



Richard F. McMahon, Jr.  
Vice President

July 27, 2011

U.S. Securities and Exchange Commission  
Office of the Chief Accountant  
100 F Street, NE  
Washington, DC 20549

Re: Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers: Exploring a Possible Method of Incorporation

Edison Electric Institute (“EEI”, “We”, “Our” or “Us”) is the association of U.S. shareholder-owned electric companies, international affiliates, and industry associates worldwide. Our U.S. members serve 95 percent of the ultimate customers in the shareholder owned segment of the industry, and 70 percent of all electricity utility ultimate customers in the nation, and generate almost 60 percent of the electricity produced in the United States. EEI is submitting this letter to the Securities and Exchange Commission (“SEC”) in response to the request for comments on the SEC’s Staff paper titled *Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers: Exploring a Possible Method of Incorporation* (the “Staff Paper”).

### **Summary**

Overall, we support the “condorsement” approach included in the Staff paper, the proposed role of the Financial Accounting Standards Board (“FASB”) and the SEC and the staged or staggered transition approach. In this letter, we include information supportive of our points of view, specifically in the context of a recent project to address an accounting issue for rate regulated entities. We also include suggestions to the proposal including the suggestion to (i) use the completion of the joint FASB/International Accounting Standards Board (“IASB”) MOU (“Memorandum of Understanding”) projects<sup>1</sup> as an assessment or decision point in determining when and whether to move in to the incorporation phase described in the Staff paper (ii) further clarify what the FASB’s process and role will be in the evaluation, interpretation and incorporation of IFRSs and (iii) make decisions regarding whether to retain existing U.S. generally accepted accounting principles (“GAAP”) not currently present in

<sup>1</sup> The term “MOU projects,” as used in this letter, has the same meaning as the term is described in footnote 28 in the Staff Paper.

International Financial Reporting Standards (“IFRS”) earlier in the process. We have attached a paper which includes the technical basis for why we believe that the retention of guidance included in Accounting Standards Codification section 980, “Regulated Operations” (“ASC 980”) and referenced in the Staff Paper is appropriate and which could be used in the determination of whether that guidance should be retained in connection with the proposed condorsement approach as also described in the Staff Paper. SFAS 71 “Accounting for the Effects of Certain Types of Regulation” was the prior statement of financial accounting standard which serves as the primary basis for conclusions in ASC 980. From earlier discussions with the SEC, we also understand that the SEC has requested more information on this issue and the detailed Attachment, we believe, will fulfill that request. Lastly, we are providing supplemental information summarizing our observations of issues raised at the recent July 7<sup>th</sup> roundtable which we request that the SEC address further in the future.

#### **Our Views on Condorsement**

Under the approach described in the Staff Paper, U.S. GAAP would continue to exist and to be promulgated by the FASB. In addition, the ultimate authority to determine accounting standards for U.S. reporting entities would remain with the SEC. We strongly support this approach, regardless of the method used (if any) to incorporate IFRSs into the U.S. financial reporting system, if such a decision is reached.

We believe that the condorsement method proposed in the Staff Paper would be a high-quality approach of incorporating IFRSs into the U.S. financial reporting system. It is our understanding that under the condorsement method, there would be a designated point in time (after the completion of the MOU process) at which a switch would be made from a convergence approach to an endorsement approach. Rather than automatically moving in to the endorsement phase as proposed in the Staff Paper, after the completion of the joint FASB/IASB MOU projects, we propose that the SEC use this as an assessment point. That is, at this point the SEC could assess the progress made under that convergence effort, and either:

- a) Direct the FASB to continue the IASB/FASB joint MOU convergence process, with a new set of priority projects to be completed over a set period;
- b) Move in to the endorsement phase of incorporating IFRSs into U.S. GAAP in the manner described in the Staff Paper;
- c) Determine another method or approach for moving toward a global set of accounting standards in the U.S; or

- d) Re-evaluate, based upon lessons learned through convergence, whether the SEC should continue to proceed with the incorporation of IFRSs into the financial reporting system for U.S. issuers.

The modification in approach described above reflects our belief that the pace of incorporation should be dictated in large part by the success of the ongoing IASB/FASB joint MOU convergence process. If the current FASB/IASB convergence process requires more time than expected, and/or where differences in opinion among the boards exist on fundamental issues, we believe that this is an indication of the breadth and depth of differences between existing U.S. GAAP and IFRSs. It should be taken as evidence that further time and work may be necessary before a smooth transition can occur. If the pace of convergence proceeds more quickly in the future, then perhaps an endorsement approach could be elected at the future assessment point.

The proposed modification would allow the SEC to better understand both the costs and benefits of moving towards a single set of globally accepted accounting standards, and adjust the pace of transition accordingly. The overall transition process would only take longer under this approach if the extra time is deemed necessary by the SEC, and through convergence efforts, we would continuously move closer to the overall goal of a single set of global accounting standards.

#### **Our Views on the Proposed Role of the SEC and FASB**

Countries throughout the world have significant differences in their political and regulatory frameworks. We believe that investors need decision-useful financial information that considers these differences. The proposed role of the FASB would give it the ability to modify, supplement or interpret IFRSs when necessary, to meet the specific needs of the U.S. system. Because accounting standards do not provide specific rules for every situation, the standards require interpretation. We believe that a defined, formal role for the FASB to provide such guidance is needed to help support U.S. companies and their third party financial statement users and investors. This is also consistent with our understanding of how IFRS is being adopted in many parts of the world today.

Absent this formal role for the FASB, we believe that U.S. registrants would seek consultations with the SEC on a company-by-company basis in situations where IFRSs are unclear, or where U.S. companies do not believe that the method of application of IFRSs in other countries represents the economics of the market in which U.S. companies operate. We believe that the proposed approach in the Staff paper outlines a necessary process for the FASB to provide accounting standards for topics not addressed in IFRS, and interpretations of IFRSs when needed to take into account the

specific economic environment in which U.S. companies operate. We also believe however that more details of the FASB's process, particularly in evaluating the sufficiency of IFRSs as issued and/or the need for interpretive guidance, in the U.S. market will ultimately be necessary.

We believe that the proposed approach would give the SEC, through its oversight of the FASB, the appropriate authority to weigh the impacts or perceptions, both positive and negative, in the global capital markets, of a more pure application of IFRSs against the need for country-specific modifications and interpretations to protect the interests of U.S. investors and comply with U.S. market regulation. In addition, under the proposed approach, we believe that the SEC would retain its ultimate authority to establish accounting standards for U.S. issuers, and continue to ensure the reliability of the financial statements provided by these issuers.

Our industry has actively participated in the consideration of a rate regulated project at the IASB. There is currently not an equivalent standard under IFRS to ASC 980 and we understand that some countries have applied existing IFRS in a manner where regulatory assets and liabilities are not recognized in the financial statements. As described further in the Attachment to this letter, a similar application in the U.S. could result in significant write-offs of regulatory assets and liabilities currently recorded in the financial statements of rate regulated entities, and an increase in volatility in the income statement going forward that is not justified by the underlying economics of a relatively stable regulated industry. Our primary financial statement users include state and federal regulators, our third party debt ratings agencies and our investors. Representatives from our regulators and third party debt ratings agencies have expressed concern regarding a possible mandated conversion to IFRS without an equivalent rate regulated standard. As described further in the Attachment, if accounting guidance comparable to ASC 980 does not exist in the future for U.S. registrants, it will result in significant and unnecessary incremental costs associated with issues such as having to track a significantly higher number of differences between our GAAP financial statements and the "regulatory view" of financial statements which are required to be submitted to our third party regulators. Our investors and ratings agencies would also likely adjust our GAAP financials to reflect the economic effects of rate regulation in their determination of the actual cash flows and other metrics of the business. This is because those financial statements would not reflect the underlying economics or actual financial results of utilities subject to rate regulation in the US.

We believe that the proposed approach in the Staff Paper would provide for the needed consideration by FASB of whether its existing guidance (ASC 980) under the condorsement approach should be retained as part of U.S. GAAP. We believe that this structure would ensure that financial statements for U.S. utilities include "decision useful" information and also support the continued path toward global accounting

standards through the FASB's formal participation in the IASB due process, as a constituent. Under this approach, the FASB and SEC would have a formal mechanism to consider concerns expressed by our third party financial statement users as described above. The proposed FASB and SEC roles would help to minimize the costs and disruption to our businesses resulting from a transition to a single set of high quality international accounting standards.

