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Regulatory Authority Competences in Monitoring the Bookkeeping of the Regulated Companies

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Overview of Regulatory Accounting

Regulatory Accounting for Utilities:

A system of accounting for a utility's financial results that is prescribed by the company's regulators

In the U.S., regulatory accounting is usually implemented through mandated use of a “uniform system of accounts,” or USOA

Regulatory accounting systems may be different in some respects from the financial reporting systems used by non-regulated businesses

Overview of Regulatory Accounting/USOAs

- The Federal Power Act of 1935 authorized the Federal Power Commission (FPC) to establish USOAs for the Companies it regulated and prescribe how the accounts were to be used
- The FPC worked with the National Association of Regulatory Utility Commissions (NARUC) to create new USOAs for electric and gas utilities – these were completed by the late 1930s
- NARUC also created USOAs for water and sewer utilities in this timeframe

Overview of Regulatory Accounting/USOAs

- The FPC was given authority over the wholesale transactions of electric and gas utilities
- The Federal Power Commission has since been renamed the Federal Energy Regulatory Commission (FERC)
- Almost all U.S. electric and gas utilities fall under the regulatory jurisdiction of FERC, as well as under the public utility commissions of the states in which they operate

Overview of Regulatory Accounting/USOAs

- Today, almost every state public utility commission has adopted the FERC USOA for use by their regulated electric and gas utilities
- Though there may be minor differences in the USOAs adopted in each state due to individual state requirements, the mass adoption of the FERC USOAs by the states for accounting purposes means there is general uniformity and consistency in the accounting practices of electric and gas utilities across the U.S. no matter what state(s) they serve

Overview of Regulatory Accounting/USOAs

- Purpose of USOAs:

Provides for **uniformity** in how the financial results of different utilities are presented, and thus allows for a meaningful comparison of earnings data between utilities

Provides for **consistency** in how utilities report their financial results from period to period, and thus allows for a meaningful comparison of earnings data for the same utility for a period of time

Overview of Regulatory Accounting/USOAs

- Uniformity and Consistency are particularly important in:
 - Classifying costs as either capital expenditures or operating expenditures
 - Classifying costs as either regulated expenditures or non-regulated expenditures. (In the U.S., utilities may be allowed to offer non-regulated/competitive service offerings as well as utility services.)

Overview of Regulatory Accounting/USOAs

- Uniformity and Consistency in reported financial results are important to:
 - Regulators
 - Utility management
 - Shareholders
 - Creditors

Overview of Regulatory Accounting/USOAs

- For U.S. regulators, including the Missouri PSC, the primary importance of USOAs is that the historical accounting information they contain are the foundation and starting point for the process of setting rates for regulated utilities
- When the utility seeks a rate request from a commission, such as the Missouri PSC, auditing the accounts and actions of the utilities is made easier because the accounts are uniform

Overview of Regulatory Accounting/USOAs

- In the U.S., non-regulated businesses are required to follow “generally accepted accounting principles” (GAAP) in preparing their published financial statements.
- All investor owned businesses are required by the Securities and Exchange Commission to undergo an annual financial audit by independent external accounting firms to verify that the firms’ financial results are compliant with GAAP.
- This requirement also applies to regulated utilities.

Overview - USOA v. GAAP

- Some differences exist between requirements of the electric and gas USOAs and GAAP for non-regulated businesses
- Most relate to the format of the published financial statements of utilities compared to non-regulated businesses

Overview - USOA v. GAAP

- As one example, Plant in Service is the first asset listed in the USOAs for utilities, because utilities are very capital-intensive businesses.
- Plant in Service means or represents the land, buildings, facilities used in or necessary to provision of utility service
- Non-regulated businesses typically list Cash as the first asset on their charts of accounts

Overview - GAAP

- Almost all of the accounting practices and procedures contained within the FERC USOAs for electric and gas utilities are consistent with GAAP standard.
- Both GAAP and the USOAs are based upon “accrual” accounting practices”.
- **Accrual accounting** recognizes the financial impact of business transactions based upon when the economic substance of a firm’s transactions occurs, not necessarily when an exchange in cash takes place.

Overview– Accrual Accounting Examples

- Examples of Application of Accrual Accounting:
 - Under accrual accounting, revenues are recognized when a service has been provided to the customer, and an amount is owed by the customer to the utility; not when the utility receives cash from the customer
 - Under accrual accounting, expenses are recognized when a service has been provided by a vendor or employee of the utility, and an amount is owed by the utility to the vendor or employee; not when the utility pays the vendor or employee for services provided

How the USOA is Used in Missouri

- The Missouri PSC has adopted the FERC USOAs for electric and gas utilities, and the NARUC USOAs for water and sewer utilities, by Rule.
- Adoption via a Commission Rule requires the applicable utilities to adhere to the requirements of the USOAs in accounting for the periodic financial results of their utility operations

How the USOA is Used in Missouri

- Utilities can apply for exceptions or waivers from the provisions of the USOAs.
 - Waivers are granted by the Commission in extraordinary circumstances and the cases are very fact specific
- Periodic Updates
 - Occasionally, FERC will update the USOAs to incorporate new costs and accounts
 - These updates are not automatically incorporated into the official USOA mandated by rule in Missouri
 - Pending Missouri Commission adoption of the update, utilities generally follow the updated rule as promulgated by FERC

Overview of Regulatory Accounting/USOAs

- The FERC USOAs include instructions and guidelines for its use, as discussed in more detail below.
- Those instructions and guidelines have created a uniform way for utilities to account for their finances and for staff members to review the utilities actions and ensure they are accurate.

