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ISSUES PAPER

APPLICATION OF CONCEPTS IN FASB STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 71 TO EMERGING ISSUES IN THE PUBLIC UTILITY INDUSTRY

October 15, 1984

Prepared by the AICPA Public Utilities Subcommittee

PRELIMINARY AND TENTATIVE

FOR DISCUSSION PURPOSES ONLY

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INTRODUCTION AND OVERVIEW

The Financial Accounting Standards Board (FASB) has asked the Public Utilities Subcommittee (subcommittee) of the American Institute of Certified Public Accountants for its views on certain accounting issues that have emerged recently in the public utility industry relating principally to the construction, operation, and abandonment of nuclear generating facilities. The subcommittee has addressed those issues in this paper in a question and answer format. The subcommittee's conclusions are based on the guidance provided in present authoritative accounting pronouncements, primarily FASB Statement of Financial Accounting Standards No. 71, Accounting for the Effects of Certain Types of Regulation (SFAS 71).

The FASB should reconsider two significant characteristics that are relevant to public utility rate-making and related financial reporting in deciding whether existing pronouncements, including SFAS 71, provide adequate accounting guidance to address the emerging issues discussed in this paper. Those characteristics are the following:

- Assets created by rate actions of a regulator are in effect long-term receivables from customers which should be carried at their discounted present value to reflect the complete economic effects of rate-making.
- Shareholders' equity is considered to have a cost for utility rate-making purposes.

Discounted Present Value

Rate actions of a regulator can provide reasonable assurance of the existence of an asset. Paragraph 9 of SFAS 71 sets forth criteria for capitalizing all or part of an incurred cost that would otherwise be charged to expense. The economic value of such an asset depends on whether it is recoverable and whether it will or will not be included in rate base and earn a return. When the FASB concluded in paragraphs 33 and 34 of SFAS 71 that deferred costs that were not earning a return during the cost recovery period should not be recorded at discounted present value, the amounts involved were less significant. Recently, cost deferrals involve substantial amounts for many utilities.

The subcommittee believes that by following the guidance in SFAS 71, the complete economic effects of rate-making are not reflected in the financial statements of public utilities unless discounting to present value is required for costs not earning a current return that are deferred pursuant to paragraph 9 of SFAS 71. Such cost deferrals are in effect long-term receivables from utility customers for which there is no stated interest rate. Therefore, the concept for discounting to present value as required by APB Opinion No. 21, Interest on Receivables and Payables, should be applicable.

Equity Has A Cost

Although footnote 1 of SFAS 71 describes the term allowable costs as including "amounts provided for earnings on shareholders' investments," current accounting practice, including that used by

public utilities, does not reflect preferred stock costs (dividends) and return to common shareholders as a cost in the income statement. The rate-making process provides for a rate of return to be applied to the rate base (allowable investment) in order that the regulated enterprise can recover its cost of capital. The rate of return is ordinarily a weighted composite of the imbedded (rather than current) cost of debt, the dividend cost of preferred stock, and a return on common equity. Various measures and mechanisms are used to determine the rate of return on common equity, but the allowed amount is usually considered to represent the cost of common equity. Under current generally accepted accounting principles, preferred dividends and return on common equity are not considered a cost, while the return on debt (interest) is clearly a cost. Although the subcommittee believes that the return on equity is a cost in an economic and rate-making sense, the subcommittee recognizes that the FASB has not accepted these amounts as an operating expense for accounting or reporting purposes (for example, SFAS 34, Capitalization of Interest) for either regulated or nonregulated enterprises.

Further, the subcommittee notes that in making an asset impairment evaluation in accordance with paragraph 10 of SFAS 71, the cost of equity is not considered when determining if there is total cost recovery associated with an operating asset. Only interest costs can be considered under generally accepted accounting principles, as such costs are reflected as costs in the income statement by both regulated and nonregulated enterprises. The subcommittee recommends that the FASB consider whether equity is a cost which must be considered in

making an impairment evaluation for <u>both</u> regulated and nonregulated enterprises. If the FASB were to conclude that equity is a cost that should be included in making an asset impairment evaluation, an immediate charge to expense of an amount up to the amount of the costs disallowed by a regulator would be required.

* * * *

Recommended FASB Actions

Summarized below are additional matters that the subcommittee believes the FASB should clarify or address in any revisions to SFAS 71.

Definition of Probable

The probability of future recovery of allowable costs is a key factor that public utilities that are regulated on a cost of service basis consider in resolving most accounting issues. The FASB in SFAS 5, <u>Accounting for Contingencies</u>, paragraph 3(a), defined <u>probable</u> in the following manner:

> The future event or events are <u>likely</u> to occur [emphasis added].

Whereas, footnote 6 of SFAS 71 states:

> The term <u>probable</u> is used in this Statement with its usual general meaning, rather than in a specific technical sense, and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.

Some have concluded that there is a significant difference in these definitions, specifically the standard in SFAS 71 is much less demanding than the one in SFAS 5. They have interpreted the definition in SFAS 71 to mean a "50/50 chance" of occurrence. As discussed further in Issue III, the subcommittee does not agree with such conclusions and believes the FASB should clarify the probability standard so that recovery of costs, as provided in paragraph 9 of SFAS 71, are evaluated using SFAS 5 criteria.

Furthermore, subparagraph 5(c) of SFAS 71 introduces the term it is reasonable to assume, which may be interpreted as being even less demanding than either of the two definitions of probable. The subcommittee recommends that the term probable, as finally defined by the FASB, be substituted for "it is reasonable to assume."

Criteria for Evaluating Cost Recovery

Subparagraph 5(c) of SFAS 71 requires that an evaluation be made to determine whether rates set at levels that will recover the enterprises costs can be charged to and collected from customers during the recovery period for any capitalized costs based upon anticipated changes in levels of demand or competition. Such an evaluation is extremely difficult to perform in practice and the creation of various phase-in plans, as described further under Issue III, adds to the complexity of such an assessment. Elasticity of customer demand, monopoly implications, general economic conditions, changes in the degree and style of regulation, and the political outlook are factors to be considered in assessing existing and future competition.

The current economic and political environment in many regulated industries is toward increased competition and deregulation. As discussed under Issue III, SFAS 71 provides no guidelines to assess the potential for recovering costs deferred pursuant to the criteria set forth in paragraph 9 of SFAS 71 or for that matter related to any capitalized asset. In addition to the change in the definition of probable as previously recommended, the subcommittee believes that the FASB should adopt guidelines, such as those listed under Issue III and/or otherwise provide a substantial amount of guidance to assist the regulators, the regulated enterprises and the accounting profession in determining whether the criterion in subparagraph 5(c) is met.

Deferral of an Equity Return

As discussed under Issue III, some phase-in plans and excess capacity determinations provide for the deferral of a return on shareholders' equity, which under conventional rate-making would be realized currently. Although SFAS 71 contains a specific standard that makes it appropriate to capitalize an allowance for funds used during construction (AFUDC), SFAS 71 contains no such specific standard for capitalizing or not capitalizing an allowance for funds used during operations (when not realized currently). The subcommittee believes the FASB should address this issue and establish formal authoritative support through a specific standard in SFAS 71 for capitalizing an allowance for funds used during operations. In addition, the subcommittee believes that the term incurred costs in paragraph 9 of SFAS 71

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should be clarified to provide for capitalization of equity costs that would otherwise be earned currently, if future recovery is probable.

Criteria for Continued Capitalization of AFUDC

Paragraphs 15 and 82 through 84 of SFAS 71 provide no guidance relating to the accounting for AFUDC in situations where it is probable that there will be a future disallowance of costs associated with an asset that will become operational. The subcommittee believes that the FASB should expand the specific standard relating to AFUDC in paragraph 15 of SFAS 71 and incorporate the subcommittee's views as described in the answer to question 4 relating to Issue II.

Transition Guidelines

As discussed under Issue IV question 3, no guidance for transition is provided in SFAS 71 if that statement no longer applies to an enterprise because it no longer meets all the criteria of paragraph 5. The subcommittee believes that the FASB should provide such guidance.

Accounting for Nuclear Plant Decommissioning Costs

The subcomittee has decided to limit the topics included in this paper to significant recent developments affecting regulated enterprises (such as, phase-in plans and plant abandonments) and to exclude questions relating to the initial implementation of SFAS 71 in existing circumstances. Questions concerning the appropriate

accounting for nuclear plant decommissioning costs are an example of such implementation issues that have not been addressed in this paper. However, the subcommittee considers nuclear plant decommissioning costs to be a significant issue and believes that the FASB should consider providing additional accounting and disclosure guidance in accounting for decommissioning costs.