### **Our Views on Proposed Transition**

#### **Staged/Phased-In Incorporation of IFRSs**

The Staff Paper proposes a three-step transition during which the content of U.S. GAAP would be replaced with the content of IFRS. The first step would be accomplished through the on-going convergence projects between the FASB and IASB MOU projects. The second step would be the incorporation of IFRSs subject to standard setting in the near term (i.e. those that are not the subject of MOU projects, but are currently on the IASB agenda). The final step would be an ongoing endorsement process for incorporating IFRSs, which are not currently subjects of the IASB's standard setting process, into U.S. GAAP. The manner in which IFRSs would be incorporated into U.S. GAAP (i.e. with or without modifications or additions) would be determined by the SEC as part of their statutory responsibilities to protect U.S. investors and maintain fair, orderly, and efficient capital markets while facilitating capital formation in the U.S. We believe that this is a logical and measured approach to transition. Depending upon the timeline that may be ultimately determined, however, we would recommend that a decision regarding the continuation of guidance that is not currently present in IFRS (for example ASC 908 or ASC 980 as referenced in the Staff Paper) be made earlier in the process. The detailed Attachment provides EEI's point of view regarding ASC 980 and a recommendation that guidance included in ASC 980 continue to exist as accounting guidance for U.S. rate regulated entities in the future. This recommendation is consistent with the viewpoint expressed by FERC who participated in the SEC's July 7<sup>th</sup> roundtable discussion. As previously noted, we understand that the SEC has asked for our point of view on this issue.

We believe that the staged or phased-in transition approach proposed (versus a single adoption date) would significantly reduce both the costs and difficulties that will be encountered in an incorporation of IFRSs into the U.S. system, regardless of the method of incorporation selected. It would allow financial statement preparers and users more time to prepare for, and make the necessary changes to, their current systems and processes. Spreading the adoption of new standards over time will reduce the need to add additional staff and/or employ outside resources to implement the changes inherent in such large-scale conversion.

*Prospective Adoption of IFRSs, when possible*

The Staff Paper indicates that prospective adoption methods would be allowed, whenever reasonably possible, for the adoption of new accounting standards during the process of incorporating IFRSs into the U.S. system. We believe that this would also significantly reduce both the costs and difficulties that will be encountered in an incorporation of IFRSs into the U.S. system, regardless of the method of incorporation selected. Prospective adoption methods would reduce the need to gather accounting information for prior periods in a manner that existing systems may not have been designed to accommodate. In addition, prospective adoption methods will reduce successive restatements of prior period statements for the adoption of new accounting standards, which we believe will confuse financial statement users.

**Observations from the July 7<sup>th</sup> SEC Roundtable**

Representatives of EEI observed the SEC Roundtable discussions held on July 7<sup>th</sup>. Several issues were raised which we believe are important in the overall consideration of the possible incorporation of IFRSs into the financial reporting system of U.S. Issuers. We request that the SEC further consider or address these issues in future communications:

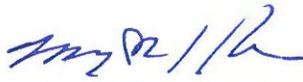
- We suggest further articulating the rationale for a single set of high quality, globally accepted accounting standards, including whether such a change would result in a more efficient allocation of capital in global markets which potentially would benefit U.S. investors. We believe that this perceived positive impact has been informally expressed in some discussion forums although our impression from the roundtable discussions was that third party investors may view the incorporation of IFRSs into the U.S. reporting system as neutral vs. positive.
- Consistent with the recommendation above, we recommend more clearly defining the role for the FASB, following the convergence period, how their evaluation process of IFRSs will work, and also how the process for the issuance of needed interpretive guidance will work.
- We recommend further information and analysis regarding the IASB structure and process and how that structure will be sufficient to support the current level of U.S. financial statement preparer requests and needs.
- We recommend that early adoption of IFRSs be permitted by those Registrants that currently have significant operations that report under IFRS in other jurisdictions, and would prefer to transition more quickly to IFRS.
- We also recommend providing for a delayed effective date for small U.S. issuers to incorporate IFRSs into their financial statements.

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**Summary**

In summary, EEI supports the objectives and principles outlined in the Staff Paper and compliments the SEC for considering an alternate point of view that is responsive to constituent concerns regarding a transition to a global set of accounting standards. We appreciate the request for comment and are happy to provide any additional information or to respond to questions based on this letter or the related Attachment.

Sincerely,

A handwritten signature in blue ink, appearing to read "R. McMahon, Jr.", with a stylized flourish at the end.

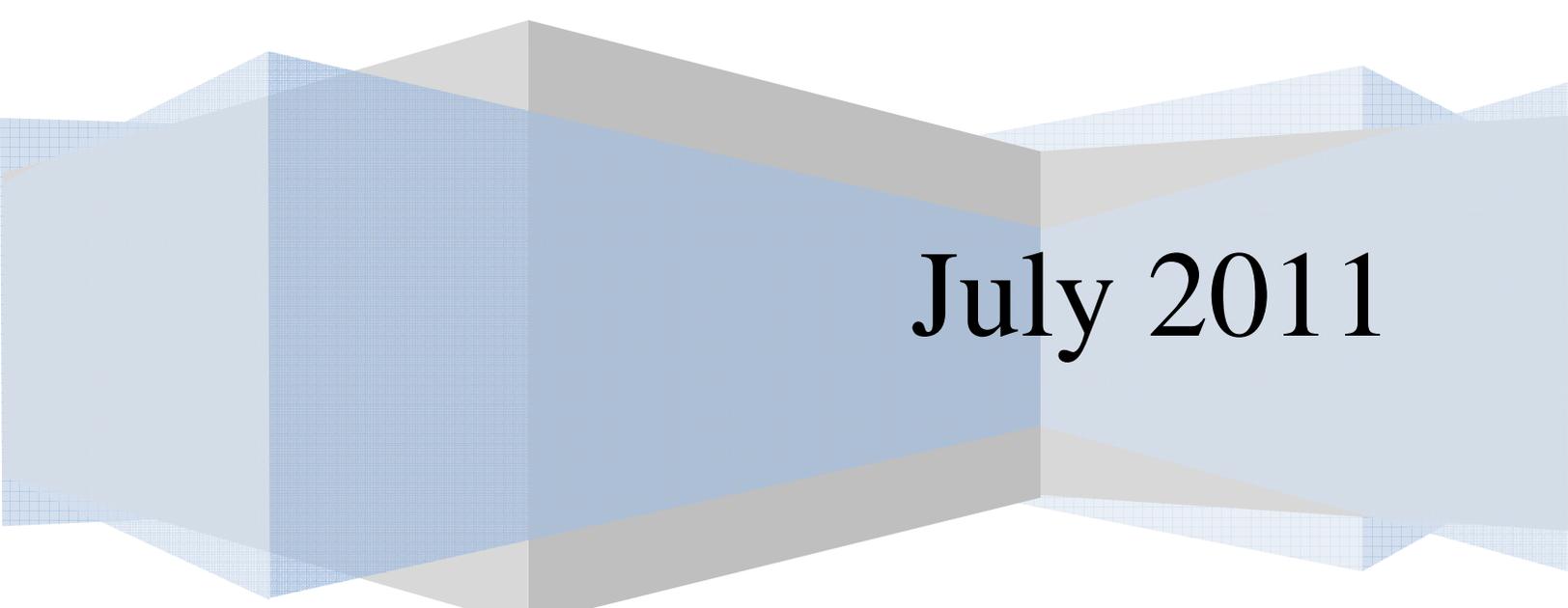
Richard F. McMahon, Jr.

Attachment:

EEI: *Accounting for the Effects of Rate Regulation*

Edison Electric Institute

# Accounting for the Effects of Rate Regulation



July 2011

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## **I. Introduction**

Edison Electric Institute (“EEI”, “We”, “Our” or “Us”) is the association of U.S. shareholder-owned electric companies, international affiliates, and industry associates worldwide. Our U.S. members serve 95 percent of the ultimate customers in the shareholder owned segment of the industry, and 70 percent of all electricity utility ultimate customers in the nation, and generate almost 60 percent of the electricity produced in the United States.

We have prepared this white paper to describe the accounting that currently exists under U.S. GAAP for the effects of rate regulation. There is currently no specific equivalent standard under International Financial Reporting Standards (IFRS). We understand that diversity in practice exists among rate-regulated entities outside the U.S. who have adopted IFRS when rate actions of a regulator create an asset or impose a liability (regulatory assets and liabilities under U.S. GAAP). In earlier discussions with the SEC staff we agreed to provide the SEC with more information on this issue and this paper is being provided in response to those discussions. This paper will also be available for consideration by the FASB to the extent that there is a transition to international accounting standards and FASB undertakes its evaluation of U.S. GAAP that does not exist under IFRS. This paper is focused on current U.S. GAAP (ASC 980) and why we believe it fairly presents the economic results of our business, provides decision-useful information to our third party financial statement users and should be retained for U.S. rate-regulated entities. However we will also describe why we believe the regulatory assets and liabilities created by the application of that guidance are consistent with the concepts articulated under the International Accounting Standards Board’s (IASB) Conceptual Framework.

