



N A R U C  
National Association of Regulatory Utility Commissioners

November 20, 2009

**The Honorable Sir David Tweedie, Chairman IASB**  
**The Honorable Thomas E Jones, Vice-Chairman IASB**  
**The Honorable Mary E Barth, Member IASB**  
**The Honorable Stephen Cooper, Member IASB**  
**The Honorable Philippe Danjou, Member IASB**  
**The Honorable Jan Engström, Member IASB**  
**The Honorable Robert P Garnett, Member IASB**  
**The Honorable Gilbert Gélard, Member IASB**  
**The Honorable Prabhakar Kalavacherla, Member IASB**  
**The Honorable James J Leisenring, Member IASB**  
**The Honorable Warren J McGregor, Member IASB**  
**The Honorable John T Smith, Member IASB**  
**The Honorable Tatsumi Yamada, Member IASB**  
**The Honorable Wei-Guo Zhang, Member IASB**

**International Accounting Standards Board**  
**30 Cannon Street**  
**London EC4M 6XH**  
**United Kingdom**

***Re: National Association of Regulatory Utility Commissioners Comments on  
the July 2009 IASB Exposure Draft ED/2009/8 Rate-regulated Activities***

Dear Board Members:

The National Association of Regulatory Utility Commissioners (NARUC), based in the United States of America, respectfully offers these comments in response to the International Accounting Standards Board (IASB) request for comments on its exposure draft –ED/2009/8 Rate-regulated Activities. These comments respond to specific questions in the ED, outline NARUC’s support for certain aspects of the proposal, and point out concerns about the possible impact of the draft on public utility<sup>1</sup> regulation in the United States.

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<sup>1</sup> For purposes of these comment, the utility industry includes the energy (electric and gas), water, wastewater, telecommunications industry and similar entities.

NARUC is consistently recognized by the U.S. Congress and Courts as an appropriate representative for those government officials in the fifty States, the District of Columbia, Puerto Rico, and the Virgin Islands, charged with the duty of regulating energy, telecommunications, water, and wastewater utilities and common carriers.<sup>2</sup>

NARUC's members are necessarily interested in the outcome of this proceeding. Indeed, just last week at the Association's 121<sup>st</sup> Annual Convention, members unanimously approved the attached resolution directing staff to file comments generated by our expert Staff Subcommittee on Accounting and Finance. A copy of that resolution is appended to these comments as Appendix A.

Any transition from the current reporting standards to international standards will impose significant costs on both utilities and regulatory agencies. These additional costs will ultimately be paid by U.S. utility consumers.

The changes may impact on the financial viability of regulated U.S. utilities because of potential earnings volatility and the elimination of comparable data for regulatory purposes. Such volatility could also create additional investor concerns and limit utility infrastructure financing options. Investments are desperately needed for additional critical infrastructure. In the United States, State and federal authorities have targeted new electric metering, generation and transmission facilities to promote green and more efficient energy operations, additional investments in broadband facilities and programs, and new funding to replace aging water and natural gas infrastructure.

Publicly issued financial statements are an essential element in setting retail public utility rates. The regulation of utilities in the United States has evolved over the last one hundred years.

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<sup>2</sup> Founded in 1889, NARUC's members include agencies in the fifty States, the District of Columbia, Puerto Rico, and the Virgin Islands charged with regulating the rates and conditions of service of utility intrastate operations. NARUC members ensure that utility services are provided at rates and conditions that are just, and reasonable. Both Congress and federal courts have consistently recognized NARUC as a proper entity to represent the collective interests of State commissions. See, e.g., 47 U.S.C. § 410(c) (1971) (*U.S. Congress designates NARUC to nominate members to Federal-State Joint Boards to consider issues of concern to State regulators and the Federal Communications Commission on universal service, separations, and other issues*); See also 47 U.S.C. § 254 (1996) (*describing functions of the Universal Service Joint Board*). See also *NARUC, et al. v. ICC*, 41 F.3d 721 (D.C. Cir 1994) (*where the Court explains "Carriers, to get the cards, applied to [NARUC], an interstate umbrella organization that, as envisioned by Congress, played a role in drafting the regulations the ICC issued to create the "bingo card" system*). See *United States v. Southern Motor Carrier Rate Conference, Inc.*, 467 F. Supp. 471 (N.D. Ga. 1979), aff'd 672 F.2d 469 (5th Cir. 1982), aff'd en banc on reh'g, 702 F.2d 532 (5th Cir. 1983), rev'd on other grounds, 471 U.S. 48 (1985).