The subcommittee believes that paragraph 80 of SFAS 71 makes it clear that plant decommissioning costs are incurred costs that should be charged against income as the plant is used, whether or not the regulator allows such charges to be recovered from customers currently. The subcommittee also believes that estimated total decommissioning costs should be based upon the specific enterprise's expected decommissioning methodology, such as dismantling or moth balling. Decommissioning costs allocated to the current period for accounting purposes that are not being recovered from customers in rates may be deferred if the criteria in paragraph 9 of SFAS 71 are met.

The subcommittee also believes that the potential magnitude of decommissioning costs and the uncertainties inherent in estimating such costs necessitate additional financial statement disclosures such as the following:

- Total estimated decommissioning costs to be incurred (in today's dollars) including date that cost estimate was last made and key assumptions used

- Expected timing of decommissioning activities

- Method for collecting costs from customers and amounts collected from customers to date and costs "incurred"

- Tax implications, if any

- Cash flow aspects of decommissioning activities, including any restrictions on funds collected from customers

Additional guidance by the FASB in the following areas would be helpful in resolving many of the questions concerning decommissioning costs:

1. Is the entire liability for decommissioning costs incurred on the date a nuclear plant is placed in service or is the liability incurred over the plant's useful life?

   The subcommittee believes that if the entire liability is recognized at the in-service date, an offsetting entry should be made to record a deferred charge, to be allocated to future periods.

2. Should plant decommissioning costs be recorded as an offset to the plant account or as a liability?

   Although the subcommittee believes that decommissioning costs meet the definition of a liability, there are precedents for contra asset treatment of similar items, such as strip-mining reclamation costs.

3. Should the estimate of future decommissioning costs consider possible inflation, its discounted present value, and future

technological and regulatory changes or should such estimates be based strictly on current costs and requirements?

The subcommittee believes that as a practical matter the effects of possible inflation and discounting to present value would tend to offset each other and that the cost estimates should be based upon current technology.

ISSUE I -- PLANT ABANDONMENTS

Background

A substantial number of electric utilities have decided to abandon generating facilities that were under construction (plant abandonments), and other utilities are considering such abandonments.

A number of the utilities have disclosed construction delays of plants and the possibility of an abandonment decision. The principal reasons cited for the delays included inadequate rate relief and corresponding lack of funds, delays in project approvals by regulatory agencies, reductions in projected sales growth, and higher construction quality requirements.

Plant abandonment decisions have been made or are under consideration for plants ranging from the early stages of construction to those nearing completion. Several nuclear plant abandonment decisions were announced by utilities in 1984 for plants that were nearing completion. Costs associated with nuclear plant abandonments in the electric utility industry aggregate many billions of dollars.

Relatively small amounts were associated with plant abandonment decisions at the time the FASB determined that deferring such costs was appropriate if it was probable that a regulator would allow reco-

very in future revenue by amortization of the amounts in cost of service for rate-making purposes.

Guidance for deferring the costs of abandoned plants for accounting purposes is provided in paragraph 9 of SFAS 71, and paragraph 20 sets forth the disclosure requirements if the unamortized balance of such a deferral does not earn a return on investment during the recovery period. The principal thrust of SFAS 71 is that the economics of rate-making be reflected in the financial statements of regulated enterprises. However, paragraphs 33 and 34 of SFAS 71 indicate that the FASB chose to differentiate between capitalized costs not earning a rate of return from those earning a rate of return by requiring disclosure rather than recording at discounted present value. Hence, although the regulator's actions create the basis for recording the cost of an abandoned plant as an asset, the complete economic effect of the regulator's decision are not reflected, but only disclosed when the asset is not allowed to earn a return on investment during the recovery period.

For rate-making purposes, exclusion of an asset from the rate base has the effect of eliminating rate recovery of associated ongoing interest costs, preferred stock dividends, and return to common shareholders. SFAS 71 does not address the fact that the weighted average rate of return on rate base granted by regulators is intended to recover the aforementioned elements. Hence, it must be concluded that

these elements are regarded as costs that need only be recorded as incurred and do not need to be considered in evaluating the recovery of costs capitalized pursuant to paragraph 9 of SFAS 71. Under current accounting practice for both regulated and nonregulated enterprises, preferred stock dividends and return to common shareholders are not recorded as costs in the income statement. Costs that would be charged to expense, absent the regulator's rate action that provides probability of the recovery of the cost of an asset, are intangible in nature and obtain value as an asset only from a regulator's promise of future revenue to permit recovery.

Some regulators take a position that losses resulting from plant abandonments should be borne entirely by the consumers. This is accomplished when the regulator allows amortization of the loss in cost of service in establishing future rates for a specified number of years and allows a rate of return on the unamortized balance. Some regulators believe there should be a sharing between the consumers and the shareholders of losses resulting from plant abandonments. The most common way to achieve this is to allow amortization of the loss in cost of service in establishing future rates for a specified number of years but not allow a rate of return on the unamortized balance.

As indicated previously, the only accounting or financial reporting difference between the two scenarios described in the preceeding paragraph is that in the latter case disclosure is required of amounts deferred on which a return on investment is not allowed by the regulator and the remaining recovery period applicable to them, if material.

Another method regulators have used for sharing such losses is to disallow a portion of the plant abandonment loss from any recovery but allow cost recovery of the remaining portion, as well as a rate of return thereon (see Issue I, Question 3).

Construction activity is usually suspended, often for an extended period of time, prior to a final decision to abandon or to resume construction. The principal accounting question is whether and for how long AFUDC and other costs, for example, real estate taxes, should be capitalized. Current practice varies considerably.

The Federal Energy Regulatory Commission (FERC) Accounting Release No. AR5 issued in 1968 states: "No interest should be accrued during period of interrupted construction unless the company can justify the interruption as being reasonable under the circumstances." The FERC has decided administratively that AFUDC should not be capitalized if the period of suspended construction is longer than two years; it readily accepts capitalization if the period is one year or less.

SFAS 34 deals with the interest capitalization period for enterprises in general. SFAS 34 refers to the capitalization period for nonregulated enterprises in paragraphs 17 and 19 as follows:

> 17. The capitalization period shall begin when three conditions are present:
>
> a. Expenditures (as defined in paragraph 16 [of this statement]) for the asset have been made.
>
> b. Activities that are necessary to get the asset ready for its intended use are in progress.
>
> c. Interest cost is being incurred.

Interest capitalization shall continue as long as those three conditions are present. The term activities is to be construed broadly. It encompasses more than physical construction; it includes all the steps required to prepare the asset for its intended use. For example, it includes administrative and technical activities during the pre-construction stage, such as the development of plans or the process of obtaining permits from governmental authorities; it includes activities undertaken after construction has begun in order to overcome unforeseen obstacles, such as technical problems, labor disputes, or litigation. If the enterprise suspends substantially all activities related to acquisition of the asset, interest capitalization shall cease until activities are resumed. However, brief interruptions in activities, interruptions that are externally imposed, and delays that are inherent in the asset acquisition process shall not require cessation of interest capitalization.

19. Interest capitalization shall not cease when present accounting principles require recognition of a lower value for the asset than acquisition cost; the provision required to reduce acquisition cost to such lower value shall be increased appropriately [emphasis added].

The extent of detail and the location of the disclosure relating to interrupted construction vary between enterprises and within an enterprise from period to period as the enterprise moves through its decision-making process.

Generally, no write-offs or write-downs of carrying value are made prior to reaching a final decision to abandon the plant. A number of auditors' "subject to" opinions were issued on 1983 financial statements because of the uncertainty associated with potential plant abandonments. Several utilities stopped accruing AFUDC in 1984 before making a final decision to abandon the project.

A long period of time may elapse from the date an abandonment decision is reached until the regulator indicates whether and how the abandonment loss will be allowable for rate-making purposes. Under generally accepted accounting principles for nonregulated enterprises,

an abandonment decision would require an immediate loss recognition of the difference between the carrying value of the asset plus estimated cancellation charges less salvage value. Paragraph 9 of SFAS 71 states that rate actions of a regulator can provide reasonable assurance of the existence of an asset. As explained in paragraph 76 of SFAS 71, paragraph 9 refers to costs that normally would be charged to expense by a nonregulated enterprise. Generally, if management of a public utility intends to pursue complete cost recovery of the cost of abandoned plants, no write-offs or write-downs of carrying value have been made prior to the determination of the rate treatment by the regulator. This approach is taken because the loss, if any, cannot be reasonably estimated in advance as required by subparagraph 8(b) of SFAS 5, the minimum loss within the range of possible loss is zero, and in accordance with FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss, paragraph 3, no loss provision is required. In situations where utilities did not pursue rate recovery of abandonment losses, the losses were recognized in the period the decision not to seek recovery was made.

Present practice varies as to where and how disclosure is made in financial statements, annual reports, and SEC Forms 10-K of the uncertainty as to whether and how the abandonment loss will be recognized for rate-making purposes. Where uncertainty exists and the amount is material, the independent auditors ordinarily would issue a "subject to" opinion.