## **II. Executive Summary**

This white paper will describe the following:

- The “regulatory compact” is a term used to describe the basis, developed through federal case law, for a rate-regulated entity’s right to recover costs that have been prudently incurred in providing reliable service to customers. In this paper, the term regulatory compact is meant to describe the concept that a rate-regulated entity incurs costs in order to provide reliable service to customers within its approved service territory in a not unduly discriminatory manner with the expectation that it will have the right to recover those prudently incurred costs.

- A rate-regulated entity is a natural monopoly because it generally has the exclusive right and obligation under its franchise to provide its product or service in a designated service area.
- This regulatory compact serves as the basis for cost of service regulation.
- Cost of service or cost-based regulation is intended to provide the entity with recovery of its prudently incurred costs plus a reasonable rate of return on its invested capital.
- This regulatory model drives the economics and decisions of a rate-regulated entity.
- Current U.S. GAAP was issued to reflect these economics and the FASB acknowledged in the issuance of Statement of Financial Accounting Standard No. 71, "Accounting for the Effects of Certain Types of Regulation" ("SFAS 71") (now codified in Accounting Standards Codification 980, *Regulated Operations*) that the economic effects of rate regulation in the U.S. should be considered in the interpretation of generally accepted accounting principles. SFAS 71 was also issued to eliminate diversity in practice at that time.
- We believe that ASC 980 is still relevant and necessary. We believe that the absence of such guidance would result in diversity in practice and understand that some rate-regulated entities in other countries have derecognized regulatory assets and liabilities upon adoption of IFRS, which causes us great concern.
- The practical implications if regulatory assets and liabilities are no longer recognized are significant to us. We believe that, among other impacts, our financial statements would be adjusted to unaudited "non-GAAP" measures by our primary financial statement users, namely ratings agencies, investors and third party regulators, to arrive at the true economic results for our companies (as is currently reflected through the application of guidance included in ASC 980.)
- A rate-regulated activities project was undertaken by IASB but currently appears to be inactive.
- Although we believe that ASC 980 is necessary and the correct guidance for U.S. rate-regulated entities, we briefly describe the aforementioned rate-regulated activities project at the IASB in further support of the need for retaining specific guidance in this area. This section also describes why we believe that the guidance included in ASC 980 is not inconsistent with the IASB Conceptual Framework.
- Based on the information included herein, as described in this Executive Summary, we believe that ASC 980 is necessary to reflect the true economics of our business.

### III. Background on Rate Regulation in the United States

The method by which utilities are regulated provides information to better understand the intent and application of existing U.S. GAAP for rate-regulated entities. Rate-regulated entities, including electric power, gas and water companies, among others, are heavily regulated in a number of areas including safety, reliability and other operational areas. This white paper focuses primarily on price regulation vs. operational or other types of regulations and although the primary example used throughout this white paper is based on a utility providing electric service to customers, the concepts described herein apply to a number of rate-regulated entities. Additionally rate-regulated entities can be regulated at the state or federal level. For example, a rate-regulated electric utility may provide electric service to a customer, which price regulation occurs at the state level. The same entity may also sell power to another company in the wholesale market or provide transmission service to another company, which price regulation occurs at the federal level. Additional information on federal regulation is therefore being included herein to describe how customer rates or prices are established at the federal level and the role that the Federal Energy Regulatory Commission (FERC), who recently participated in the SEC's July 7 roundtable discussion, has in setting those rates.

#### *a. Legal Basis for State Rate Regulation*

Utility service is provided from a rate-regulated entity to a customer pursuant to a long-standing regulatory compact between that entity, its customer and its regulator. The regulatory compact has been developed through federal case law, to establish a rate-regulated entity's right to recover costs that have been prudently incurred in providing reliable service to customers. A rate-regulated entity incurs costs in order to provide reliable service to customers within its approved service territory in a not unduly discriminatory manner with the expectation that it will have the right to recover those prudently incurred costs, plus earn a fair rate of return on the capital that has been invested in the business to support reliable utility service.

The U.S. Supreme Court case of *Munn v. Illinois* in 1876 established the government's right to regulate the use of private property being used in a certain manner. The decision in this case stated that private property:

“does become clothed with a public interest when used in a manner to make it of public consequence, and affect the community at large.

When, therefore, one devotes his property to a use in which the public has an interest, he, in effect, grants to the public an interest in that use, and must submit to be controlled by the public for the common good, to the extent of the interest he has thus created.”

This ruling has been applied to justify the government’s regulation of public utilities providing services including electric power, gas and water.

The utilities’ obligation to serve customers under the modern regulatory system begins with the granting of a franchise by a state commission or other independent third party regulator. The granting of a franchise gives a utility the exclusive right to provide its service (e.g. electric power, gas, water, etc.) to the public within the designated service area. However, the granting of the franchise, along with multiple federal<sup>1</sup>, state and local laws and regulations, creates an obligation on the part of the franchisee to provide reliable service to all customers within the service area in a non-discriminatory manner.

The utility has the right to charge customers rates (as approved by the applicable regulatory body) which allow it to recover all of its prudently incurred costs, plus a fair rate of return on the capital used in providing such services. This legal right was first established by the U.S. Supreme Court in the case of *Bluefield Waterworks v. Public Service Commission of West Virginia* in 1923. In this case, the court ruled:

“A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.”

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<sup>1</sup> Federal legislation which establishes a utility’s obligation to provide reliable service at rates which do not unduly discriminate against any customer or group of customers includes, among other statutes, the Federal Power Act of 1935, the Natural Gas Act of 1938, and the Energy Policy Act of 2005.

While the right to charge rates allowing a fair return on capital was established in the *Bluefield* case, the manner in which such rates were to be established was not determined until the U.S. Supreme Court case of *Federal Power Commission v. Hope Natural Gas Company* in 1944. This case established that commissions have the right to establish rates in any reasonable manner in which they see fit, as long as the result is a rate which meets the standard established in the *Bluefield* case. The ruling opinion in this case stated:

“We held that the Commission [FPC] was not bound to the use of any single formula...in determining rates... and when the Commission’s order is challenged in the courts, the question is whether that order ‘viewed in its entirety’ meets the requirements of the act. Under the statutory standard of ‘just and reasonable’ it is the result reached, not the method employed, which is controlling.”

Prior to this decision, many public service commissions were determining the value of capital on which rates were calculated, based on the current replacement value, or ‘fair value’ of the plant in service. This was in accordance with a prior Supreme Court ruling in the case of *Smyth v. Ames* in 1898. Subsequent to the *Hope* case, virtually all commissions began using original cost as the valuation standard.

While the laws and legal decisions noted above represent the legal basis for the regulatory compact, many other cases and regulatory rulings over the years have defined the details of the current regulatory system for rate-regulated entities. Collectively, they create the legal rights of these entities to recover the prudent costs incurred in fulfilling these obligations, and to earn a reasonable return on their capital.

As described above, a rate-regulated entity incurs costs with the expectation that those costs will be recoverable through the regulatory process which has been interpreted and supported by U.S. federal case law. An asset or liability is recognized when a cost is incurred or liability imposed when the actions of the entity’s regulator provides for recovery of costs from customers, or return of benefits to customers through a corresponding increase or decrease in future customer rates. For example, when a major storm hits a franchised utility’s service territory, it is the utility’s responsibility to restore service to customers as quickly and reliably as possible. Storm restoration costs can be significant. For example, a major storm resulted in approximately \$360 million of non-capital storm damage costs for one of our member companies. It is the utility’s responsibility to repair the storm damage and return service to customers with the expectation that those costs represent assets that are

recoverable from customers in the future. In an unregulated environment, a company would not be allowed a future price increase to recover that incurred cost as is the case for the rate-regulated utility and therefore may choose not to undertake those activities. An unregulated entity is not assured recovery of that cost beyond what the market will bear. However, the rate-regulated utility (having monopoly status) is more assured of recovery of its prudently incurred costs because its prices are established pursuant to the regulatory process described further in this paper.

This concept and legal framework is critical to our point of view that the U.S. regulatory process drives the economics and financial results of rate-regulated entities in the U.S. Absent the assurances of recovery pursuant to the regulatory compact, our third party equity and debt investors would likely not invest their capital in our companies, or would require significantly higher rates of return. Without the guidance in ASC 980, in this example, the company may be required to record an approximate \$360 million loss in the income statement in the year of the storm, and record income in subsequent periods when the costs are billed to and collected from customers. If the storm restoration costs truly represented an economic loss to the utility in the period incurred, investors likely would not invest their capital in this company. Also, since the incurred storm cost does not represent an economic loss to the entity, our investors also find it useful that the financial statements reflect an asset for that future recovery, which is consistent with the actual economic impact of the storm on the entity.