Each State, as well as the District of Columbia and U.S. territories, currently has at least one statutorily designated entity to oversee the operations of public utilities within its jurisdiction. Utility prices are often established based on cost-plus ratemaking. This methodology allows a utility to earn up to an authorized return on investment and/or return on equity, while also recovering its operating expenses, operating taxes, and investment cost. Other methods of establishing utility rates include price caps, price indices, or cost-plus pricing. These methods are all typically subject to adjustment based on certain performance measures. Ratemaking standards and utility customer protection remain the core of rate setting for rate-regulated utilities in the United States regardless of the method utilized by the regulatory body. It is common practice for regulators to monitor investments, expenses, and earnings through utility financial statements. Moreover, the foundation or starting point for many of these methodologies is the utility's audited financial statements.

The first look at a public utility's investment, revenues, expenses, and current earnings is in the issued financial statements or the books of account used to develop those statements. Under traditional public utility economic regulation, the determination of prices generally begins with *audited* financial statements. The widespread use of Statement of Financial Accounting Standard 71 (SFAS 71) *Accounting for the Effect of Certain Types of Regulation*<sup>3</sup> means the publicly issued financial statements used by investors generally reflect the operations and costs as viewed by regulators.

Regulatory analysts typically do not try to recreate the audited financial statements or independently verify their accuracy. They are generally accepted as a reasonable and accurate starting point. From there, adjustments are made to reflect the specifics of that sector's regulatory process. Regulatory audits tend to verify whether a cost or investment should be the responsibility of the ratepayer or shareholder. For example, charitable expenses are generally deemed to be the cost responsibility of shareholders and not ratepayers, and thus are excluded when determining the level of costs that should be included in rates charged retail customers. These adjustments tend to be a relatively small percentage of the underlying capital investment amounts that are generally incorporated into the ratemaking process without change. Moreover, the audited financial statements, currently based on GAAP (including SFAS 71) are vital information for utility regulators.

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<sup>3</sup> Financial Accounting Standards Board, Accounting Standards Codification, Topic 980 Regulated Activities is the general reference for SFAS 71. For these comments, SFAS 71 will be used because a search of historical Order references from regulatory bodies will find it as SFAS 71.

Regulators also use financial statements to monitor certain new investments or specific expenses. Regulators continue to approve additional tracking or pass-through rate mechanisms that allow for the recovery of one particular expense or investment. Some public utilities are authorized to change its rates periodically based on the change in these cost components. SFAS 71 is a critical component of these mechanisms.

Today, the way financial transactions are recognized in rates is well synchronized with the way they are reported on publicly issued financial statements. However, because of some substantial differences between the accounting for certain items under IFRS and GAAP, *the current level of synchronization between the accounting and regulation is likely to be lost.*

Nonetheless, NARUC *supports* the Board's stated *objectives* for the proposed IFRS to (a) establish criteria for the recognition of assets and liabilities arising from rate regulation, (b) clarify that regulated entities follow the requirements of all other IFRSs in addition to the proposed IFRS, and (c) require disclosures to enable users to understand the nature and financial effects of rate regulation on an entity's activities.

Recognition of rate-regulated activities is a critical concept that must be included in IFRS. If a rate-regulated activities provision is not adopted, it will necessarily constitute a significant detriment to rate-regulated utilities in the United States and Canada as well as any utility's customers. Without such a provision, regulatory bodies could be required to establish programs differently to establish fair, just and reasonable rates. *Therefore, while NARUC supports the proposed IFRS for the most part, we must question some of the specific criteria.* Some of our concerns are addressed *infra* in the response to the Draft's questions.

A regulatory body ultimately establishes a utility's rates (prices) and therefore controls the ability of the utility to increase or reduce rates. This ability is controlling for all benefits, costs and investments currently or in the future. When a regulatory body determines costs or benefits in a current year will be reflected over time in future rates, it impacts that utility's ability to recover costs and earn a reasonable return.

