Rate-regulated Activities: Accounting under U.S. GAAP

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Rate Regulation in the U.S.

- Rate-regulated utilities are granted the exclusive right to provide services essential to the public good within a designated geographic area in exchange for a duty to serve all customers within that territory; creating a supplier monopoly with captive customers

- The objective of U.S. rate regulation is to balance the economic interests of all stakeholders so that:
  - Customers are provided non-discriminatory access to electricity, natural gas, and water in the most economically efficient manner
  - Rate-regulated utilities have the right to recover prudently incurred costs and the opportunity to earn a fair return on their investments

Rate Regulation in the U.S. (cont.)

- There are significant differences in regulatory regimes for monopoly service providers around the world and these different rate-making approaches may appropriately give rise to different accounting conclusions
- In the U.S., a "cost of service" model is most common
  - Rates are set at levels that provide recovery of all prudent operating expenditures in addition to a return on investment
  - The operating expenditures used in the calculation of rates are based on the company's historic or projected expenditures
  - Balancing accounts often are provided for expenses that are volatile and cannot be reliably estimated (e.g., fuel) to ensure there is no over- or under-recovery in current rates
  - For those expenditures that can be reliably estimated, adjustments in rates generally are permitted only when there is a significant variance, such as in the case of a major storm. These adjustments commonly occur only as a result of future rate-making actions.

Rate Regulation in the U.S. (cont.)

- Regulatory rate-making decisions today bind future customers, as a class – making the customer class (however it is constituted) the counterparty to the entity in the regulatory compact
- Utility rates are set prospectively (often for up to 3-5 years) and, once established, cannot be changed retroactively
  - The effect of this prohibition is that once a commission provides for the recovery of a previously incurred cost in future rates, laws support the legality of that recovery and generally prohibit future commissions from reversing the previous conclusion
- If revenues and costs fall out of alignment (i.e., cost significantly exceed revenues or vice versa), either the rate-regulated entity, the rate regulator, or others may seek to reset rates through a new rate-making action

Conceptual Frameworks

U.S. GAAP	Current IFRS	Proposed IFRS
	Asset	
Probable future economic benefits obtained or **controlled** by a particular entity as a result of **past events**	A **resource controlled** by the entity as a result of **past events** from which **future economic benefits** are **expected** to flow to the entity	A **present economic resource controlled** by the entity as a result of **past events**
Involves a **capacity**, singly or in combination with other assets, **to contribute** directly or indirectly **to future net cash inflows**		Economic resource: A right or other source of value that is **capable of producing economic benefits**
	Liability	
Probable future sacrifices of economic benefits arising from **present obligations** of a particular entity to transfer assets or provide services to other entities in the future as a **result of past transactions or events**	A **present obligation** of the entity arising from **past** events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits	A **present obligation** of the entity to transfer an **economic resource** as a result of past events

Evaluation of Regulatory Assets & Liabilities under U.S. Framework

- The "Regulatory Compact" is the basis under which rate regulation creates legally enforceable rights and obligations with corresponding economic consequences for rate-regulated utilities
  - Utilities are granted a franchise (or monopoly), with an obligation to serve all customers in the franchise territory
  - In exchange, utilities are granted a legally-enforceable right to charge customers for prudently incurred costs
  - Likewise, regulators can impose legally enforceable obligations, or regulatory liabilities
  - The cause-and-effect relationship of revenues and costs is the principal economic effect of regulation
- The Regulatory Compact has been developed and legally enforced over many decades via U.S. Federal and State statutes, Supreme Court rulings and other case law

Evaluation of Regulatory Assets under U.S. Framework

- Under "cost of service" rate regulation, the regulator's actions can create probable future economic benefits (economic resources) that are under the control (establishing a right) of a rate-regulated entity as the result of past events
  - If it is probable specific incurred costs will be recovered in the future rates, such rights would qualify for recognition as a (regulatory) asset

- For example, if a regulator approves the recovery of costs to repair damage caused by a major storm, the rate action creates a new regulatory asset as a result of this rate making decision
  - The entity has probable future economic benefits – the additional revenue that will result from including the repair costs in allowable costs in future rate-making decisions
  - The future benefits are controlled by the entity – as a result of the regulatory decision
  - The future benefits are a result of a past event – that is, the incurred costs to repair the damage

Evaluation of Regulatory Assets under U.S. Framework (cont.)