*b. Federal Regulation*

Public utilities are regulated by their respective state commissions as noted above and are also generally subject to the requirements of the FERC if they either (i) engage in interstate purchases or sales of electricity or (ii) are classified as a “major utility” which is based upon a specified level of either energy purchases or sales. Most, if not all, of our member companies are subject to FERC regulation.

Several federal statutes (as described in footnote 1 above) define FERC’s regulatory authority. This authority encompasses, but is not limited to, regulating the transmission and wholesale sales of electricity and natural gas in interstate commerce. This includes regulating the rates at which utilities and other electric power and gas providers can sell their products and services (i.e. transmission services) to other providers and purchasers of energy and natural gas.

*c. Uniform System of Accounts*

In addition to regulating rates, the FERC also has statutory responsibility for the accounting and financial reporting regulations for companies subject to its jurisdiction. This is accomplished primarily through the development and maintenance of the Uniform System of Accounts (USOA) and the issuance of various forms of accounting guidance. The FERC is also responsible for enforcing its regulatory requirements through the imposition of civil penalties and other means for violations. These regulatory responsibilities give the FERC a vested interest in the application of accounting principles, including U.S. GAAP, to the regulated companies within its jurisdiction.

Public utilities that are subject to FERC regulations must maintain their books and records in accordance with the FERC USOA, which include a detailed chart of accounts, instructions as to which account transactions should be included in, and general accounting instructions. The USOA also provide specific guidance and instructions about where and how to record regulatory assets and liabilities which have been created by the actions of the utility company's regulators. Therefore our regulators, as a primary financial statement user, understand and require that the regulatory compact be reflected in a rate-regulated entity's books and records. The income statement and balance sheet, from our regulator's perspective, must reflect the regulatory process. Regulators have historically and will in the future require differences between the regulatory view and another basis of accounting to be separately adjusted and accounted for in a regulated entity's financial statements. In addition to financial statements required under SEC regulations, rate-regulated entities are also required by FERC to file a Form 1 (for electric) and Form 2 (for gas) among other statutorily required reports. The Form 1, as an example, is a comprehensive financial and operating report, required to be submitted to FERC annually by rate-regulated entities and also required to be updated quarterly via a Form 3Q. The Form 1 instructions require that the company's external auditor also provide an opinion confirming that the company's Form 1 is prepared in accordance with the USOA.

**IV. Cost of Service Rate Making and Determination of Customer Rates**

Cost of service or cost-based rate regulation follows the theories established through the regulatory compact as described above and aligns customer rates with specifically incurred costs. A rate-regulated entity's revenue requirement includes the entity's cost of providing service to

customers and a return on invested capital. The following section provides background and a simplified example of cost of service rate-making for an electric utility.

The basic formula used by a public service commission to determine the revenue requirement to be billed to customers is:

*Revenue Requirement = Operating Expenses (labor, benefits, materials and supplies among others) + Depreciation + Taxes + Return on Rate Base (generally represents investment in plant to support the utility business)*

The revenue requirement can be allocated to customers in different ways. For example, the revenue requirement could be divided by the projected power usage of customers within the designated service area and billed based on usage. The examples in this white paper assume that an entity's revenue requirement is allocated and billed to customers on a per kilowatt-hour (kwh) basis. During a rate case before a public service commission, a company generally proposes an increase or decrease in current rates, supported by evidence regarding the variables in the above equation. Rate cases are generally based on a "test year," which is a 12-month period that is used to measure revenues and expenses to come up with the appropriate change in rates. The "test year" can either be a historical period, or forward-looking. The rates determined through this "test year" remain in effect until another rate case is completed. If an unusual or unexpected event occurs, such as a major storm event that was not previously contemplated as a component of cost of service, a company may seek recovery of those costs through separate regulatory filings. In some cases when customer revenue or operating expense varies from what was contemplated, an automatic customer rate adjustment for the company may or may not occur. This type of adjustment is dependent on the rate making methodology approved by the third party regulator.

Table 1 below is a simplified example of the determination of a revenue requirement, using a "test year" based on a historical period. In this example, the public service commission approves a return on rate base (pre-tax) of 10%. Based on this rate of return, the utility was expected to recover its cost of service and earn net income, or a return on its invested capital, of \$60,000 in year 1. However, since neither operating expenses nor taxes in Year 1 are equal to those incurred in the "test year," the actual return of \$54,000 is less than the rate of return authorized by the public service commission. Because there is not an automatic rate adjustment to customers in this example to make up the difference between the expected and actual return, there would be no regulatory asset recorded for that difference under ASC 980.

However, also in year 1 of the example, the utility experiences a major storm, resulting in \$100,000 of unanticipated costs to restore service to its customers. These costs meet the criteria under ASC 980 for recognition as a regulatory asset based on the past orders by the public service commission that major storm costs are recoverable costs in a future period for the utility if the storm costs are in excess of amounts currently included in the utility's cost of service. Therefore, in year 1 the utility recorded the storm restoration costs as a regulatory asset, rather than as operating expenses. The public service commission follows its past precedent and the utility receives a specific rate order allowing it to recover these costs in rates during year 2. As such, revenue in year 2 includes the recovery of \$100,000 of storm recovery costs in addition to \$400,000, based on the revenue requirement calculated during the test year. Operating expenses in year 2 includes \$100,000 of regulatory charges, as the regulatory asset recognized in year 1 is amortized.

**Table 1**

Year	Test Year	1	2
<b>Income statement</b>			
Revenue	\$ 400,000	400,000	500,000
Operating expenses	(100,000)	(110,000)	(95,000)
Regulatory charge	0	0	(100,000)
Depreciation	(200,000)	(200,000)	(200,000)
Income before income taxes	100,000	90,000	105,000
Income taxes (40%)	(40,000)	(36,000)	(42,000)
Net income	\$ <u>60,000</u>	<u>54,000</u>	<u>63,000</u>
<b>Return on rate base</b>			
Rate base *	\$ 1,000,000	1,000,000	1,000,000
Rate of return (pre-tax)	<u>10%</u>	<u>10%</u>	<u>10%</u>
Return on rate base (pre-tax)	\$ <u>100,000</u>	<u>100,000</u>	<u>100,000</u>
Return on rate base (net of tax)	\$ <u>60,000</u>	<u>60,000</u>	<u>60,000</u>

**Revenue requirement**

Operating expenses	\$	100,000		
Depreciation		200,000		
Return on rate base (pre-tax)		<u>100,000</u>	<u>                    </u>	<u>                    </u>
	\$	<u>400,000</u>	<u>                    </u>	<u>                    </u>
Storm recovery costs	\$	0	100,000	0

\* For purposes of this example, the utility is assumed to have a capital structure comprised of 100% equity.

If the utility had recorded the storm restoration costs as operating expenses in year 1, then it would have reported a net loss of \$6,000, (\$10,000 loss before income taxes, plus a tax benefit of \$4,000) followed by net income of \$123,000 (\$205,000 income before income taxes, less income taxes of \$82,000) in year 2. Because of the Regulatory Compact, the utility has the right to recover the costs necessary to restore service to its customers following the storm. By recording a regulatory asset rather than expensing these costs in year 1, in accordance with ASC 980 because it was deemed probable that the regulator would allow recovery of these costs in a future period, the utility's accounting treatment is consistent with its legal rights and obligations in these circumstances, as well as the underlying economics. Recording a loss in year 1, followed by a large profit in year 2 would reflect greater volatility in its results of operations than actually exists, and could be misleading to users of the financial statements. At a minimum, it would require greater effort on the part of financial statement users to understand the overall financial impact of the storm on the utility.

As noted above, customer rates are generally determined through a regulatory proceeding called a rate case. The rate case generally begins with "per book" data. Virtually all state regulators rely on per book data as prepared in accordance with the USOA. The first phase of the rate case determines the company's cost of providing service to customers which establishes the level of cost including a return to be recovered through customer rates. The second phase determines the rate design or tariff structure. This latter phase results in the allocation of the approved levels of cost of providing service and the allowed return to customers. Also as noted above, when unusual or large events occur and generate the requirement for a rate-regulated entity to expend significant resources, such as a large storm event, a separate regulatory filing to seek recovery for those costs may be

undertaken. The entity's rights under the regulatory compact are the same, however, under any type of regulatory proceeding that the entity initiates. An additional example of a separate filing is a utility's fuel recovery mechanism or "fuel adjustment clause" filing. In some jurisdictions, a utility will exclude fuel (e.g., gas, coal or other commodity used in the electricity production process) from its estimate of cost of service and separately file for recovery of fuel costs. In such jurisdictions, a fuel rate is determined based upon expected fuel costs for a period and that rate is then multiplied by usage resulting in revenues to the utility for that period. However, differences in actual fuel costs vs. collected fuel revenues (based upon the original estimate noted above) for that period are ordered by the regulator to be tracked in a "deferred fuel" account. That difference will result in an adjustment to customer rates in a succeeding period to collect that difference because the regulator has ordered that fuel costs should be recovered "dollar for dollar" by the utility. In such cases, the utility records a deferred fuel regulatory asset or liability in accordance with ASC 980. Absent this application of ASC 980, the volatility in fuel costs would affect the utility's net income even though recovery of actual fuel costs incurred has been assured through the rights established under the regulatory compact.