This cause and effect supports continued and new recognition of regulatory assets and regulatory liabilities on the accounting books for utility rate-regulated entities. Without a rate-regulated provision, utility earnings under IFRS will be more volatile, customer confidence could be substantially reduced and the ability to finance severely hindered when investments in infrastructure are greatly needed.

## **DISCUSSION OF QUESTION 1:**

At paragraphs 3–7 of the draft IFRS and paragraphs BC13–BC39 of the Basis for Conclusions, the exposure draft proposes two criteria that must be met for rate-regulated activities to fall within the scope of the proposed IFRS. The draft IFRS specifically addresses rate-regulated activities that meet the following criteria:

- (a) An authorized body is empowered to establish rates that bind customers.
- (b) The price established by regulation (the rate) is designed to recover the specific costs the entity incurs in providing the regulated goods or services and to earn a specified return (cost-of-service regulation).

NARUC fully supports the first criteria.

NARUC also supports the second criteria as written but believes the intent behind the examples may be too restrictive for regulatory bodies utilizing regulatory assets and regulatory liabilities to implement an alternative regulation plan.

A decision by a regulatory body using regulatory assets or regulatory liabilities to support its decisions imposed on a utility should be reflected in the financial statements. Utility regulation in the United States is not likely to change substantially. The ongoing ability of the authorized regulatory body to determine the appropriate costs, including a reasonable return, and application of ratemaking methodology is critical to establish recovery of costs and set rates (prices) charged customers. The ultimate goal is to allow a regulated entity the opportunity to recover its reasonable costs of providing service, including a fair return.

Financial statements are intended to reflect the underlying transaction. Utility regulators in the United States require by order specific rate treatment (creation of regulatory assets and regulatory liabilities) to recover costs of specific approved actions or transactions. The decisions and orders of the regulatory body are a binding determination of rates (prices) and changes to rates. The regulatory body is the entity that controls the resource resulting from past events and the future economic benefit (change in prices) that will have an economic impact on the utility. This creates the cause-and-effect relationship required under the proposed IFRS.

Without the recording of regulatory assets and regulatory liabilities for utilities in the United States, financial statements will not reflect operations, recovery of costs and prices as established by the regulatory bodies. IFRS accounting provisions (similar to the proposed IFRS) should allow these requirements imposed by regulatory bodies for rate-regulated activities to be recorded as regulatory assets and regulatory liabilities when they would not otherwise be recorded as an asset or liability under IFRS.

#### **DISCUSSION OF QUESTION 2:**

The exposure draft proposes no additional recognition criteria. Once an activity is within the scope of the proposed IFRS, regulatory assets and regulatory liabilities should be recognized in the entity's financial statements (see paragraphs BC40–BC42 of the Basis for Conclusions).

NARUC agrees that no additional recognition criteria are appropriate.

#### **DISCUSSION OF QUESTION 3:**

The exposure draft proposes that an entity should measure regulatory assets and regulatory liabilities on initial recognition and subsequently at their expected present value, which is the estimated probability-weighted average of the present value of the expected cash flows (see paragraphs 12–16 of the draft IFRS and paragraphs BC44–BC46 of the Basis for Conclusions).

NARUC supports measurement of regulatory assets and regulatory liabilities on initial recognition. *However we do not support the use of expected or estimated probability-weighted present value as the measurement.* The value established by regulatory bodies by order in the United States is usually a nominal value based on actual amounts or best estimates. Present value approaches may result in amounts that do not reflect the transaction and may create lack of consistency. Therefore, NARUC supports a best estimate approach.

#### **DISCUSSION OF QUESTION 4:**

The exposure draft proposes that an entity should include in the cost of self-constructed property, plant and equipment or internally generated intangible assets used in regulated activities all the amounts included by the regulator even if those amounts would not be included in the assets' cost in accordance with other IFRSs (see paragraph 16 of the draft IFRS and paragraphs BC49–BC52 of the Basis for

Conclusions). The Board concludes that this exception to the requirements of the proposed IFRS is justified on cost-benefit grounds.

NARUC agrees. Including the regulatory portion of the self-constructed property, plant and equipment or internally generated intangible assets with the underlying asset reflects the entire value of the asset recognized by the regulatory body for recovery of costs in rates (prices). The entire value and the approved depreciation/amortization are part of the rates set by the regulatory body so all costs recovered by that revenue stream should be recorded as part of the underlying asset. Separation or combination with other regulatory assets could cause disconnect and confusion for customers and investors. It could also result in less consistency among utilities.