QUESTION 1: Under what circumstances should plant abandonment losses be deferred for financial reporting purposes?

Conclusion of the Subcommittee

Plant abandonment losses should be deferred for financial reporting purposes when a regulator intends to allow at least recovery of cost, including the capitalized cost of financing construction activities (AFUDC), and such costs can be recovered. Paragraph 9 of SFAS 71 provides guidance for the establishment of an asset in such situations. Paragraph 20 of SFAS 71 requires that the utility disclose the remaining amounts of such assets, if material, if the recovery of the costs is provided without a return on investment during the recovery period and the remaining recovery period applicable to those assets.

Although paragraph 92 of SFAS 71 could be interpreted to permit carrying certain assets at their discounted present value, paragraph 34 prohibits the costs from being recorded at discounted present value. The subcommittee notes that paragraph 34 is contained in Appendix B, which provides guidance for the application of SFAS 71 to specific situations; whereas paragraph 92 is contained in Appendix C, which discusses factors considered by the FASB in arriving at the conclusions contained in the Statement itself and Appendix B. Therefore, the subcommittee has concluded that paragraph 34 governs and that discounting to present value is not permitted.

The subcommittee believes that the complete economic effects of rate-making are not reflected in the financial statements of public utilities because deferred charges, such as plant abandonment losses, are not required to be discounted when no return is allowed for rate-

making purposes. The subcommittee believes that such assets created by regulation are, in effect, long-term receivables from customers, and as such require discounting to present value. APB Opinion No. 21, Interest on Receivables and Payables, requires discounting to present value of long-term receivables on which there is no stated interest rate. The discount rate could be based on the weighted average cost of debt for the enterprise or the allowed weighted average rate of return used in the latest rate case of the enterprise.

QUESTION 2: If a regulator does not allow a plant abandonment loss to be recovered through inclusion in cost of service over a future period must the loss be recognized in the current reporting period?

Conclusion of the Subcommittee

In most circumstances, the plant abandonment loss should be recognized in the current reporting period if it is not allowed as a cost of service in establishing future rates. The subcommittee has concluded, in accordance with paragraph 9(a) of SFAS 71, that cost recovery of an abandoned plant may be accomplished indirectly even though the regulatory process does not provide for the recovery of the plant abandonment loss through amortization in cost of service, provided that the regulator's intent was to provide recovery through some other means and the amount of recovery is measurable. For example, if it can be established that the weighted average rate of return allowed on assets included in the rate base will be measurably higher than it

would have been absent the disallowance of the abandonment loss, then the incremental weighted average rate of return can be considered to be the mechanism for the recovery of the plant abandonment loss, and the entire loss need not be recognized in the current reporting period. If a direct linkage and regulatory intent cannot be established to indicate that the costs associated with the abandonment will be recovered in future periods, the costs must be written off in the current reporting period. This linkage must be re-established in each succeeding rate case. The subcommittee believes that situations where direct linkage and regulatory intent can be established will be rare. As stated previously, the amount should be discounted to present value.

<u>QUESTION 3</u>: If a regulator does not allow a <u>portion</u> of a plant abandonment loss to be recovered through inclusion in cost of service in future periods, must the loss on the portion disallowed be recognized in the current reporting period?

<u>Conclusion of the Subcommittee</u>

Some regulators are alleging that some utilities should have decided sooner than they did on a cancellation or that there were inefficiencies in connection with the construction costs accumulated prior to the decision to abandon. Frequently, in such cases, the regulator may do either of the following:

1. Disallow a portion of the cost of the abandoned plant and allow the remainder to be recovered in cost of service in establishing future rates for a specified number of years and

not allow rate base treatment and a rate of return on the unamortized balance of the portion allowed in cost of service

2. Disallow a portion of the cost of the abandoned plant and allow the remainder to be recovered in cost of service in establishing future rates for a specified number of years and allow a rate of return on the unamortized balance of the portion allowed through rate base treatment

If the regulator makes a partial disallowance as described in (1) above, the disallowed portion should be written off in the period the regulator makes the determination or any earlier period if it is probable that disallowance will result and it can be quantified. The allowed portion would be deferred and amortized over the period designated by the regulator, and disclosed in the notes to the financial statements. The subcommittee believes that the amount should be discounted to present value.

If the regulator makes a partial disallowance as described in (2) above and the regulator does not intend to attribute all or a portion of the return on the allowed portion to the recovery of the cost of the disallowed portion, the subcommittee believes that the disallowed portion should be written off in the current reporting period. An indication of such intent would be an accounting order by the regulator that the disallowed amount should be written off.

Some, nevertheless, may argue that the currently allowed return on the portion of the loss allowed in the rate base should be considered recovery of the portion of the loss not allowed in cost of service. The subcommittee believes that intent of the regulator and linkage, as discussed in Issue I, question 2, are required to support

such a position because the costs associated with plant abandonments are "intangibles" and should be written off in the current reporting period absent a regulator's promise to allow recovery. Establishing such linkage and intent may be difficult, and they must be re-established in each succeeding rate case. As stated previously, the subcommittee believes that the amount should be discounted to present value.

If the required linkage and intent can be established and deferral of abandonment losses is deemed appropriate, paragraph 20 of SFAS 71 requires disclosure of amounts deferred that are not earning a return (up to the entire abandonment amount in such circumstances because some or all of the rate of return on the allowed portion is considered to be the recovery of the cost of the disallowed portion). If the return allowed on the allowed portion is insufficient to recover all the disallowed costs, a write-off in the current reporting period of a portion of the disallowed portion would be necessary.

QUESTION 4: What are the accounting implications and disclosure requirements from the time a utility considers a plant abandonment to the time a final decision to abandon (or resume construction) is reached?

Conclusion of the Subcommittee

The subcommittee believes that a determination should be made as to whether and for how long AFUDC and other costs should continue to be capitalized for each suspended construction project based upon the

individual circumstances. SFAS 34 provides authoritative accounting guidance with respect to the continuing capitalization of interest costs. In addition, the FERC administrative policies dealing with this issue, although arbitrary, also serve as a useful guide. One of the most important factors to be considered in determining the accounting treatment and disclosure requirements is the anticipated treatment of the abandonment for rate-making purposes by the regulator if a decision to abandon is ultimately made, including the regulator's policy on recognition of AFUDC and other costs capitalized during a suspension period.

The subcommittee also believes the extent and location of the required financial statement disclosures during the period construction is suspended pending a final decision will vary between companies and over time within companies. The amount of money invested in plant construction in relation to the financial statements as a whole, as well as the effect of established rate precedent, obviously indicates the significance of any potential loss. When the circumstances indicate that an abandonment decision is possible and incomplete recovery of associated costs is possible, the following should be disclosed in the notes to the financial statements:

- Amounts expended to date (and amount of AFUDC included therein) plus estimated cancellation charges
- Percentage completed
- Whether AFUDC and other costs are continuing to be capitalized and, if so, the amount on a continuing basis
- Expected regulatory treatment, if abandoned, and precedent therefor

- Worst case scenario (that is if plant is abandoned and no regulatory relief is granted, the effect on net income and equity, including the possibility of being in default under indenture provisions, etc.)

The management discussion and analysis (MD&A) contained in the annual report should address cash flow implications including the ability to continue to pay dividends (see Issue I, question 5).

QUESTION 5: What are the accounting and disclosure requirements from the time a final abandonment decision is reached until the time the regulator determines the treatment for rate-making purposes?

Conclusion of the Subcommittee

The subcommittee believes that the enterprise's management should conduct a comprehensive ongoing review to determine whether abandonment costs should be written off or written down. The review should include a thorough evaluation of the anticipated rate treatment by the regulator and any changes in the regulatory environment (for example, changes in commissioners, changes in statutes, etc.). SFAS 71, paragraph 9, provides that the dictionary definition of probable be used in the probability assessment. The subcommittee notes that that definition may be construed to be less stringent than the criteria set forth in SFAS 5. The subcommittee believes that the probability criteria should be modified and clarified by the FASB so that recovery of costs, as provided in paragraph 9 of SFAS 71, are evaluated using SFAS 5 criteria.

The subcommittee believes that the uncertainty during this time lag period should be disclosed in a note to the financial statements. For guidance as to the extent of the disclosure see Issue I, question 4.

Whether an auditor would issue a "subject to" opinion on the financial statements will depend on whether the amount of the abandonment loss, if subsequently determined by the regulator not to be allowed for rate-making purposes, is material in relation to ~~net income and~~ the equity of the enterprise and whether the enterprise's dividend paying ability would be affected. If nonrecovery of the abandonment loss would jeopardize the financial viability of the company, a "going concern" opinion may be required. Guidance concerning materiality is set forth in an interpretation of Statement on Auditing Standards No. 2, <u>Reports on Audited Financial Statements</u>, issued by the AICPA Auditing Standards Board in October 1979.