Appendix A includes other examples of regulatory assets and liabilities generally recorded under ASC 980. Appendix B provides a description of the use of FERC formula rate plans that include an automatic true-up mechanism for revenues and incurred costs.

## **V. Current U.S. GAAP on Accounting for Effects of Rate Regulation**

### *a. Background on SFAS 71*

Preceding the issuance of SFAS 71 in 1982, the FASB's Discussion Memorandum, *Effect of Rate Regulation on Accounting for Regulated Enterprises* raised two pivotal threshold issues associated with the accounting for rate-regulated activities (identified within SFAS 71 Basis for Conclusions):

- Should accounting prescribed by regulatory authorities be considered in and of itself generally accepted for purposes of financial reporting by rate-regulated enterprises? (par. 51, SFAS 71)
- Does rate regulation introduce an economic dimension in some circumstances that should affect the application of generally accepted accounting principles to rate-regulated entities? (par. 56, SFAS 71)

Virtually all respondents to the Discussion Memorandum responded “no” to the first question noting that the function of accounting is to report economic conditions and events. Ratemaking which causes no economic effect does not justify deviation from the generally accepted accounting principles applicable to business enterprises in general. Said differently, the economic effect of regulatory decisions (not the mere existence of regulation) was deemed the pervasive factor in determining the application of generally accepted accounting principles to rate-regulated entities.

On the second question, the majority of respondents agreed that rate regulation does introduce an economic dimension in certain circumstances which should affect the application of generally accepted accounting principles. Respondents cited the cause-and-effect relationship of costs and revenues as the principal economic effect of regulation that affects the accounting for regulated enterprises. For an enterprise with prices regulated on the basis of its costs, allowable costs are the principal factor that influences its prices. Conversely, cost might be one factor used by unregulated enterprises to establish prices, but it would often not be the most important factor – usually, prices are limited by the market.

The economic effect cited by most respondents was the ability of a regulatory action to create a future economic benefit—the essence of an asset. Future benefits are obtained or controlled by the enterprise as a result of a past event. Thus, the criteria of Concepts Statement 6 for an asset were deemed to be met. The respondents who opposed special accounting for the effects of regulation cited the need for comparability between regulated and unregulated enterprises; however, the FASB ultimately concluded that comparability would not be achieved by accounting for rate regulation as though regulation had no economic effect.

The deliberations resulting in SFAS 71 ultimately acknowledged that there is no “special accounting” for rate-regulated activities; there are only generally accepted accounting principles which must account for (among other things) the effects of regulation consistent with the US Financial Reporting Framework. In fact, regulated entities in the US were already accounting for the effects of rate regulation although to varying degrees and not necessarily consistently prior to the issuance of SFAS 71. SFAS 71 did not introduce new accounting for the effects of rate regulation; rather, it narrowed the scope and recognition of those related previous accounting practices in order to provide a consistent framework

and refined recognition and measurement criteria consistent with the US Framework.

SFAS 71, now codified within ASC 980, addresses the economic effects of the regulatory compact described above. The summary to SFAS 71 stated that “for a number of reasons, revenues intended to cover some costs are provided either before or after the costs are incurred. If regulation provides assurance that incurred cost will be recovered in the future, this Statement requires companies to capitalize those costs. If current recovery is provided for costs that are expected to be incurred in the future, this Statement requires companies to recognize those current receipts as liabilities.” In determining whether an entity qualifies for the application of SFAS 71, the FASB established the following criteria:

- The enterprise’s rates for regulated services or products are established by or subject to approval by an independent, third-party regulator or governing body empowered by statute or contract to establish rates that bind customers.
- The regulated rates are designed to recover the specific enterprise’s costs of providing the regulated services or products.
- It is reasonable to assume that rates set at levels that will recover the enterprise’s costs can be charged to and collected from customers (considering demand for the regulated services or products and the level of competition during the recovery period).

Entities operating within rate-regulated environments which meet the above criteria are subject to the requirements and criteria of ASC 980 regarding recognition of regulatory assets and liabilities. The standard contemplates the regulatory compact in that a rate-regulated entity is promised the ability to recover its prudently incurred costs plus earn a reasonable rate of return on its investment. The criteria above are intended to ensure that those applying the guidance are subject to the regulatory principles, i.e., the regulatory compact, or cost of service regulation described herein. The standard implicitly acknowledges that, for example in a large storm event, that the rate-regulated entity has not incurred a period cost, but rather a cost generating an asset, whose cash flows will occur in the future as ordered by its third party regulator. Without the specific guidance or structure provided under SFAS 71, we believe that diversity in practice would exist and the usefulness of a rate regulated entity’s financial statements would be reduced (either by not recognizing the economic effects of the regulatory process, or by doing so in an inconsistent manner across rate-regulated entities). Given that the method of rate making in the U.S. has not substantially changed since

the issuance of SFAS 71 these economic effects continue today and we believe that the guidance under ASC 980 should be retained.

Assuming the above criteria are met, an enterprise would record regulatory assets and liabilities under ASC 980 when the relevant criteria or specified events within paragraphs ASC 980-340-25-1 and ASC 980-405-25-1 (paragraphs 9 and 11 of SFAS 71) are met (per below):

ASC 980-34-25-1 Asset Recognition Criteria	ASC 980-405-25-1 Liability Recognition Events (not all inclusive)
It is probable that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost allowable for ratemaking purposes.	Refunds to customers imposed by a regulator that meet the criteria for accrual of loss contingencies of FASB Statement No. 5, Accounting for Contingencies recorded as liabilities and reductions of revenue or expenses (see ASC 450-20-25-2).
Based on available evidence, future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs. If the revenue will be provided by an automatic rate adjustment clause, the regulator's intent must clearly be to permit recovery of the previously incurred cost.	The regulator provides current rates intended to recover costs 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.
	The regulator requires that gains or other reductions of net allowable costs be given to customers over future periods. In these events, the regulated enterprise shall recognize such amounts as a liability for future reductions of charges to customers that are expected to result.

Implicit in the issuance of SFAS 71 (now codified within ASC 980), is consistency of that standard with the FASB Conceptual Framework. FASB Concept Statement No. 6 identifies the definitions of elements of financial statements, while Concept Statement No. 5 addresses the relevant recognition and measurement criteria under the FASB's Conceptual Framework. Both are summarized in the table below and further support that regulatory assets and liabilities meet the general definitions of assets and liabilities under the FASB Conceptual Framework.

Assets	Liabilities
Definitions	
Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.	Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.
Essential Characteristics	
Probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows	Present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand
A particular entity can obtain the benefit and control others' access to it.	The duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice.
The transaction or other event giving rise to the entity's right to or control of the benefit has already occurred.	The transaction or other event obligating the entity has already happened.
Recognition Criteria (Assets & Liabilities)	
<ul style="list-style-type: none"> <li>• Definitions – The item meets the definition of an element of financial statements (above).</li> <li>• Measurability – It has a relevant attribute measurable with sufficient reliability.</li> <li>• Relevance – The information about it is capable of making a difference in user decisions.</li> <li>• Reliability – The information is representationally faithful, verifiable, and neutral.</li> </ul>	

*b. Assets Arising From Rate-Regulated Activities*

Assets arise for a rate-regulated entity when the actions of its third party regulator provide reasonable assurance of the existence of an asset. This generally results when a regulated entity has incurred a cost but the regulator's actions make it probable that the incurred cost will be recovered in a future period. As a result, the entity is entitled to recover costs through future rates – i.e., rates will be increased from what would otherwise exist so that the value of the expected increase in cash flow will equal the unrecovered costs. Regulatory assets meet the definition of an asset under the FASB's Conceptual Framework because:

- There is a future economic benefit because customer rates will be increased in the future to recover the specifically incurred cost;
- The entity can control the asset or restrict others' access to it; and
- The transaction or event giving rise to the asset (namely, incurring a cost subject to the regulatory compact) has already occurred. As noted in the storm event example above, the transaction or event, (e.g., incurring the cost to repair storm damage) has already occurred, and the utility has restored service with the expectation that the costs will be recoverable through the regulatory process.