#### **DISCUSSION OF QUESTION 5:**

The exposure draft proposes that at each reporting date an entity should consider the effect on its rates of its net regulatory assets and regulatory liabilities arising from the actions of each different regulator. If the entity concludes that it is not reasonable to assume that it will be able to collect sufficient revenues from its customers to recover its costs, it tests the cash-generating unit in which the regulatory assets and regulatory liabilities are included for impairment in accordance with IAS 36 *Impairment of Assets*. Any impairment determined in accordance with IAS 36 is recognized and allocated to the assets of the cash-generating unit in accordance with that standard (see paragraphs 17–20 of the draft IFRS and paragraphs BC53 and BC54 of the Basis for Conclusions).

NARUC agrees that an assessment of changes in recovery of regulatory assets or return of regulatory liabilities is appropriate. Regulatory assets or regulatory liabilities that are impaired should not remain on the books or in the financial statements.

#### **DISCUSSION OF QUESTION 6:**

The exposure draft proposes disclosure requirements to enable users of financial statements to understand the nature and the financial effects of rate regulation on the entity's activities and to identify and explain the amounts of regulatory assets and regulatory liabilities recognized in the financial statements (see paragraphs 24–30 of the draft IFRS and paragraphs BC59 and BC60 of the Basis for Conclusions).

The draft seeks comment on whether the proposed disclosure requirements provide decision-useful information and asks commenters to identify requirements that should be removed or added to the draft.

NARUC supports disclosure requirements. Disclosure should enable users to understand the nature and financial effects of rate regulation. Changes during the reporting period reflect reasonable disclosure requirements. The ongoing calculation of numerical differences for property, plant and equipment and interest costs are not useful. Once the regulatory asset or regulatory liability has been reviewed and included in rates by the regulatory body, the rationale and approval typically will not change. This makes disclosure of changes in the reporting period useful. However, disclosure of accumulated ongoing numerical differences is not useful to regulatory bodies, customers or investors and may detract from the importance of the changes.

#### **DISCUSSION OF QUESTION 7:**

The exposure draft proposes that an entity should apply its requirements to regulatory assets and regulatory liabilities existing at the beginning of the earliest comparative period presented in the period in which it is adopted (see paragraph 32 of the draft IFRS and paragraphs BC62 and BC63 of the Basis for Conclusions). Any adjustments arising from the application of the draft IFRS are recognized in the opening balance of retained earnings.

NARUC supports this approach. NARUC believes the number of comparative periods should be consistent with provisions for First-time Adopters.

#### **DISCUSSION OF QUESTION 7 - OTHER COMMENTS:**

The draft IFRS recognizes the importance and controlling economic impact that regulatory bodies have on the utilities regulated. It recognizes the cause-and-effect relationship between an entity's costs and its revenue stream established by the regulatory body. The draft allows accounting provisions used for financial statements to reflect the operations, recovery of costs and rates (prices) established by the regulatory bodies. This consistency will reduce the expected cost and impact on utility customers and regulatory bodies associated with IFRS adoption. It also provides investors with necessary information to understand and use the reported information for rate-regulated activities.

NARUC appreciates the opportunity to comment on the Rate-regulated Activities Exposure Draft. If you have any questions about these comments, please do not hesitate to contact the undersigned via phone at 202.898.2207 or via e-mail at [jramsay@naruc.org](mailto:jramsay@naruc.org).

Respectfully Submitted,

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## APPENDIX A

### *Resolution on the International Accounting Standards Board Exposure Draft ED/2009/8 Regarding Rate-Regulated Activities*

**WHEREAS**, Rate regulation is widespread and significantly affects the economic environment of rate-regulated entities; *and*

**WHEREAS**, A specific standard on accounting for the effects of rate regulation exists in U.S. Generally Accepted Accounting Principles (GAAP), but it has no counterpart in International Financial Reporting Standards (IFRS); *and*

**WHEREAS**, Billions of dollars of ‘regulatory’ assets and liabilities are currently recognized in jurisdictions that refer to U.S. GAAP making clarification of the treatment of assets and liabilities arising from rate regulation in IFRSs critical; *and*