ISSUE II -- DISALLOWANCE OF A PORTION OF COSTS ASSOCIATED WITH AN OPERATING PLANT

Background

There have been recent instances where regulators have disallowed a portion of the cost of major generating projects which have been completed and placed in service, from inclusion in the rate base and/or from recovery through cost of service by reducing allowable depreciation. Among the reasons cited for the disallowance have been allegations that:

- Significant cost overruns should not be borne entirely by the rate payer

- Imprudent expenditures or construction mismanagment by the company

- The plant represents excess capacity which is not needed to serve customers

- The construction period was excessive, leading to excessive AFUDC or inflated costs

- Rates set on the basis of the recovery of all costs would place too great a burden on customers or cannot be economically recoverable

Alternatively, regulators may "penalize" the utility by reducing the rate of return otherwise allowable on the cost of the plant (or the entire base).

The accounting question is whether the actions described above require a write-down in the carrying amount of the operating plant. Paragraph 10 of SFAS 71 refers to a regulator excluding all or part of a cost from allowable costs in current and future periods, thereby not providing for recovery in revenues. For that situation, the carrying amount is to be reduced "to the extent that the asset has been impaired. Whether the asset has been impaired shall be judged the same as for enterprises in general." Therefore, in order to determine whether a write-down of a regulated enterprise's long-lived assets is required, the appropriate accounting for "enterprises in general" in similar circumstances must be determined. This is difficult to do.

Generally accepted accounting principles provide little specific guidance for accounting for impairment of value of assets with long useful lives. This lack of specific guidance was acknowledged in 1977 by the FASB in SFAS 19, Financial Accounting and Reporting by Oil and Gas Producing Companies, paragraph 209, which states:

> The question of whether to write-down the carrying amount of productive assets to an amount expected to be recoverable through future use of those assets is unsettled under present generally accepted accounting principles. This is a pervasive issue that the Board has not addressed.

An issues paper prepared by the AICPA Accounting Standards Division Task Force on Impairment of Value entitled Accounting for the Inability to Fully Recover the Carrying Amount of Long-Lived

Assets, dated July 15, 1980 ~~(Appendix B),~~ recommended that asset impairment should be reflected in the financial statements. However, the FASB has taken no action as a result of that paper. The paper indicated that impairment write-downs have been rare in practice.

There are general references in accounting literature relating to the accounting for the "impairment of the value of an asset," however, write-downs have been rare in practice. The following references are applicable:

- Section M-5C of Chapter 7 of APB Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises, states:

  In unusual circumstances persuasive evidence may exist of impairment of the utility of productive facilities indicative of an inability to recover costs although the facilities have not become worthless. The amount at which those facilities are carried is sometimes reduced to recoverable costs and a loss recorded prior to disposition or expiration of the useful life of the facilities.

- Paragraphs 74 and 75 of SFAS 5, state:

  74. The accrual of some loss contingencies may result in recording the impairment of the value of an asset rather than in recording a liability, for example, accruals for expropriation of assets or uncollectible receivables. Accounting presently recognizes impairments of value of assets such as the following:

      ...e) Paragraph 193 of APB Statement No. 4 (Section 1027.09) states that when enterprise assets are damaged by others, asset amounts are written down to recoverable costs and a loss is recorded. [emphasis added].

  75. A recurring principle underlying all of these references to asset impairments in accounting literature is that a loss should not be accrued until it is probable that an asset has been impaired and the amount of the loss can be reasonably estimated. As indicated by those references, impairment is recognized, for instance, when a non-temporary decline in the market

> price of marketable securities below cost has taken place, when the utility of inventory is no longer as great as its cost, when a commitment, in terms of a formal plan, has been made to abandon a segment of a business or to sell a segment at less than its carrying amount, when enterprise assets are damaged, and so forth. ...

It is clear in authoritative literature that cost recovery is the key criteria to be used in making an impairment evaluation of long-lived assets.

Statement of Financial Accounting Concepts No. 3, Elements of Financial Statements of Business Enterprises (SFAC 3), defines one of the characteristics of an asset as:

> It embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows.

SFAC 3 further defines that an asset must have "service potential for future economic benefit."

By itself, a disallowed cost for rate-making purposes associated with a long-lived operating asset provides no future economic benefits or cash inflow but in combination with all of the other related costs of the plant, it may produce revenues sufficient to recover all of the costs of providing the service including the disallowed costs.

Some believe that SFAS 71 requires that utilities report the economic effect of all aspects of rate regulation in their financial statements and that any partial disallowance of costs associated with an operating asset should be written off. However, the specific requirements of SFAS 71 do not always reflect all of the economic effects of

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regulation, such as not permitting costs not included in the rate base to be carried at discounted present value. Furthermore, SFAS 71 refers to making an impairment evaluation in the same manner as nonregulated enterprises. Accordingly, many believe that under existing literature the only sound basis for making an asset impairment evaluation relates to whether or not cost will be recovered.

QUESTION 1: Should a partial disallowance of costs associated with an operating plant result in an immediate charge to expense?

Conclusion of the Subcommittee

The subcommittee has concluded, based on existing authoritative accounting literature, that the ability to recover the disallowed costs is the only factor to consider in determining whether an asset has been impaired. No consideration should be given to whether the asset will produce an equity return on investment. The subcommittee has concluded, therefore, that where a partial disallowance of costs associated with an operating plant will be recoverable using this standard, an immediate charge to expense is not permitted. A determination of whether costs incurred will be recovered in the rate-making process must be made to determine the amount, if any, to be charged to expense. The asset impairment evaluation should be the same as for enterprises in general as required by paragraph 10 of SFAS 71.

QUESTION 2: When a regulator disallows for rate-making purposes certain costs associated with an operating asset, what fac-

tors should be considered in determining whether the value of the asset has been impaired?

Conclusion of the Subcommittee

As noted in the AICPA issues paper (Appendix B), very few enterprises have written down operating assets to reflect an impairment in value; hence, it is not entirely clear how impairment evaluations should be made under generally accepted accounting principles.

The key element in determining whether there is an impairment is the factors considered in the measurement process. One view would be that the operating revenues less related expenses must be adequate to allow recovery of all costs associated with the plant (that is, must cover depreciation and related operating expenses). Another view would be that unless the discounted amount of future net cash inflows exceed the cost of the plant, there is an impairment. Related questions are whether expenses and cash outflow include interest, preferred stock dividends and/or return to common shareholders, and what discount rate, if any, should be used.

The subcommittee has concluded that the measure of whether an asset has been impaired is whether net cash inflows (revenues less applicable expenses) are sufficient to cover the cost of the asset. In measuring expenses, interest applicable to the unit should be included, but equity return would not be included. Since income taxes are a function of income under generally accepted accounting prin-

ciples, income taxes may not need to be considered in this calculation. However, where there will be income tax expense even with no equity return, such as where flow-through accounting was followed for capitalized overheads during the construction period and/or equity AFUDC is included in the disallowed plant cost, the cash flows for such income tax expense must be considered when measuring recoverability. (If recoverability were to be measured by the discounted amount of future net cash inflows, a similar result may be achieved if interest expense were excluded and the discount rate was the weighted cost of debt.)

It is also the conclusion of the subcommittee that the measurement of revenues and expenses should be based on the smallest unit, generally a generating plant.

Although it is not known whether enterprises in general consider interest costs in making an asset impairment evaluation, the subcommittee believes that interest associated with a utility operating plant should be included because interest costs are specifically provided for in determining revenue in the rate-making process.

Preferred stock dividends and return to common stockholders are also considered costs in the rate-making process for which revenue is specifically provided. However, such elements are not currently reflected as costs under generally accepted accounting principles in the income statement of regulated or nonregulated enterprises. The subcommittee recommends that the FASB consider whether equity is a cost which should be considered in making an impairment evaluation by

both regulated and nonregulated enterprises. If the FASB were to conclude that preferred stock dividends and/or return to common sharholders were costs that should be included in making an asset impairment evaluation, an immediate charge to expense of an amount up to the amount of the costs disallowed by a regulator would be required.

QUESTION 3: Is an accounting entry required when a regulator issues a rate order that indicates a "penalty" related to excessive costs in constructing a plant is to be reflected by a reduced rate of return allowed on common equity, but does not quantify the amount of such penalty? If not, what disclosures, if any, are required in the notes to the finanical statements?

Conclusion of the Subcommittee

Paragraph 20 of SFAS 71 states that a regulator may permit an enterprise to amortize an allowable cost over a period of time for rate-making purposes that a nonregulated enterprises would charge to expense. If recovery of such major costs is provided without a return on investment during the recovery period, the enterprise shall disclose both the remaining amounts of such assets and the remaining recovery period applicable to them.