*c. Liabilities Arising From Rate-regulated Activities*

Liabilities arise for a rate-regulated entity when the actions of that entity's third party regulator result in a determination that it is probable that the rate-regulated entity will be required to return some benefit to customers in the future either by requiring that the regulated entity make future expenditures or decrease future rates. Also, through provisions in rates for costs not yet incurred and gains to be deferred and amortized over future periods, a regulator can create a regulatory liability. For example, if a plant that has been devoted to utility service and its costs (net book value) to date recovered through customer rates is sold at a gain, both the USOA and the utility's state regulatory commission generally require that the gain be deferred and amortized over a period of time as a reduction to the utility's future rates. Because the utility must reduce rates in the future to return that gain back to customers, a regulatory liability results and is recorded under ASC 980.

Regulatory liabilities also meet the definition included in the FASB's Conceptual Framework because:

- The regulated entity has a present obligation pursuant to the regulatory treatment afforded to the item (e.g., the gain on sale) to make expenditures or decrease future rates from what would otherwise be allowed;
- The settlement of the obligation is expected to result in a reduction in resources embodying economic benefits in the form of a decrease in future cash flow from the sale of regulated services (e.g., the amortization of the gain on sale as a decrease to customer rates); and
- The obligation is imposed due to a past transaction or event which, as noted above, is the sale of that plant that has previously

been devoted to utility service and which the regulator will require be returned through a reduction of future customer revenues. If an entity were not subject to rate regulation and all of the terms and conditions of the sale were met, that entity would likely record the gain and not subsequently defer any of that gain as a regulatory liability. However because of the obligation to share the gain with rate payers a regulatory liability results for the deferral of the gain under ASC 980.

As discussed above, the assets and liabilities arising from the regulatory process essentially represent timing differences. They arise because a regulated entity either under or over-recovers the costs of providing service in the current period and as a result, the regulator allows the regulated entity the opportunity to recover or return such amounts in periods subsequent to when they would normally be expensed or recognized as income. This timing difference in the cash flows of the regulated entity, and the related rights and obligations associated with the underlying regulation and the regulatory compact giving rise to those differences, reflects the economic impact of rate regulation.

## **VI. Practical Implications of no longer applying ASC 980**

There are a number of practical issues that would result from the elimination of the guidance set forth in ASC 980 for U.S. rate-regulated entities. These practical considerations would result most significantly in circumstances where regulatory assets and liabilities are not recorded in a rate-regulated entity's financial statements. The following sections describe this issue and other issues in more detail.

### *a. Diversity in Practice*

Prior to issuance of an accounting standard for rate-regulated activities in 1982, rate-regulated entities generally recorded regulatory assets and liabilities, although practice varied. The cost of service rate making model had been used for years dating back to the early 1900's, and so recognition and measurement of regulatory assets and liabilities was guided by application of state commission rules and regulations to accounting principles on a company-by-company basis.

The elimination of ASC 980 would result in a reversion back to determining the appropriate accounting in accordance with the conceptual framework. We believe that this would result in diversity of practice in assessing under what conditions it would be appropriate to recognize regulatory assets and liabilities. As noted above diversity in practice among countries who have

adopted IFRS on this issue currently exists. For example, one company may determine that recognition of revenue collected from customers for future asset removal costs should be deferred as a regulatory liability, while another company may recognize such collections currently in income. We understand that the SEC has previously expressed a point of view on removal costs indicating that those should be reflected as a regulatory liability (if revenues have been collected in advance of the removal costs being incurred.) However we believe that it is unclear how this previous informal guidance would be applied given that the prior interpretation assumes that regulatory assets and liabilities exist under U.S. GAAP. Likewise, one company could reach a conclusion to recognize a regulatory asset pursuant to a specific rate order for a cost that is deferred for recovery to a future period while another company could reach a conclusion where the same type of costs are recognized as expense when incurred and revenues when billed. We believe that such diversity in practice is unnecessary particularly in light of the fact that current guidance is well accepted and understood and would adversely affect the usefulness of the financial statements by investors and other users of our financial statements.

*b. Increase in Use of Non-GAAP Financial Measures*

Investors and other users of rate-regulated entity financial statements have a significant interest in the actions of regulators and the current and future effect of such actions. Due to the impact on cash flow, rate actions, together with the assessment of the regulatory environment in which investor owned utilities operate, are important considerations to rating agencies and investors. We believe that the elimination of the guidance included in ASC 980 would adversely affect our ratings agencies' ability to effectively rate our companies, since adjustments to the primary financial statements would be needed to reflect actions of regulators.

A common valuation methodology across investor owned utilities, is a price earnings ratio. This valuation approach is generally based on U.S. GAAP net income. To the extent that rate actions are not reflected as regulatory assets and liabilities, the resulting earnings will be highly volatile due to time lags between recognition of costs and revenues and their associated impacts to customer rates. As a result, investors are likely to make adjustments to such financial statements to create non-GAAP unaudited financial measures to compare utility performance in the same manner that is currently evaluated in the marketplace today.

In addition, the need for investors or other users of the financial statements to make non-GAAP adjustments in order to reflect rate actions seems counter-intuitive to the responsibility of management to provide financial

information that faithfully represents the economic activities of the enterprise. Rate actions have both “predictive and confirmatory value” that is capable of making a difference in an investment decision, consistent with the Conceptual Framework underlying U.S. GAAP. As a result, omitting the cause-and-effect relationship between costs and revenues would result in management and users of the financial statements making “non GAAP” adjustments to reported financial information for their purposes, contrary to the fundamental objective of decision useful financial reporting.

*c. Decrease in Usefulness of GAAP Financial Statements by Regulators*

As described above, in addition to preparing general purpose financial statements, some entities are required by FERC to file annual reports (e.g., Form 1 or Form 2 described above, among others). The accounting requirements of FERC are interrelated with U.S. GAAP and used as part of the process to determine just and reasonable rates. Furthermore, state utility commissions rely on the USOA as a basis for rate making in the respective state jurisdictions. Accordingly, FERC and state regulators are among the key users of rate-regulated entity financial statements. The elimination of ASC 980 would reduce the usefulness of the U.S. GAAP financial statements to such regulators as the economic effect of their actions would not be recognized.

*d. Higher Costs to Maintain Additional Accounting Records*

Utilities and other rate-regulated entities have designed their accounting systems to comply with the USOA and meet the financial reporting requirements under U.S. GAAP. Although some limited differences currently exist between the USOA and U.S. GAAP (for example the classification of uncertain tax positions in the balance sheet for USOA vs. U.S. GAAP purposes), we believe that the elimination of ASC 980 would result in substantially more adjustments to keep track of regulatory assets and liabilities on a different basis than required by FERC. Rate-regulated entities typically have very large, complex systems of accounting to collect and allocate costs for rate making purposes. Our third party regulators require significant amounts of details to support our “per book” data which serves as the starting point in the rate setting process as described above. Also, in a number of instances, utilities are organized as utility holding companies with large, centralized corporate and operational functions that require allocations of centralized function costs to each utility operating company since those costs are included as a component of a utility’s cost of providing service. These issues amplify the effect of system changes to accommodate

the differences described above. Developing a parallel accounting system for U.S. GAAP, if changes become more substantive as a result of the absence of specific accounting guidance for rate-regulated entities could be cost prohibitive.

*e. Negative Impacts to Equity Recorded Under U.S. GAAP*

The elimination of ASC 980 guidance could also significantly affect the amount of equity reported under U.S. GAAP for rate-regulated entities who have recorded significant regulatory assets and liabilities. The likely effect of the discontinuation of ASC 980 guidance would be substantial reductions in a rate-regulated entity's reported equity. The estimate of recently reported regulatory assets, regulatory liabilities and equity for our member companies is approximately \$92 billion, \$53 billion and \$300 billion, respectively as of December 31, 2010. Equity reported under U.S. GAAP is a component of a rate-regulated entity's capitalization ratios which are generally included as part of debt covenants. Rate-regulated entities are capital intensive in nature because the entities spend large capital dollars to support an infrastructure that provides reliable utility service to customers and have substantial covenants embedded in their numerous debt agreements. The elimination of regulatory assets would result in a significantly increased debt to total capital ratio, which is not reflective of a rate-regulated entity's true financial picture. Additionally, the reduction of book equity could affect an entity's ability to declare dividends where corporate charters or articles of incorporation require a certain level of book equity to support the declaration of a dividend. While such documents could be modified, we believe that this is an unnecessary and potentially significant incremental cost resulting from the absence of relevant accounting guidance currently included in ASC 980.

