

Main Street Gold Mine

Funds collected for cost-of-removal liabilities could finance capital spending.



BY MICHAEL J. MAJOROS JR., *ET AL.*



ast year *Public Utilities Fortnightly* noted that recession-related demand destruction was pressuring industry operating margins and financial returns in the electric industry and that conservation and environmental demand destruction were likely to continue that pressure for the foreseeable future. The author correctly concluded that “companies that aren’t earning their allowed return on equity (ROE) due to depressed energy sales are looking to regulators to make them whole. Going forward, rate treatment largely will determine who the winners will be (see “*The 40 Best Energy Companies*,” September 2009, p. 37).

Many utilities are proposing capital intensive smart-grid initiatives, often as a means of facilitating conservation and demand response. While the federal government is providing some funding for a smart-grid roll out via matching grants under the *American Recovery and Reinvestment Act* of 2009, the winners likely will be those utilities that are successful in obtaining regulatory approvals to capture in customer rates the up-front capital costs of smart-grid and environmental expenditures.¹ Consequently, many electric utilities, such as Baltimore Gas & Electric Co. (BGE), are pursuing non-traditional Main Street capital funding approaches for environmental and infrastructure initiatives. The Maryland Public Service Commission, however, rejected BGE’s request to obtain up-front ratepayer financing in the form of an incremental surcharge, questioning both the proposed Main Street funding and the purported efficiency and economics underlying its smart-grid Initiative.² Only after BGE removed the tracking surcharge in its amended filing in August did the commission approve the company’s smart-grid plan.

Utilities and regulators in many states face similar tensions, without any apparent easy solutions. However, industry might be overlooking an important source of capital for smart-grid and similar investments: depreciation accounts already collected to cover future cost-of-removal liabilities.

Main Street vs. Wall Street

Regulatory commissions use a rate-base/rate-of-return model to set utility prices. The traditional regulated rate-of-return model assumes utilities obtain capital from third-party investors (e.g., Wall Street) and earn a return on these capital investments by charging their customers (e.g., Main Street). Contrary to this traditional model, however, some utilities have obtained—and many more are requesting—Main Street advance-funding requests for the smart grid and environmental spending projects in their rate-base calculations.

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Main Street funding requests usually involve one or more of the following: 1) the inclusion of future plant additions in rate base; 2) special revenue-requirement surcharges; and 3) increased depreciation rates, all of which provide increased cash flow to the utilities. Regardless of the form, these Main Street funding approaches result in customers, rather than investors, providing capital in advance. Depreciation expense allocates a portion of an asset’s cost to a particular year. In turn, depreciation drives utility prices because the higher the expense, the higher the price. Unlike other expenses, such as payroll, there isn’t a corresponding cash outflow associated with depreciation expense. Hence, depreciation increases Main Street prices and the utilities’ bank accounts. Recent smart-meter applications are requesting accelerated depreciation of existing meters to pay for the new meters. In those circumstances, Main Street customers, rather than Wall Street investors, will pay for the smart-meter investment.

In addition to accelerated depreciation rates, another little-understood source of Main Street funding has been the inclusion of inflated future cost-of-removal ratios in annual depreciation rates. The resulting higher depreciation rates have led to cash collections from Main Street customers that have exceeded vastly the utilities’ actual cost-of-removal expenditures. Utilities have accounted for these excess collections as increases to their accumulated depreciation accounts. Accumulated depreciation is a balance sheet contra-account reflecting the level of investment in property, plant and equipment written off in the form of annual depreciation expense. Inflated cost-of-removal ratios have resulted in accumulated depreciation balances far greater than required for capital recovery over the life of the capital assets.

General purpose financial statements, prepared in accordance with generally accepted accounting principles (GAAP), recognize the excess charges as a liability to ratepayers. Paragraph B.73 of the Financial Accounting Standards Board’s (FASB) Statement of Financial Accounting Standard 143 (SFAS

FIG. 1

FORTNIGHTLY 40 COST-OF-RECOVERY LIABILITIES

2007-2009 COR Regulatory Liability (\$M)

Company	State	2009	2008	2007
DPL	OH	99	96	92
Exelon	IL	1,212	1,145	1,145
Energen	AL	137	130	122
Mirant	GA	0	0	0
PPL	PA	0	0	0
National Fuel Gas**	NJ	105	103	91
Public Service Enterprise Group	NJ	289	307	325
Energy	LA	44	63	-6
Dominion Resources	VA	766	688	623
Energy, Inc	MT	0	0	0
NRG	PA	0	0	0
Questar	UT	0	0	0
AGL Resources	GA	183	178	169
Allegheny Energy	PA	374	407	396
Sempra Energy	CA	2,557	2,430	2,522
NJ Resources**	NJ	56	63	61
TECO Energy	FL	554	551	543
So Jersey Industries	NJ	50	49	49
Nstar	MA	220	217	214
Equitable Resources	PA	0	0	0
OGE Energy	OK	168	151	140
Centerpoint Energy	TX	506	534	581
El Paso Electric	TX	0	0	0
Nicor	IL	797	752	721
Constellation Energy	MD	210	198	182
MGE Energy	WI	12	12	13
Southern Company	GA	1091	1,321	1,308
UGI**	PA	0	0	0
FPL Group, Inc	FL	2251	2,142	2,098
DTE Energy	MI	506	534	581
Edison International	CA	2515	2,368	2,230
Northwest Natural Gas	OR	239	224	205
Piedmont Natural Gas***	NC	386	359	325
AES	VA	482	459	351
Alliant	WI	403	409	411
Allete (Minnesota Power)	MN	16.9	16	0
Delta National Gas*	KY	304	615	304
Southern Union	TX	0	0	0
RGC Resources	VA	7	7	6
WGL Holdings**	VA	319	306	285
TOTAL F40		16,859	16,834	16,087