Therefore, no accounting entry would be necessary if the regulator reduces the rate of return since the amount of the "penalty" is not specifically identified and disallowed. However, the enterprise

should disclose the reduced rate of return, and whether it is expected to be a continuing reduction or only a one-time "penalty."

The above conclusion of the subcommittee addresses the specific question but there are ramifications that deserve consideration.

The nature of the "penalty" or "imprudence" disallowance should be considered. In practice, imprudence has a variety of meanings--some commissions use it frequently; others limit its use to specific findings related to a specific situation. The question above appears to involve a case where there is a general finding of inefficiency in building plants rather than a specifically identified cost that is considered "imprudent." As stated above, SFAS 71 would not require a write-down of an asset although the rate of return adjustment should be disclosed.

If, however, the disallowance were identified to a specific plant and cost, the question arises whether there has been, in fact, a disallowance of a specific asset disguised as a reduced rate of return. Issue I, question 2 discusses factors to be considered in evaluating whether a cost recovery is being accomplished by the regulator by permitting a higher than normal rate of return. The effects of the allowance of a lower than normal rate of return should be accounted for consistently.

If it is determined that a specifically identified cost has been disallowed (in the form of a lower allowed return), then the evaluation of whether to charge to expense for an impairment is necessary and should be consistent with the subcommittee's views in Issue II, Questions 1 and 2.

QUESTION 4: Should AFUDC continue to be capitalized in situations where it is probable that there will be a future disallowance of costs associated with a plant that is expected to become operational in the future?

Conclusion of the Subcommittee

While SFAS 71 does not provide guidance as to when it is no longer appropriate to record AFUDC, the FASB in paragraphs 17 and 19 of SFAS 34 (as quoted under Issue I) did address the issue as it relates to capitalizing interest.

If the capitalization of AFUDC were nothing more than interest capitalization in accordance with SFAS 34, capitalization would continue even in situations in which total cost recoverability was in doubt, as long as construction work was not suspended. However, because AFUDC includes an equity component, no authoritative accounting guidance exists.

Extensive discussion surrounding the concept of AFUDC has occurred over many years. The FERC addressed this subject extensively and in 1977 issued Order 561 which outlines how AFUDC should be computed. The FERC concluded that the concept of AFUDC capitalization was sound as it relates to regulated enterprises because it considers financing costs to comprise interest on short-term and long-term debt, preferred stock dividends, and return to common shareholders. As stated previously, all these elements are considered to be costs in establishing rates to be charged to customers.

The FASB's rationale in paragraph 15 of SFAS 71 for allowing the capitalization of AFUDC to include the equity component was that the amount so capitalized would be recovered through the rate-making process. That being the case, continued capitalization of AFUDC may be deemed inappropriate by some in situations where a partial disallowance of cost associated with a future operative plant is expected to occur. Supporters of this view would require that capitalization of interest begin in accordance with the provisions of SFAS 34.

Some FASB members, as stated in paragraph 84 of SFAS 71, considered capitalized AFUDC to be an acceptable substitute for the amount of interest that would have been capitalized in accordance with SFAS 34. This view is shared by many individuals. Considering the weight the AFUDC calculation under FERC order 561 gives to short-term indebtedness, the concept that AFUDC approximates the amount of interest capitalized under SFAS 34 is logical. Using the rationale that AFUDC is a substitute for interest, all AFUDC should continue to be capitalized as provided for in paragraphs 17 and 19 of SFAS 34.

It is noted that the FASB has not provided any specific guidance to assist regulated enterprises and auditors in responding to the question being asked above. The subcommittee believes, however, in the situation described above, that the company should make an assessment under the provisions of SFAS 5 to determine whether or not the plant in question has been impaired. The impairment valuation should be made using the criteria under Issue II, question 2. The costs to be compared with the future revenue stream should be the sum

of costs (including AFUDC) incurred to date plus estimated costs, including future AFUDC, to complete the project. The subcommittee believes that AFUDC should continue to be recorded regardless of the outcome of the assessment. It is noted that the current period impairment provision, if any, would include the effect of AFUDC to be capitalized in the future.

If the regulator specifically orders the discountinuance of AFUDC capitalization, this would indicate impairment because recoverability of future AFUDC would be unlikely. Upon discontinuance of capitalizing AFUDC, interest costs should be capitalized pursuant to SFAS 34 and an impairment evaluation made using interest costs rather than AFUDC.

QUESTION 5: What should the financial reporting to shareholders be when the FERC orders a write-off of amounts that would not be permitted to be written off under generally accepted accounting principles?

Conclusion of the Subcommittee

Financial reporting to shareholders must be in accordance with generally accepted accounting principles, and state accounting orders are not considered to provide, by themselves, accounting support under SFAS 71. However, consideration must be given to the authority of the FERC over reports to stockholders, as well as over reports to it. The FERC relies on the Appalachian case decision of 1962, which essentially said that the Federal Power Act of 1935 gave the FPC (FERC prede-

cessor) the authority to require that its accounting requirements be reflected in its reports, including annual reports to stockholders. This would mean that if the FERC accounting requirements do not meet generally accepted accounting principles, the FERC requirements must be followed in annual reports to shareholders. (This requirement resulted in Montana Power Company's for many years presenting two sets of financial statements, one in accordance with generally accepted accounting principles and one in accordance with the FERC rules.)

There has been a belief by some that certain accounting authority of regulatory agencies was transferred to the SEC (which enforces generally accepted accounting principles) by the Railroad Revitalization and Regulatory Reform Act of 1976, Public Law 94-210, February 5, 1976 (4R Act). To the knowledge of the subcommittee, this question, as it concerns the FERC, has not been litigated. However, the following data extracted from a recent FERC order would indicate that the FERC position is that it still has primary accounting authority.

The Massachusetts Department of Public Utilities (MDPU) had allowed the utility (Eastern) to restate its accumulated depreciation such that subsequent balance sheets have reflected an accumulated depreciation reserve that is $1.4 million lower than if the restatement had not been made.

In its order on accounting adjustment (issued July 5, 1984, Docket No. FA84-2-000), the FERC stated:

> We have reviewed the actions of the MDPU, and circumstances indicate that Eastern will likely recover the restated depreciation amount through rate-making at the retail level. However,

as recognized by the courts, this Commission's accounting requirements take precedence over the actions of state regulators for books of account and published financial statements of utilities subject to our jurisdiction. 5/

5/ In Appalachian Power Co. v. F.P.C., 328 F.2d 237, 246 (4th Cir. 1964), the court stated:

> We agree with the Commission's determination that it, rather than state agencies, has the power to regulate the basic accounts which a company subject to its jurisdiction must use for financial reporting purposes.

The court further cited the Supreme Court's findings in Northwestern Electric Co. v. F.P.C., 321 U.S. 119, 125 (1944), that state regulatory accounting actions are subordinate to Congress' appropriate exercise of the commerce power."

ISSUE III -- PHASE-IN PLANS

Background

Many electric utilities face the need for significant rate increases when major new generating stations are completed, especially nuclear fired generation. Such increases can increase base rates by 30, 40, or 50 percent and even more in isolated cases.

As a result of such dramatic increases, many electric utilities, regulatory commissions, and others have offered proposals to limit the amount of the rate increase allowed when new generating facilities go into service. Such proposals have been referred to as "rate moderation" or "phase-in plans."

The basic characteristic of these plans is to limit the amount of immediate rate increase that will be charged to consumers and defer for future recovery the difference between what would normally be charged and what is being charged. The methods of achieving this goal are quite varied. Some are quite simple, such as reducing the in-service rates for a period of time equal to the revenue that is generated during the construction period from having allowed construction work in progress (CWIP) in the rate base (various Connecticut decisions). Others can be much more complex such as deferring amounts equal to the difference between the costs of generating power from the new plant compared to an estimate of costs if older oil and gas units had been used. Such deferrals might be continued for three or four years and then charged to customers over

some future period, like five years. In some cases, a return on the deferred amounts may be recovered currently, in others it may also be deferred (similar to proposals in Louisiana and California).

A current proposal before the California Commission would use sinking fund depreciation and in addition defer for future recovery the inflation factor included in the rate of return normally granted on the investment in the new plant. Such a proposal, billed as economic depreciation, continues to capitalize additional costs for approximately nineteen years of a thirty-year plant life. The actual cash flow occurs in the last eleven years and the majority of that is in the last five years.

Some rate moderation proposals (as in New Mexico and South Carolina) relate to the issue of the proper level of generating capacity. In these cases a certain level of generating capacity (calculated at either average system cost or specific plant cost) is eliminated from the rate base, and carrying costs are deferred and recovered over future periods.

A number of proposed phase-in plans also include the deferral for rate purposes of part or all of an equity return on a plant going into service as a rate moderation technique. Such plans provide that the rate of return that would be allowed currently under conventional rate-making will be included in rates in future years, and accordingly, accounting orders may be forthcoming that provide for recording such amounts as deferred assets, with a credit to current income. This results in the same net income being reported as would be reported if

no phase-in plan was in effect, but revenues are less and therefore cash flow is negatively impacted.