## **VII. The IASB Framework**

The preceding sections describe why we believe that the application of ASC 980 results in financial statements for rate-regulated entities that provide decision useful information, the negative practical implications of no longer applying that guidance and why it should be retained for U.S. rate-regulated entities. We acknowledge that the topic of a potential rate-regulated standard under IFRS has been previously considered at the IASB but that ultimately no decision was reached on that project. This amplifies our concern regarding a potential transition to or incorporation of IFRS in to the U.S. reporting system without the retention of ASC 980 or comparable guidance for U.S. registrants. We understand that in the absence of such specific guidance, diversity in practice

exists for rate-regulated entities who have adopted IFRS. We are therefore providing the supplemental information below to address the consistency of ASC 980 guidance with the IASB conceptual framework and also addressing issues that we understand were raised in connection with the IASB’s previous rate-regulated activities project.

FASB Concept Statement No. 2	IASB Framework
<p><b>Relevance –</b> The capacity of information to make a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct prior expectations.</p>	<p><b>Relevance –</b> Relevant financial information is capable of making a difference in the decisions made by users. Information may be capable of making a difference in the decision even if some users choose not to take advantage of it or already are aware of it from other sources. Financial information is capable of making a difference in decision if it has predictive value, confirmatory value or both.</p>
<p><b>Representational Faithfulness –</b> Correspondence or agreement between a measure or description and the phenomenon that it purports to represent (sometimes called validity).</p>	<p><b>Faithful Representation –</b> Financial reports represent economic phenomena in words and numbers. To be useful, financial information not only must represent relevant phenomena, but it also must faithfully represent the phenomena that it purports to represent.</p>

The following table compares the definition of an asset and liability under Concept Statement No. 6 with the IASB Framework.

FASB Concept Statement No. 6	IASB Framework
<p><b>Definition of an Asset –</b> Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.</p>	<p><b>Definition of an Asset –</b> An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow.</p>
<p><b>Definition of a Liability –</b> Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.</p>	<p><b>Definition of a Liability –</b> A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.</p>

The following table compares the fundamental recognition criteria of assets and liabilities under Concept Statement No. 5 with the IASB Framework.

Element Recognition Criteria	
FASB Concept Statement No. 5	IASB Framework
<ul style="list-style-type: none"> <li>• Definitions – The item meets the definition of an element of financial statements (above).</li> <li>• Measurability – It has a relevant attribute measurable with sufficient reliability.</li> <li>• Relevance – The information about it is capable of making a difference in user decisions.</li> <li>• Reliability – The information is representationally faithful, verifiable, and neutral.</li> </ul>	<ul style="list-style-type: none"> <li>• It is probable that any future economic benefit associated with the item will flow to or from the enterprise; and</li> <li>• The item has a cost or value that can be measured with reliability.</li> </ul>

FASB Concept Statement No. 6 defines assets, liabilities and equity in similar terms to those of the IASB Framework. Further, FASB Concept Statement 5 includes in its recognition criteria reliable measurement similar to that of the IASB Framework, while also adding the criteria of relevance and reliability. While the inflow or outflow of future economic benefits mentioned within the IASB Framework is not a specific criterion in FASB Concept Statement 5, this concept is included in the US definitions of each element of the financial statements (see above). The following sections further describe why we believe that regulatory assets and liabilities are supported by the IASB Conceptual Framework including the outlined Recognition criteria.

*a. Definition of an Asset*

As indicated above, the definition of an asset (set out in paragraph 4.4(a) of the IASB Framework) is a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity. According to paragraph 4.8 of the Framework, “The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity.”

The regulatory compact creates a right to recover prudently incurred costs and earn a fair return for providing service to customers. A rate-regulated entity’s right to recover its costs is linked to specific costs it previously incurred in completing performance of its obligation to serve (the past event). Collection of the amounts through future billings is merely a settlement or allocation

mechanism similar to an installment or other receivable that provides for the asset to be paid for over time.

Several issues have been raised in differing forums which would question whether regulatory assets are assets under the IASB Framework including an entity's right to control and whether there is a contract between the utility and its customer.

*i.*      Ability to Control

Some believe the control required by the definition of an asset does not exist with assets arising from the regulatory process. This concern was described in the "Basis for Conclusions on Exposure Draft Rate-Regulated Activities" dated August 2009 ("BFC"). Paragraph BC18 of the BFC stated:

*Some who do not support the recognition of regulatory assets believe that a rate-regulated entity does not control the recoverability of future economic benefits because it does not control whether the customers will use the good or service. They believe that because the entity cannot force individual customers to purchase goods or services in the future, the entity's right to increase future rates does not create an asset.*

For an entity to control an asset there is no requirement that the economic benefits resulting from the asset be certain, and not contingent on future events outside the control of the entity. It is only required that the entity be able to obtain the future economic benefits flowing from the asset, and restrict the access of others to those expected benefits. For example, an unregulated company in an unrelated industry may not have control over whether a counter-party pays a receivable, but that does not result in an assertion that an asset does not exist. The collection of that receivable is separately evaluated as would be the case in determining whether the utility believes that the regulatory asset is probable of recovery. The regulated utility also controls the cash flows resulting from the collection of the regulatory asset. An additional specific example of a rate-regulated entity's ability to control is a securitization transaction where a regulatory asset and the "right to bill" has been considered the utility's property and considered collateral in securitization related financings.

We believe that the criteria for recording an asset under the IASB Framework are met when a rate-regulated entity incurs a cost, pursuant to the regulatory compact, and the regulator defers recovery of that cost to a future period. As previously described, the regulator may choose to do this for a number of reasons, but in many instances it is to avoid “rate shock” to customers. For example, the pass through of 100% of the major storm costs in the example noted above in the same year the storm occurred could have resulted in unprecedented, unexpected and unaffordable rates to customers in the jurisdiction affected by the storm. Spreading the recovery of these costs through rates over an extended period, rather than trying to recover them in the year incurred does not, in our opinion, generate concerns regarding whether an asset exists because the spreading of costs over future periods actually increases the likelihood that collectability of the recorded asset from customers will not be an issue.

Although the timing of the cash flows is predicated on future sales of the regulated service/good, future demand risk will only affect the period in which the cash flows will occur, not whether they will occur. In recognizing a regulatory asset, a rate-regulated entity makes the assertion that it is probable (e.g., likely to occur or expected) that future revenue/cash flows will result from future collection of these amounts from customers as a result of incurring the specified cost. That assertion is based upon specific rate actions, including current rate actions and past precedent of similar incurred costs. Although the customer base may change over time, that also does not affect the underlying legal concepts of the regulatory compact and that the entity is entitled to recover its incurred cost, irrespective of who the actual payer within the approved franchise territory may be.

*ii.* Absence of a Contract

In the IASB deliberations about accounting for assets and liabilities resulting from rate regulation, the issue that there does not appear to be a contract with a specified counterparty or counterparties in situations where an entity’s customers can change from time to time has been expressed. This matter was addressed in the November 2008 IFRIC agenda papers as follows:

...the staff thinks it can be argued that the regulator acts on behalf of the customers who individually have no bargaining power with

the utility company. Agreements between a rate-regulated entity and its customers cannot be understood without reference to the regulation in place. Therefore, it can be argued that such agreements are different from agreements between an entity and its customers in a non-regulated environment. Another view is the one adopted by the Board in its revenue recognition project when it concluded that a customer contract did not need to include all the terms of relevant regulation for them to be considered in the accounting. Thus, it can also be argued that customer contracts in regulated entities are the same as those in a non-regulated environment in that surrounding terms imposed by legislation/regulation have to be considered. In either case, the staff believes that the effect of regulation needs to be considered as part of the agreement with the customer.

The staff notes that IAS 37, paragraph 20, specifically states that **'It is not necessary, however, to know the identity of the party to whom the obligation is owed—indeed the obligation may be to the public at large.'** (*emphasis added*). In the case of rate-regulated entities, any asset or obligation arises in relation to a specifically identifiable group—the customer base. Although the individual members of that group may change over time, the relationship the regulator oversees is the one the entity has with the group. The cash flows the regulator monitors are those arising from transactions with the group as a whole.

We believe that it is not a requirement to have known counterparties to identifying assets and liabilities arising from rate regulation. The regulatory compact provides that under its approved franchise, the entity has the right to recover its prudently incurred cost associated with providing service to customers. The specific customer that pays a bill is not a factor in determining whether or not the legal framework under which the entity operates provides for full recovery of that asset. The method by which the incurred cost is allocated is not determinative of whether or not an asset exists.

*b. Definition of a Liability*

As indicated above, Paragraph 4.4(b) of the IASB's Framework defines a liability as "a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits." We believe that similar to an asset, a liability arising from the regulatory process meets the definition of a liability. Such a liability would result where a regulated entity has an obligation to reduce rates in order to return a benefit back to customers based on the actions of the entity's regulator.