Source: SEC Filings and the 2010 Fortnightly 40 Report

* Fiscal Year June 30, 2009
 ** Fiscal Year Sept. 30, 2009
 *** Fiscal Year Sept. 31, 2009

future rates will be reduced by corresponding amounts. If current rates are intended to recover such costs and the regulator requires the enterprise to remain accountable for any amounts charged pursuant to such rates and not yet expended for the intended purpose ... those amounts shall be recognized as liabilities and taken to income only when associated costs are incurred.”

While this understanding with regard to costs of removal has been in most cases implicit, it has been sufficiently clear that, in response to FASB 143 and FASB 71, leading investor-owned utility companies have recorded a significant cost-of-removal regulatory liability for GAAP financial reporting purposes (see Figure 1).

Regulatory Liability

The cost-of-removal regulatory liability of the companies ranked in the 2010 *Fortnightly 40* report (September 2010) is surprisingly large. They collectively reported a \$16.1 billion regulatory liability as of Dec. 31, 2007, which increased to \$16.8 billion at the end of 2008, and to \$16.9 billion for 2009. We also note that six companies that weren't included in the 2009 *F40* made it into *Fortnightly's* top-40 ranking in 2010. Combined, those companies reported an additional \$5 billion regulatory liability at the end of 2009.

This cost-of-removal regulatory liability is a pot of gold, prepaid by Main Street customers, that utilities could use for future environmental and smart-grid capital improvements. Utilities have the cash—they collected it but as yet haven't incurred the underlying cost.

The SEC's impending move from GAAP to International Financial Reporting Standards (IFRS) poses a question regarding the disposition of the utilities' cost-of-removal liability, as confirmed by two *Fortnightly* articles. (*John Ferguson, "Fixing Depreciation Accounting," October 2008, pp. 16-20 and Scott*

143) required utilities to reclassify the excess depreciation charges from accumulated depreciation into a regulatory liability account. The excess funds were reclassified as a regulatory liability because, per SFAS 71, "Rate actions of a regulator can impose a liability on a regulated enterprise. Such liabilities are usually obligations to the enterprise's customers."

For example, "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,

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Hartman, "Ready for IFRS?" January 2009, pp. 10-16.) In November 2008, Ferguson proposed that when these companies move to IFRS, they should transfer the regulatory liabilities to their equity accounts. In January 2009, Hartman reiterated Ferguson's proposal.

As originally contemplated, IFRS would have sanctioned this treatment. However, on July 23, 2009, the International Accounting Standards Board (IASB) published for public comment an exposure draft on rate-regulated activities. This exposure draft proposes requiring utilities to report legal and non-legal ARO liabilities "at the expected present value of the cash flows to be recovered or refunded as a result of regulation, both on initial recognition and at the end of each subsequent reporting period"³ and to take into income all amounts collected above those present values.

Utility rate regulators must decide whether they intend to

adhere to traditional ratemaking principles or alternatively require Main Street financing of environmental improvements and smart-grid technologies. That decision should be transparent and obvious. Assuming that such expenditures yield positive benefits to Main Street, it might be feasible to use the huge pot of gold that already exists in cost-of-removal liability accounts. ■

Endnotes:

1. Under the ARRA, the Department of Energy has awarded \$4.5 billion dollars to utilities, municipalities, cooperatives, and states. Of this, \$3.5 billion has been awarded through the smart-grid investment grant program, and \$700 million in grants were awarded through the smart-grid regional and energy storage demonstration project. The remaining \$300 million have been awarded for workforce development, interconnection, transmission planning and analysis, state/local governments energy assurance, state assistance on electricity policies, program direction, and interoperability standards and framework.
2. The commission stated in its decision on BGE's filing, "As an initial matter we disagree with BGE that surcharge recovery is appropriate here. The proposed project is in our view, classic utility infrastructure investment that should be recovered through distribution rates, not in a supplemental surcharge that begins long before customers could realize any benefits from the project. Just as we have declined other companies' efforts to move a broader range of expenses out of rate base and base-rate cases, we decline here to depart from the core principle that utilities recover the cost of infrastructure investments through distribution rates." Maryland Public Service Commission, Case No. 9208, Order No. 83410, pp. 4-5.
3. IASB July 2009 Exposure Draft—Rate-regulated Activities, p. 9.

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