Asset Retirement Obligation

Asset Retirement Obligation (ARO) is rapidly becoming a significant rate determinant for both gas pipelines and electric power companies.

An ARO is a legal obligation associated with the retirement of long-lived tangible assets. As a result of existing law, regulation, contractual or promissory estoppel, a company may be required to retire and remove certain facilities, including related obligations to restore the land to its original condition. The cash flow and financial reporting are recorded according to guidelines set out by the Financial Accounting Standards Board (FASB). ARO is the result of the SFAS No. 143. The Federal Energy Regulatory Commission, among other regulatory agencies has addressed regulatory accounting, financial reporting and rate treatment requirements (FERC Order No. 631).

In Order No. 631, the FERC set out its requirements concerning ARO.

The employment of an ARO requires that the legal obligation associated with the retirement of tangible long-lived assets be recognized as a liability and measured at fair value at the time the asset was acquired. Fair value refers to the present value of future cash flows that would be required for the decommissioning at the time of retirement and removal. In essence, it is an amount at which the ARO liability could be incurred in a current transaction between willing parties.

One clear example of a retirement, which would qualify under the ARO obligation are offshore Gulf of Mexico oil and gas pipelines and producing platforms. By regulatory law, such facilities must be decommissioned when no longer in use.

ARO is measured by estimating the cash flows required to settle the retirement liability. This entails an estimate of the amount and timing of the related cash flows, incorporating explicit assumptions about inflation and the estimated cost of retirement. Cash flows must be discounted using a "credit-adjusted risk-free rate."

This translates into ARO costs, which are two-fold: depreciation expense of the decommissioning cost and accretion expense. Specifically, depreciation here refers to the recoupment of the present value of the capital cost of decommissioning. The accretion expense recognizes the increasing value (through cost inflation) of the obligation until the date of removal. Please contact our office so that a BWMQ consultant can explain the complex issues surrounding ARO recovery and the potential benefits to your company.