The capitalization (and credit to current income) of an equity return on plant not allowed currently in rate base as some phase-in plans suggest, occurs during operations not construction, and thus the Specific Standard in SFAS 71 concerning AFUDC does not establish an authoritative basis for such capitalization.

Conventional generally accepted accounting principles contains no authoritative support for capitalizing an equity return (or equity cost of capital) during construction or operations. SFAS 34 specifically rejected the concept during construction because the Board did not believe it conformed to the present accounting framework. The question of capitalization during operations was not pursued.

The problem with the present accounting framework (accounting model) is that the cost of using equity funds never appears as a cost in the income statement but is reflected as net income. Thus, to credit the income statement with an amount representing the cost of using equity funds results in a credit for which there is no debit in the body of the income statement. The use of borrowed funds presents no such dilemma because interest expense is recorded on the income statement as a cost, and the credit for use of borrowed capital during construction or operations offsets a cost that is recorded in the income statement.

Paragraph 9 of SFAS 71 provides that regulators can provide reasonable assurance of the existence of an asset and an enterprise

shall, under appropriate circumstances, capitalize an incurred cost that would otherwise be charged to expense. An incurred cost is defined as "a cost arising from cash paid out or obligation to pay for an acquired asset or service, a loss from any cause that has been sustained and has been or must be paid for." The explanations in paragraphs 75 and 76 clearly indicate that paragraph 9 is referring to costs that would be charged to expense by an unregulated enterprise. While footnote 1 to SFAS 71 states that "the term allowable costs is used throughout this Statement to refer to all costs for which revenue is intended to provide recovery. . . including amounts provided for earnings on shareholders' investments," it is noteworthy that paragraph 9, which indicates that rate actions of a regulator can provide reasonable assurance of the existence of an asset, deals with incurred costs that would otherwise be charged to expense, not allowable costs.

Since an equity rate of return on the rate base is not an "incurred cost that would otherwise be charged to expense" in accounting literature for nonregulated enterprises, paragraph 9 of the General Standards of SFAS 71 provides no authoritative support for capitalization by reason of a regulator's action.

Many point out that any cost item can be selected by a regulator for deferral in the rate-making process to accomplish a phase-in plan of rate increase. Hence, in their veiw the selection of equity costs or incurred costs for deferral by regulators is not a factor which should be important to accountants. The key factor is the probability of recovery of the amount which are deferred.

The probability of future recovery of costs is the generic issue to all questions in the accounting for utilities that are regulated on a specific cost of service basis. In SFAS 5, subparagraph 3(a), probable is defined as: "The future event or events are likely to occur." (emphasis added). Footnote 6 to SFAS 71 states: "The term probable is used in this Statement with its usual general meaning, rather than in a specific technical sense, and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved." Some have concluded there is a significant difference in these definitions; they concluded that the standard in SFAS 71 is much less demanding than the definition in SFAS 5. They note a distinction between likely and probable. They conclude the definition in SFAS 71 means a 50/50 chance of occurrence. Others do not agree with such conclusions and believe the probability standard must be that the recovery is likely to occur.

Another issue raised with regard to costs deferred in connection with phase-in plans relate to paragraph 27 of SFAS 71. Some have concluded that if a regulator designates a cost for future recovery, it meets the definition of probable. Others believe that a regulatory statement in a rate order cannot, by itself, provide a basis for a conclusion of probable assurance of recovery. Such statements, by themselves, must be considered along with a variety of factors, such as the economics of the specific regulated industry, timing of recovery, the location of or future prospects of the specific enterprise, and the circumstances surrounding the event.

As discussed in paragraphs 114 and 115 of SFAS 71, the FASB decided against a cookbook approach in categorizing types of evidence

required and the reliance placed on each. It is certainly recognized that it is impossible to eliminate the need for judgment in evaluating individual facts and circumstances. However, many believe that it is now necessary for the FASB to provide some additional guidance to ensure that conclusions reached in similar circumstances are the same.

Because of the materiality of the amounts involved with phase-in plans, the FERC is in the process of amending its Uniform System of Accounts to establish separate accounts to accommodate phase-in cost deferral accounting. It is noted that the FERC has the authority to control the form of reporting to the public and hence its consideration of this subject is important.

There can be sound economic reasons for some phase-in proposals. There is some elasticity of demand in electric rates, and immediate rate increases of 30, 40, or 50 percent or more can prompt residential customers to decrease their usage and cause industrial customers to change energy sources or move to another state. As a result, adequate revenue levels would not be achieved. While these economic reasons may be valid, the accounting questions generated by these proposals are significant.

QUESTION 1: What factors should be considered in evaluating the probability of future recovery of deferred costs?

Conclusion of the Subcommittee

Future recovery of incurred costs under phase-in plans require an assessment of the probability of future recovery as discussed in

paragraph 9 of SFAS 71. The subcommittee believes the term probable, as it appears in SFAS 71, should be redefined to be consistent with SFAS 5.

The subcommittee believes that the following factors should be considered in evaluating the probability of future recovery of deferred costs.

1. Time Horizon -- The probability of cost recovery requires an assessment of the future events. In general, the longer the delay in the start of the recovery period or the longer the time period for recovery, the less the chances are for recovery. For example, chances of recovery are better when a cost is deferred and recovered over a five year period that begins immediately, than when costs are deferred for five years and recovery begins thereafter.

   It is an accepted fact of regulation that the decisions of a presently constituted regulatory body cannot be binding on the future decisions of a regulatory body. This makes judgments of recoverability that are affected significantly by a long time period very difficult.

   The subcommittee believes that situations in which no cash recovery begins until after five years significantly decreases the probability of ultimate recovery. The subcommittee suggests that the FASB consider whether it would be appropriate to establish a time frame limitation, although arbitrary, which could be used in assessing the probability

of recovery. Such a time frame restriction may also aid in the evaluation of other factors, such as future load growth, economics of the industry, and so forth.

The subcommittee believes that the issuance of "subject to" opinions with respect to public utilities will be the norm rather than the exception unless additional guidelines relating to the accounting associated with recoverability of costs are established by the FASB.

2. Economic Studies -- The deferral of incurred costs for future recovery in the rate-making process should be economically justified. For example, deferral of costs may stimulate increased short- and long-term load growth. In evaluating the probability of recovery, the subcommittee believes that there should be evidence that the regulators and utility officals developed economic projections that supported the economic basis for delaying the recovery of current costs and demonstrated that the costs deferred will be recovered from rate payers in the future. For instance, studies showing that future costs (per KWH/therm, etc.) will be increasing without including the deferred amounts may reduce the probability that total costs including those previously deferred, can be charged to rate payers in the future. In such situations, it would not seem logical to assume that future regulators would be any more prone to increasing rates further than would present regulators. In addition to assisting in a current evaluation of the proba-

bility of future recovery of the deferred costs, such studies would also provide useful guidelines for making a continuing evaluation concerning the recovery of all cost deferrals.

3. Regulatory Assurance -- In judging probability of cost recovery of deferred costs, the subcommittee believes that the regulators should recognize that the deferred amounts are costs that must be recovered in the future. Accordingly, a recovery plan for such deferred costs that does not require additional regulatory action may provide strong probability of cost recovery. On the other hand, a rate decision that does not specify the recovery plan or period for recovery of deferred costs would raise serious doubts about the probability of recovery. An even more negative factor would be a regulatory statement that the regulatory commission would review the deferred costs in the future to determine whether, how, and when such costs are to be recovered.

A listing summarizing some of the key factors that should be considered in evaluating the probability of recovery of cost deferrals is shown below:

- Significance of amounts deferred
- Length of deferral of cost period
- Length of recovery period of costs deferred
- Assurance of recovery of costs deferred (by statute, by commission order, or by stipulated assurance)
- Recovery plan outlined in statute or commission order

- Recovery period outlined in statute or commission order

- Precedent (or lack thereof) by commission for frequently changing prior commission orders

- Recovery contingent (or not contingent) on future events (such as load growth)

- Utility is operating in an increasing cost environment (that is, future costs will increase significantly absent an additional phase-in plan in the future) vs. a stable or decreasing cost environment

- Future plant additions will (or will not) require additional phase-in plans

- Recovery of decommissioning costs (current recovery vs. minimal recovery vs. no recovery)

- The performance of economic studies (or lack thereof) to demonstrate the reasonableness of the plan and cost recovery in the future

The subcommittee believes that if the FASB established guidelines, such as those presented above, it would be beneficial to the regulators, the regulated enterprises, and the accounting profession. Such guidelines should demonstrate that the substance of rate-making decisions must be taken into consideration in determining the appropriate accounting treatment to be followed.