**WHEREAS**, The wide-spread use of Statement of Financial Accounting Standard 71 (SFAS 71) *Accounting for the Effect of Certain Types of Regulation*, means the financial statements used by investors generally reflect the operations and costs as viewed by regulators; *and*

**WHEREAS**, The audited financial statements, currently based on GAAP (including SFAS 71) are vital information for utility regulators; *and*

**WHEREAS**, Without a rate-regulated provision, utility earnings under IFRS will be more volatile, customer confidence could be substantially reduced and the ability to finance severely hindered when investments in infrastructure are greatly needed; *and*

**WHEREAS**, In December 2008, the International Accounting Standards Board (IASB) added a project to develop a standard on rate regulated activities that clarifies whether regulated entities could or should recognize an asset or a liability as a result of rate regulation, which culminated in the release of an exposure draft on July 23, 2009, regarding rate-regulated activities, available at, <http://www.iasb.org/Current%20Projects/IASB%20Projects/Rate%20regulated%20activities/Summary.htm>, seeking comments by November 20, 2009; *and*

**WHEREAS**, The draft IFRS (a) specifically addresses rate-regulated activities where an authorized body is empowered to establish rates that bind customers, and the price established by regulation (the rate) is designed to recover the specific costs the entity incurs in providing the regulated goods or services and to earn a specified return (cost-of-service regulation); *and*

**WHEREAS**, Many international entities are opposed to the draft IFRS allowing regulatory bodies to continue utilizing regulatory assets and liabilities as a tool to achieve regulatory objectives; *and*

**WHEREAS**, Incorporation of the principles of SFAS 71 is a critical component of these mechanisms, *now, therefore be it*

**RESOLVED**, That the National Association of Regulatory Utility Commissioners, convened at its 2009 Annual Convention in Chicago, Illinois, commends the IASB for seeking comments and gathering input on rate-regulated activities; *and be it further*

**RESOLVED**, That NARUC encourages its members to also file comments on the exposure draft; *and be it further*

**RESOLVED**, That NARUC file comments on the Exposure Draft ED/2009/8 regarding Rate-regulated Activities specifically to encourage adoption of rate-regulated activities allowing regulatory assets and liabilities, *and be it further*

**RESOLVED**, That NARUC generally supports the stated objectives to (a) establish criteria for the recognition of assets and liabilities arising from rate regulation; (b) clarify that regulated entities follow the requirements of all other IFRSs; and (c) require disclosures to enable users to understand the nature and financial effects of rate regulation, *and be it further*

**RESOLVED**, That NARUC supports the exposure draft's proposals that:

- Two criteria must be met for rate-regulated activities to be within the scope of the IFRS, though the examples cited to support the second criteria may be too restrictive for regulatory bodies utilizing regulatory assets and liabilities to implement an alternative regulation plan; *and*
- An entity should include in the cost of self-constructed property, plant and equipment or internally generated intangible assets used in regulated activities all the amounts included by the regulator even if those amounts would not be included in the assets' cost in accordance with other IFRSs; *and*
- Changes in reporting periods should be disclosed, though the ongoing calculation of numerical differences for property, plant and equipment and interest costs are not useful; *and*
- An entity should apply its requirements to regulatory assets and liabilities existing at the beginning of the earliest comparative period presented in the period in which it is adopted as long as (a) any adjustments arising from the application of the draft IFRS are recognized in the opening balance of retained earnings, and (b) the number of comparative periods should be consistent with provisions for first-time adopters; *and*
- An assessment of changes in recovery of regulatory assets or return of regulatory liabilities is appropriate, and impaired regulatory assets or liabilities should not remain on the books; *and*
- Regulatory assets and liabilities should be measured on initial recognition, though NARUC does not support the use of expected or estimated probability-weighted present value to measure as nominal value based on actual amounts or best estimates provides a more useful and consistent measurement; *and*
- No additional recognition criteria are appropriate once an activity is within the scope of the proposed regulatory assets and regulatory liabilities and recognized in financial statements.

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*Sponsored by the Committees on International Relations and Water  
Recommended by the NARUC Board of Directors November 17, 2009  
Adopted by the Committee of the Whole, November 18, 2009*