The definition of a liability under the IASB Framework refers to an outflow of resources, not a reduction in resources. However settlement of an obligation through a reduction in the inflow of resources is substantially the same as settlement through an outflow of resources. In both cases, the end result is a reduction in resources from what an entity would otherwise have experienced.

Some may question whether regulatory liabilities constitute a "legal obligation". However we believe that, similar to regulatory assets, regulatory liabilities are created through the regulatory compact which reflects legal principles and concepts for rate-regulated entities.

Also similar to regulatory assets, where a regulatory asset is created when a cost is incurred but deferred for recovery by the regulator to a future period, a regulatory liability arises in the period that a benefit occurs and is required to be flowed back to customers in a future period. For example, a utility could pay less for power than allowed in rates in a particular period, because estimated fuel costs on which rates were initially set were higher than actually incurred. However the regulator specifies that fuel costs are recovered "dollar for dollar" by the utility and those differences are either collected from or returned to customers through a "fuel adjustment clause." In these cases, a regulatory liability in that period for the difference would be recorded because, based on the specified regulatory treatment, the utility has not "over earned" because billed revenues are higher than incurred fuel costs. Rather, the utility has an obligation to return that excess related to the cost of power to the customer because fuel is recovered "dollar for dollar." It is not the utility's right to retain that excess which results in a regulatory requirement to flow funds or the "over earnings" back to customers in a future period.

Paragraph 4.6 of the IASB's Framework also requires that an entity should consider the underlying substance and economic reality and not merely the legal form. It states that, "In assessing whether an item meets the definition of an asset, liability or equity, attention needs to be given to its underlying substance and economic reality and not merely its legal form." We believe that liabilities arising from the regulatory process are legal obligations from the time they arise because of the regulation imposed pursuant to the regulatory compact.

*c. Recognition Criteria*

The recognition criteria included in paragraph 4.38 of the Framework are as follows:

*An item that meets the definition of an element should be recognized if:*

- (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and*
- (b) the item has a cost or value that can be measured with reliability.*

ASC 980 requires probability assessments in determining (i) whether an entity meets the recognition criteria for SFAS 71 and (ii) whether regulatory assets and liabilities are probable of recovery or refund to customers. ASC 980 does not eliminate the similar judgment required under the IASB Conceptual Framework in determining whether an event has occurred which will result in either inflows or outflows to or from the rate-regulated entity. ASC 980 therefore maintains consistency with the recognition concepts articulated under the IASB Conceptual Framework.

## **VIII. Summary and Conclusion**

- U.S. rate regulation is based upon a legal framework, the regulatory compact, which has been consistently interpreted through federal case law.
- The regulatory compact represents the concept that a rate-regulated entity incurs costs in order to provide reliable service to customers within its approved service territory in a not unduly discriminatory manner with the expectation that it will have the right to recover those prudently incurred costs.
- SFAS 71 (now codified within ASC 980) acknowledges this form of regulation and that the actions of regulators pursuant to the regulatory compact create assets and liabilities. It also results in financial statements that reflect these

economics and decision useful information to our investors, ratings agencies, and regulators, our primary financial statement users.

- We further believe that the absence of such specific guidance will result in diversity in practice and significant but unnecessary implications given that our financial statements currently reflect the underlying economics of our domestic rate regulation. Therefore we believe that this guidance is necessary under U.S. GAAP or IFRS, if IFRS is ultimately incorporated in to the U.S. reporting system.

We appreciate the opportunity to present our views on this issue.

Appendix A  
Description of Certain Common Regulatory Assets and Liabilities

Regulatory Asset/Liability	Description
<b>Deferred income taxes</b>	Traditional ratemaking allows for recovery of current and deferred income taxes as part of a regulated entity's operating costs. In some cases, a regulator only allows recovery of the current amount of income taxes in rates and delays recovery of deferred income taxes until future periods when they become current. When this regulatory approach is followed, the amount of tax benefits from accelerated deductions are "flowed-through" to rate payers. Because temporary differences give rise to a deferred tax balance that will eventually reverse, a regulatory asset is established for the expected future cost recovery.
<b>Pension and other postretirement benefits</b>	Regulated utilities record defined benefit plans in accordance with ASC 715 which includes recording an asset or liability for the over- or underfunded status of a plan. Regulatory assets or liabilities are recorded for the cumulative differences between the amounts recognized for ratemaking purposes and the amounts of expense recorded under GAAP, including the amount of underfunding. These regulatory assets or liabilities represent the future recovery of pension and other postretirement benefits through rate making.
<b>Unamortized loss on reacquired debt</b>	Traditional ratemaking allows for recovery of interest as part of a regulated entity's operating costs. Because of the highly capital intensive nature of a utility, debt is frequently refinanced by the utility. In such instances, a regulated utility will be allowed to recover or return the amount of unamortized loss or gain on reacquired debt from or to customers, generally over the period that debt was expected to be outstanding consistent with the period in which that cost will be recovered in rates.
<b>Asset removal costs</b>	Traditional ratemaking generally allows for recovery of asset removal costs over the estimated useful life of property, plant and equipment. A regulatory asset or liability is recorded when actual removal costs are incurred in excess of amounts previously recovered in rates or when amounts have been collected in rates in advance of the removal costs being incurred.

<p><b>Nuclear decommissioning</b></p>	<p>Nuclear decommissioning liabilities are recorded under U.S. GAAP at fair value in accordance with ASC 410. The fair value amount includes required assumptions that a third party will be required to perform that asset retirement activity. Amounts collected in customer rates typically are based upon decommissioning studies which assume that the entity will perform its own decommissioning activities. Decommissioning costs are collected, however in rates and it is expected that the entity will fully recover its costs to decommission. Therefore differences between the expense and liability amounts recorded at fair value under U.S. GAAP and the amounts currently collected in rates are deferred as a regulatory asset. Conversely if amounts collected in rates are higher than amounts recorded under U.S. GAAP, that difference would be recorded as a regulatory liability.</p>
<p><b>Derivatives</b></p>	<p>Regulated utilities record derivatives in accordance with ASC 815 which includes recording derivatives at fair value. A regulatory asset or liability is recorded for unrealized gains or losses from derivatives when such contracts are subject to cost recovery. For example, if a regulated utility hedges fuel costs through a derivative instrument, the actual gain or loss on such derivative may be considered part of the cost of the fuel for cost recovery purposes. In such circumstances, a regulatory asset or liability for the unrealized gain or loss is recorded based on the regulatory treatment of actual realized gains or losses.</p>

Appendix B  
Description of FERC Formula Rates

FERC has accepted formula based rates as one mechanism to establishing customer rates for transactions (e.g., transmission service) subject to its jurisdiction. A formula rate is a more automatic rate adjustment type of mechanism, as compared to a periodically prepared rate case and is intended to allow an entity to recover its cost of service while at the same time providing assurance that transmission rates will not over-recover transmission costs. FERC supported the use of formula rates in Order No. 679 to provide more certainty of recovery in periods of large transmission expansion. Under a formula rate, a utility obtains FERC’s approval of a methodology for determining cost of service using traditional cost of service rate making (i.e., operations and maintenance expenses, depreciation and amortization expenses, and cost of capital). Using this formula, rates are established based on projections of amounts billable to customers on a non-discriminatory basis for a specific period. The formula requires the utility to systematically adjust its rates in order to reflect changes in transmission costs and loads over time. Typically this is done on an annual basis.

Under this type of FERC approved formula rate plan, a utility establishes a balancing account, which is recorded as a regulatory asset or liability, to track differences between the amounts forecasted for the fiscal period and the actual costs and billings. At the end of the fiscal period, a utility then provides the actual results which are trued-up in the next fiscal period. This type of rate adjustment clause also is supported by the regulatory compact. For example, FERC, through support of a formula rate for transmission expansion approves recovery of the transmission investment made by the utility to support reliable customer service. The following chart provides an overview of an illustration of formula rate plan and in this example, under ASC 980, a regulatory asset would be recorded for \$10,000.

Fiscal Period	Period 1			Period 2
	Forecasted	Actual	True-up	Forecasted
Cost of service				
Operations and maintenance	100,000	110,000	10,000	110,000
Depreciation and amortization	220,000	220,000	-	242,000
Property taxes and insurance	10,000	10,000	-	11,000
Interest costs	22,500	22,500	-	24,750
True-up on prior fiscal period				10,000
Return on equity (pre-tax)	76,981	76,981	-	84,679
	429,481	439,481	10,000	482,429
Amounts Billable	429,481	429,481	-	482,429
Total true-up			10,000	