With the recognition that there maybe situations where phase-in, or rate moderation plans may be justified, and future recovery assured, the subcommittee emphasizes that such plans interject further arbitrary and political factors into the accounting process. The subcommittee does not endorse the use of such plans to simply defer the recovery of costs when application of historical regulatory principles does not produce rate increases at levels that produce "rate shock" after taking into consideration the rate of inflation.

QUESTION 2: Can equity return on the rate base deferred under a phase-in plan be established as an asset (deferred charge), with a credit to current year's income, if it is probable that the regulator will permit recovery of that equity return in future years?

although SFAS 71 contains no specific standard for capitalizing or not capitalizing an allowance for funds used during operations

Conclusion of the Subcommittee

The subcommittee believes that a return on equity that would be earned currently, absent a phase-in plan, may be deferred as any other cost as provided in SFAS 71.

QUESTION 3: Is it appropriate to capitalize carrying charges (calculated in the same manner as AFUDC) authorized by a regulatory authority on postponed costs (including a portion of an operating plant not allowed in rate base due to excess capacity) associated with a phase-in plan?

Conclusion of the Subcommittee

Subject to the subcommittee's reservations relating to deferring any costs, as previously stated, the subcommittee believes it is acceptable to defer such carrying costs assuming, of course, there is probability of recovery.

QUESTION 4: How should deferred costs be classified in the balance sheet and the income statement, and what disclosures, if

any, should be made in the notes to the financial statements?

Conclusion of the Subcommittee

The subcommittee believes that the notes to the financial statements should disclose phase-in plans under consideration, expected to be proposed in the future, or presently in effect. Such disclosures should include all significant details relating to the phase-in plan (that is, nature and magnitude of the costs to be deferred, length of recovery and deferral periods, cash flow implications, etc.)

The FERC is undertaking currently a project to determine how phase-in plans should be disclosed in the balance sheet and income statement. Various alternatives exist with respect to such disclosures, and interested parties will have an opportunity to respond to the FERC's preliminary views.

ISSUE IV -- APPLICABILITY OF SFAS 71 IN PLANT PHASE-IN OR PARTIAL DISALLOWANCES OF COST SITUATIONS

Background

Paragraph 5 of SFAS 71 sets forth the criteria for determining whether SFAS 71 is applicable to an enterprise. The second criterion is that the regulated rates are designed to recover the specific enterprise's cost of providing the regulated services or products. Paragraph 65 of SFAS 71 discusses the cause-and-effect relationship between an enterprise's costs and its revenues (rates), which is required under paragraph 5. If the regulated rates are designed to recover the enterprise's cost, SFAS 71 would apply to the enterprise. As long as the regulated rates are based on the conventional accounting costs of the specific enterprise rather than on arbitrary rates or rates based on all companies in the industry or on some regional basis, SFAS 71 would continue to apply to the enterprise.

The disallowance of incurred costs by regulators from recovery through rates has always occurred in practice. However, the magnitude of potential disallowances is currently much greater. A disallowance does not, by itself, eliminate the cause and effect relationship addressed in SFAS 71. Cost-based rate-making concepts have never guaranteed the recovery of all costs. For example, the disallowance by a regulator of a portion of a company aircraft from inclusion in rate base and/or the exclusion of associated expenses from cost of service recovery would not necessarily eliminate the cause-and-effect

relationship of costs and revenues for the enterprise as a whole. Further, SFAS 71 does not require costs to be collected currently, provided there is reasonable assurance that the costs will be collected in the future.

The third criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs to determine if it is reasonable to assume that the established rates can be charged to and collected from customers. Paragraph 66 of SFAS 71 concludes that regardless of the actions of a regulator, if the market for the regulated services will not support a rate based on cost, then the statement would not apply to such regulated operations. In practice this evaluation is extremely difficult to do. Furthermore, no guidelines have been set forth by the FASB.

In paragraph 67, the FASB explains that it does not intend that the enterprise earn a fair return on shareholders' investment under all conditions. Accordingly, the inability to earn a fair rate of return on equity is not necessarily a determination that costs are not being recovered sufficiently for SFAS 71 to continue to apply. It is noted that most utilities do not actually earn the rate of return granted in rate cases.

The third criterion also requires reasonable assurance that the regulated environment and its economic effects will continue. Paragraph 68 discusses circumstances that must be evaluated in determining the probability of recovery. For example, if the enterprise has an exclusive franchise, there is usually a reasonable expectation

that the regulated environment and its economic effects will continue. Paragraph 69 addresses the concern that rates set at levels that will recover the enterprise's costs can be charged to and collected from customers in light of the recent changes in the regulatory environment. It states that it may not be reasonable to expect that rates established to recover cost can be charged and collected under such conditions. Obviously, elasticity of customer demand, monopoly implications, general economic conditions, changes in style and degree of regulation, and the political outlook are factors to be considered in assessing existing and future competition. The Board concluded that users of financial statements should be aware of the possibility of rapid unanticipated changes in an industry but accounting should not be based on such possibilities unless their occurance is probable. However, changes of a long-term nature could modify the demand for an enterprise's regulated services sufficiently to affect its qualifying under the criterion of subparagraph 5(c).

The current political and economic environment in many regulated industries is toward increased competition and deregulation. Furthermore, the regulatory environment that exists presently has changed from that in existence at the time the FASB undertook the writing of SFAS 71, primarily because costs have increased faster than inflation. The evolving customer expectations, the role of government, the media, and market conditions have become much more important. Resistence to rate increases comes from political pressures, consumer advocates, and industry groups. While these are not new factors to the rate regulation scene, their role has intensified

resulting in increased pressure on regulators to limit rate increases through any means possible. When rate increase limitations or other cost avoidance schemes reach the point that it is no longer possible to identify a cause-and-effect relationship of costs and revenues, then cost-based rate-making ceases to exist and defacto deregulation is present.

There are differing views as to when an enterprise does not meet the criteria of subparagraphs 5(b) and 5(c) of SFAS 71.

At one end of the spectrum is the view that under the regulatory environment that currently exists in some jurisdictions, probability of cost recovery cannot be determined because regulators refuse to grant any assurances, and franchises that effectively preclude competition in reality do not exist. Further, those who take that view state that cost recovery requires that the demand for regulated services be insensitive to price (inelastic), that is, regardless of the change in price, demand will not change significantly. Accordingly, proponents of such a view would likely conclude that the mere existence of any rate moderation plan, such as a plant phase-in, is sufficient evidence to conclude that demand is price sensitive and, therefore, implementation of such programs by regulators would preclude the applicability of SFAS 71 to the enterprise.

At the other end of the spectrum is the view that a regulated utility that meets the criteria of subparagraph 5(a) and 5(b) will always meet the third criterion over the long run, because the regulated enterprise's cost, including a fair rate of return must be reco-

vered. ~~under current law.~~ It is assumed that regulators will maintain a balance between the interests of customers and shareholders over the long run.

Another view between the two ends of the spectrum is that when it is deemed probable that over the long run rates cannot be charged and collected because of demand and the level of competition, regardless of the actions of the regulator, and that the resultant cause-and-effect relationship of costs and rates no longer exists, the enterprise is operating in an environment of defacto deregulation and SFAS 71 would no longer apply to such an enterprise.

Determining the point at which the enterprise reaches the condition of defacto deregulation is a significant and difficult determination and the FASB has not provided any substantive guidance. Rate regulation that is deemed to be undesirable does not by itself give rise to long term and relatively permanent conditions necessary to conclude that SFAS 71 would no longer be applicable to an enterprise. In evaluating demand and the level of competition under subparagraph 5(c), the availability of alternative supplies, sources, or types of energy, each at competitive prices, normally would be considered. Under this view, the short-term or one time suppression of rates by regulators due to political or other pressures is not necessarily a true factor of competition or the loss of the cause-and-effect relationship of cost and revenues for the enterprise as a whole.

<u>QUESTION 1</u>: Does a partial disallowance by a regulator of the cost of an operating plant provide persuasive evidence that SFAS 71 is no longer applicable to that utility?

Conclusion of the Subcommittee

The subcommittee believes that based upon the criteria set forth in paragraph 5 of SFAS 71, a disallowance by a regulator of costs associated with an operating plant generally would not provide conclusive evidence that SFAS 71 does not apply. If rates continue to be based on the specific enterprise's costs and a cause and effect relationship between costs and revenues continues to exist for the enterprise, SFAS 71 would continue to apply to the enterprise. Even assuming the partial disallowance of the cost of an operating plant results in a write-off as a result of an impairment evaluation, such a disallowance and write-off would not necessarily change the long-term applicability of SFAS 71 to the enterprise. Each situation would require a careful evaluation to determine the continued applicability of SFAS 71.

QUESTION 2: Does implementation of a phase-in plan provide persuasive evidence that SFAS 71 is not applicable to that utility?

