No. Just because there is no legal obligation to remove assets, it is incorrect to  
15 assume that such costs will not be incurred. Avista incurs several million dollars of removal  
16 costs each year. Based on prior experience, Avista will incur removal costs to replace property  
17 that wears out or is removed for other reasons. It is probable that such costs will be incurred in  
18 order for the utility to meet its obligation to serve customers. As such, it is important for the  
19 ratepayer who is receiving the benefit from using the fixed asset to pay the related removal cost.  
20 Otherwise, the ratepayer who just happens to move into the service territory toward the end of  
21 the useful life of the asset, will bear the cost of removing the asset even though that customer did  
22 not receive much (if any) of the output from that asset.

23

**VII. FERC ORDER NO. 631**

1  
2           **Q. Did the FERC adopt the provisions of FAS 143?**

3           A. Yes. The FERC issued Order 631 on this issue in April 2003.

4           **Q. Can you summarize this FERC Order?**

5           A. Yes. FERC Order 631 is a regulatory accounting requirement that basically  
6 adopted the requirements of FAS 143 for legal AROs and amended the USoA to include the  
7 appropriate ARO accounts. For non-legal AROs, **the FERC concluded that such amounts can**  
8 **remain on the books of regulated enterprises to the extent that they represent estimated**  
9 **amounts included in the revenues collected from ratepayers to be used to fund actual cost**  
10 **of removal expenditures.** FERC Order 631 continued to permit the pre-existing accounting  
11 treatment, as FAS 143 does, in allowing recognition of differences that may arise for rate-  
12 regulated entities. FERC also concluded there was no reason to change regulatory accounting  
13 concepts for costs that do not qualify as legal retirement obligations (i.e., non-AROs).

14           FERC Order 631 recognized that utilities subject to its accounting jurisdiction should  
15 simply keep subsidiary records of the amounts of removal costs recovered and incurred rather  
16 than establish a separate refundable regulatory liability.

17           **Q. Did FERC Order 631 address the ratemaking treatment or change the**  
18 **regulatory accounting for removal costs for non-AROs?**

19           A. No. Jurisdictional entities continue to account for such costs, consistent with the  
20 requirements of the USoA. FERC Order 631 did not change regulatory accounting, but clarified  
21 that utilities are to maintain subsidiary records for identifying the cost of removal in depreciation  
22 accruals. For non-legal ARO's, the FERC did not adopt FAS 143 or the SEC guidance requiring  
23 reclassification of the regulatory liability outside of accumulated depreciation.

1 FERC Order 631 does not address the ratemaking treatment of cost of removal but  
2 supports differences between the ratemaking and regulatory accounting treatment by including  
3 regulatory asset and regulatory liability accounts.

#### 4 VIII. FERC USoA

##### 5 **Q. What is the FERC USoA and why is it important?**

6 A. Utilities in the state of Washington must use the uniform system of accounts  
7 applicable to electric and natural gas utilities as published by the FERC in Title 18 of the Code of  
8 Federal Regulations (WAC 480-100-203 and 480-90-203.) USoA General Instruction 25 defines  
9 AROs and prescribes how cost of removal other than legal obligations should be recorded in  
10 FERC Account No. 108 – Accumulated Provision for Depreciation. The FERC instructions for  
11 Account 108 state that entities should not transfer any portion of Account 108 to retained earnings  
12 or make any other use without the authorization of FERC.<sup>3</sup>

##### 13 **Q. What guidance must Avista follow for cost of removal that do not qualify as** 14 **legal obligations?**

15 A. FERC has stated that costs of removal that do not qualify as legal obligations, as  
16 defined by FAS 143, fall outside of Order No. 631.<sup>4</sup> Therefore, Avista must follow USoA Plant  
17 Instructions 10, which states that the cost of removal and the salvage shall be charged or credited  
18 to accumulated provision for depreciation. In addition, Account 108 provides that cost of  
19 removal other than legal obligations should be recorded in Account 108. In its annual report to  
20 FERC on FERC Form 1, Avista includes the accumulated cost of removal as a component of  
21 accumulated depreciation.

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<sup>3</sup> Title 18: Conservation of Power and Water Resources: Part 101 — Uniform System of Accounts Prescribed for Public Utilities and Licensees Subject to the Provisions of the Federal Power Act, Account 108.

<sup>4</sup> FERC Order No. 631, ¶37.



1           The accumulated costs of removal are reviewed as part of periodic depreciation studies.  
2           The most recent depreciation study was presented by Avista and reviewed by parties, in its recent  
3           2007 general rate case.

4           The accumulated costs of removal are required to pay for Avista's actual future removal  
5           costs. As such, they are not available to offset the recovery of other unrelated costs. The  
6           recovery of the confidential litigation costs is a separate issue and should not be confused with  
7           cost of removal recovery.

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

9           A.     Yes.