- Other common rate-making actions of a regulator that also create regulatory assets (that is, present rights to future economic benefits) of the regulated entity, include:
  - Fuel service adjustments that allow the recovery of changes in purchased fuel prices in current rates
  - Adjustments that allow the recovery of losses, such as from derivative contracts or debt extinguishments
- In contrast, certain phase-in plans related to newly constructed plants that defer the decision about increases in rates into the future do not create regulatory assets
  - The existence of these plans questions whether future rates will, in fact, be set at levels that will recover costs
  - They also question the premise that rates are set based on cost of service

Evaluation of Regulatory Liabilities under U.S. Framework

- Under “cost of service” rate regulation, the regulator’s actions can create a probable future economic sacrifice of economic benefits that represents an obligation of a rate-regulated entity that is the result of past events
  - If a future reduction in rates creates a probable reduction in future revenues as a result of a past event, such an obligation would qualify for recognition as a (regulatory) liability

Evaluation of Regulatory Liabilities under U.S. Framework (cont.)

- For example, if a regulator requires a reduction in future rates when a rate-regulated entity sells property for a “gain”, the rate action creates a new regulatory liability as a result of this rate making decision
  - The entity has probable future economic sacrifice – the reduction in revenue that will result from the rate-making decision
  - The future sacrifice is an obligation of the entity – as a result of the regulatory decision
  - The future sacrifice is a result of a past event – that is, the sale of property at a gain
  - The “gain” initially is recognized as a liability and recognized in income when the entity sells products in the future at reduced rates
  - These liabilities could be described as performance obligations, that will result in the recognition of additional revenue in the future when the products are sold to the customer at reduced rates

Evaluation of Regulatory Liabilities under U.S. Framework (cont.)

- Other rate-making actions of a regulator also can create liabilities (that is, present obligations to the entity's customer base) by:
  - Requiring refunds to the customer class in the future (evaluated under Topic 450 on Contingencies in U.S. GAAP)
  - Providing current rates to recover costs that are expected to be incurred in the future (perhaps creating a performance obligation)
  - Requiring other reductions in net allowable costs to be returned to the customer class through lower rates in the future

Overview of U.S. GAAP

- Topic 980 (formerly Statement 71) recognizes that in certain circumstances, the actions of a rate regulator can create economic rights or obligations of the entity that should be recognized in the financial statements as assets and liabilities

- Key scope criteria (which are similar to but not as robust as those in the IASB DP):
  - Rates that bind customers are established by independent, third party regulator or governing board
  - Rates are designed to recover the entity's cost of providing the regulated services or products
  - It is reasonable to assume that rates are set at levels that can be charged to and collected from customers (considering demand and competition during the recovery period)

Overview of U.S. GAAP (cont.)

- Topic 980 addresses "cost of service" rate regulation
  - The rate regulator establishes a price designed to recover an entity's allowable costs (including cost of capital), such that there is a cause-and-effect relationship between an entity's specific costs and its revenues
- Under "cost of service" rate regulation, the regulator's actions can create economic resources for or claims against a rate-regulated entity's future cash flows as the result of past events
  - If it is probable specific incurred costs will be recovered in the future rates (e.g., purchased gas tracker), such costs must be capitalized as a regulatory asset; generally profit is not capitalized in the measurement of a regulatory asset
  - If a future reduction in rates is probable as result of a past event (e.g., gain on plant sale), such obligation must be recognized as a regulatory liability
  - Revenues, expenses, gains and losses not affecting future rates are accounted for consistent with other GAAP

Pitfalls/Challenges in U.S. GAAP

- New entities not thoroughly evaluated to determine whether in scope of Topic 980
  - Inappropriate evaluations of the cause-and-effect relationship between costs and revenues
  - Index-based rates rather than entity cost-based rates (e.g., fuel costs)
- Untimely assessment of falling outside the scope of Topic 980
  - Long-term rate freeze (rates may no longer be based on costs)
  - Aggressive incentive rate-making or other alternative forms of rate-making
  - Competition
- Classifying a (non-Topic 980) GAAP asset or liability within regulatory assets or liabilities
- Capitalizing amounts a company intends to seek recovery of rather than amounts that are probable of recovery
- Capitalizing equity return as a regulatory asset (unless a specific exception is met)
- Alternative revenue (incentive) programs