Conclusion of the Subcommittee

The implementation of a phase-in plan does not in itself provide persuasive evidence that SFAS 71 is not applicable to the regulated operations of an enterprise. The facts and circumstances of the phase-in plan must be compared to the criteria set forth in paragraph 5. If any one of the three criteria is not met, then SFAS 71 would no longer be applicable.

Although the existence of a phase-in plan may not provide persuasive evidence that SFAS 71 no longer applies, the examination and evaluation of the elements of the phase-in plan could change that conclusion. An examination of the phase-in plan may indicate that it is not probable that the rates under the phase-in plan for the regulated services will ever be allowed to be charged and collected from customers because the market will not support such rates. Such market conditions could alter the enterprise's long-term regulated environment sufficiently to prevent it from meeting the criteria set forth in subparagraph 5(c). These long-term conditions would need to establish the existence of defacto deregulation of the enterprise as a whole.

Absent any offsetting factors, examples of a phase-in plan that could lead to the conclusion that reasonable assurance of cost recovery for the regulated operations as a whole does not exist are as follows:

- The plan pertains to a significant portion of the enterprise's costs.
- Recovery is contingent upon certain future events, such as load growth.
- Deferral periods are long.
- The regulator has precluded recovery of other jurisdictional costs.
- The regulator has not promised to allow specific cost recovery over a specific period.
- An evaluation of market and demand conditions during the recovery period and a determination as to whether the deferred costs could be reasonably expected to be recovered under the conditions that would exist during the recovery period has not been made.

While a phase-in plan may preclude the deferral of the costs of a particular plant under paragraph 9 of SFAS 71, other conditions applicable to the regulated operations as a whole may still meet the criteria of subparagraphs 5(b) and 5(c). Making the determination as to when the enterprise is operating in a deregulated environment in which the relationship between costs and revenues no longer exist is a difficult determination.

As long as it is probable that future cost increases, including those associated with a phase-in plan, will be recovered through future revenues, SFAS 71 will continue to apply.

QUESTION 3: If it is concluded that SFAS 71 is no longer applicable, how should a utility make the transition from a regulated enterprise to a nonregulated enterprise for financial accounting and reporting purposes?

Conclusion of the Subcommittee

APB Opinion 20, Accounting Changes, specifies how accounting changes will be reported based on what type of change occurs. That pronouncement defines three types of accounting changes: (1) change in accounting principle, (2) change in accounting estimate, and (3) change in reporting entity. The question arises as to which, if any, of the three categories fits a transition from a regulated to a nonregulated enterprise for financial accounting and reporting purposes. Based on the definitions in APB Opinion 20, such a transition would not be a change in reporting entity, although it is a change from

being a regulated entity to a nonregulated entity. Such a change would require the entity to adopt conventional generally accepted accounting principles that it would have been following absent the impact of rate-regulation.

It might also be argued that the change resulted from the recognition of events or transactions occurring for the first time and, therefore, would be classified under APB Opinion 20 as a change in accounting estimate to be accounted for on a prospective basis.

It might also be argued that it is a change in accounting principles resulting from adoption of a generally accepted accounting principle different from the one used previously. However, the adoption of SFAS 71 or the discontinuance of reporting under SFAS 71 is, in the opinion of many, much more substantive than merely a change in an accounting principle. If it is considered a change in accounting principle, it is certainly pervasive, as it establishes the basis for following the specific accounting principles used in establishing rates. Furthermore, a change in accounting principle, as defined in APB Opinion 20, relates to situations where there is a choice between acceptable principles.

Paragraph 22 of SFAS 71 addresses the question of adoption of the provisions of SFAS 71. However, SFAS 71 does not address the question of discontinuing reporting under SFAS 71 when the criteria set forth in paragraph 5 are no longer met.

When discontinuing reporting under SFAS 71, there is a need to evaluate certain accounting principles followed that would not be generally accepted accounting principles absent SFAS 71 justification.

Since neither APB Opinion 20 nor SFAS 71 deals specifically with a change from an enterprise reporting to reflect the impact of rate regulation to a conventional generally accepted accounting principles basis, the subcommittee believes the FASB should address the manner in which such a change should be reported. The subcommittee believes it is essential that neither retroactive reporting nor pro forma disclosure of the effect on prior years be considered because the previous financial statements appropriately reflect the impact of rate regulation.

The subcommittee believes that discontinuing reporting under SFAS 71 results from a change in events and circumstances (accounting estimate) in which a cumulative effect adjustment would, under APB Opinion 20, be recorded in the year of transition to reflect the elimination of the effect of regulators actions that are no longer applicable. The subcommittee further believes that the cumulative effect adjustment ~~would~~ should be reported as an extraordinary item. ~~under the broad concepts provided in APB Opinion 30, Reporting the Results of Operations.~~ However, such a presentation should not be construed as precluding the entity from converting to reporting under SFAS 71 at some future date when events and circumstances change and the entity again meets the criteria of paragraph 5 of SFAS 71.

Examples of items which were appropriately reflected or not reflected in the balance sheet at the date of the change by reason of past rate regulatory treatment which will need to be reconsidered at the date of the change as to their appropriateness under generally accepted accounting principles for nonregulated enterprises are as follows:

- The equity portion of AFUDC remaining in the undepreciated property balance to the extent that it exceeds interest that would have been capitalized under SFAS 34

- Intercompany profit not eliminated

- Any deferred income taxes not provided for in the past because the utility was all or partially on a flow through basis for rate regulation purposes

- Unamortized balances of regulation created assets deferred pursuant to paragraph 9 of SFAS 71 (such as plant abandonment losses, "excess" purchased power costs, "abnormal" maintenance)

- Unamortized gains or losses on early extinguishment of debt that is amortized in accordance with regulatory treatment

- Revenues billed but deferred on the balance sheet pursuant to subparagraph 11(b) of SFAS 71 because the rates were intended to recover costs that are expected to be incurred in the future

- Deferred charges or deferred credits to reflect automatic fuel clause recovery mechanisms

SUBCOMMITTEE BALLOT ON CONCLUSIONS AND RECOMMENDATIONS PRESENTED IN ISSUES PAPER

APPLICATION OF CONCEPTS IN FASB STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 71 TO EMERGING ISSUES IN THE PUBLIC UTILITY INDUSTRY

	Approve	Disapprove	Abstain
INTRODUCTION AND OVERVIEW			
o Discounted Present Value	10	0	1
o Equity Has A Cost	8	1	2
o Definition of Probable	11	0	0
o Criteria for Evaluating Cost Recovery	11	0	0
o Deferral of an Equity Return	11	0	0
o Criteria for Continued Capitalization of AFUDC	11	0	0
o Transition Guidelines	11	0	0
o Accounting for Nuclear Plant Decommissioning Costs	11	0	0
Issue I - Plant Abandonments			
o Question 1	10	0	1
o Question 2	11	0	0
o Question 3	10	0	1
o Question 4	11	0	0
o Question 5	11	0	0
Issue II - Disallowance of a Portion of Costs Associated with an Operating Plant			
o Question 1	10	1	0
o Question 2	9	2	0
o Question 3	10	1	0

	Approve	Disapprove	Abstain
o Question 4	10	1	0
o Question 5	10	0	1
Issue III - Phase-In Plans			
o Question 1	9	1	1
o Question 2	11	0	0
o Question 3	11	0	0
o Question 4	11	0	0
Issue IV - Applicability of SFAS 71 in Plant Phase-In or Partial Disallowance of Cost Situations			
o Question 1	11	0	0
o Question 2	11	0	0
o Question 3	10	0	1

AICPA American Institute of Certified Public Accountants

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November 7, 1984

Mr. James J. Leisenring
Director of Research and
  Technical Activities
Financial Accounting
  Standards Board
High Ridge Park
Stamford, CT 06905

Dear Jim:

Enclosed are 15 copies of an issues paper, "Application of Concepts in FASB Statement of Financial Accounting Standards No. 71 to Emerging Issues in the Public Utility Industry." It was prepared by the AICPA's Public Utilities Subcommittee (subcommittee) in response to an inquiry made by the staff of the FASB.

The Accounting Standards Executive Committee (AcSEC) discussed the paper at its meeting on November 1, 1984. Because the FASB staff would like to receive the paper as soon as possible, AcSEC did not perform an indepth review of the issues and conclusions contained in the paper and therefore, has taken no position on them. However, AcSEC does believe after discussions with members of the subcommittee and the staff of the FASB that all issues contained in the paper should be considered by the FASB when it reviews SFAS 71.

If you should require any additional information or assistance in this project, please contact me.

Sincerely,

Roger Cason
Chairman
AICPA Accounting Standards
  Executive Committee

RC:md

Enclosure

cc: AICPA Accounting Standards Executive Committee
    AICPA Public Utilities Subcommittee