Use of the USOA in Missouri

- The FERC USOAs include instructions and guidelines for its use
 - Includes definitions of common regulatory accounting terms
 - As an example, “Original Cost” is defined as “the cost of electric/gas plant to the person first devoting it to public service”
 - Includes instructions on appropriate procedures for capitalization of plant in service costs
 - Includes instructions on proper recording of operating expenses
 - Includes guidelines on accounting record retention

USOA Accounts

- Account Groupings
 - 100 Accounts – Assets
 - 200 Accounts – Liabilities and Owners Equity
 - 300 Accounts – Plant in Service
 - 400 Accounts – Utility Operating Income
 - 500 to 800 Accounts – Production, Transmission, Distribution Expenses
 - 900 Accounts – Customer Accounts, Customer Service, Sales and Administrative & General Accounts

USOA Accounts

- The USOA prescribes the minimum detail required for a utility's accounting system
- A utility can create “subaccounts” with the USOA to separate certain costs at a greater level of detail than required by the USOA
- The Missouri PSC also has the authority to direct the utilities to create subaccounts within the FERC USOA account structure in some situations

USOA Accounts/Assets

- **Assets** are expenditures made by the utility that will result in future long-run benefits to the business. For utilities, assets include:
 - Plant in Service
 - Materials & Supplies
 - Prepayments
 - Fuel Inventories
 - Regulatory Assets

USOA Accounts/Assets – Plant in Service

- Account 101 - Major Components include:
 - Utility Labor (Salaries and Benefits)
 - Plant Materials (Concrete, etc.)
 - Outside Contractor Costs (Construction Companies, Consulting Firms)
 - Engineering Services
 - Insurance Costs
 - Legal Costs
 - Allocated Administrative & General Expenses
 - Capitalized Return (Allowance for Funds Used During Construction, or AFUDC)

USOA Accounts/Assets

- Capitalized Administrative and General Costs
 - Include items such as executive salaries and other overhead costs
 - Assignment of these executive costs to construction projects is based upon an assumption that part of executive responsibilities include monitoring and oversight of construction projects
 - This assignment is not to be based on arbitrary assignments, but rather on periodic examinations of actual executive time spent on oversight of construction projects

USOA Accounts/Assets

- Allowance for Funds Used During Construction (AFUDC)
 - For large construction projects that may take years to complete, AFUDC balances included in plant may total to hundreds of millions of dollars
 - In Missouri, AFUDC is included in the plant in service balances included in utility rate base in Missouri in lieu of rate base treatment

USOA Accounts/Assets

- Functional Classification of Plant
 - While all Plant in Service costs are accumulated in USOA account 101, these costs are separated by functional category in the “300” accounts
 - Per the USOA, Plant in Service is classified by account in the following manner:
 - Intangible (Accounts 301-303)
 - Production (Accounts 310-346)
 - Transmission (Accounts 350-359)
 - Distribution (Accounts 360-373)
 - General (Accounts 389-399)

Intangible Plant (Accounts 301-303)

- Intangible plant - expenditures made that are not tied to specific physical plant assets that are nonetheless includable in plant in service accounts

Production (Accounts 310-346)

- Production plant - those assets associated with the generation of electric power to serve customers' demand for electricity

Transmission (Accounts 350-359)

- Transmission plant - those assets dedicated to moving power from the generating station to end-use customers, often over long distances

Distribution – Accounts 360-373

- Distribution plant - those assets associated with movement of power from transmission facilities to the customers' homes and businesses

General – Accounts 389-399

- General plant - includes those facilities and buildings not directly associated with the generation, transmission or distribution of electric energy

Accumulated Depreciation Reserve - Account 108

- The costs of plant assets are recovered from customers over the estimated life of the asset through inclusion of depreciation expense in rates.
- As depreciation expense is recorded by the utility, the amounts booked are also recorded in this account.
- The balance of this account at any time represents the amount of original plant investment made by the utility that has been subsequently recovered from customers in rates.

USOA Accounts/Assets

- Accumulated Depreciation Reserve
 - The overall balance of the depreciation reserve account is offset against the plant in service account balance for purposes of valuing rate base; i.e., the utility should only receive a return on the portion of its plant investment that is yet to be recovered from customers
 - The accumulated depreciation reserve balance is offset against the gross plant in service balance (account 101) to present the utility's net plant in service balance at a point in time on the utility's balance sheet

Acquisition Adjustments - Account 114

- This account comes into play anytime assets are sold to another entity at a price higher than or lower than the net original cost of the asset to the first utility owner.
- The FERC USOAs are premised upon an “net original cost” philosophy for valuation of assets.
- “Net Original Cost” – the amount paid for the assets by the original owner, less accumulated depreciation on the assets.
- Missouri PSC follows a policy of using the “net original cost” concept for setting rates for acquired plant; Missouri PSC does not recognize positive or negative acquisition adjustments for ratemaking purposes.

Plant Held for Future Use (Account 105)

- This account is for plant assets purchased with the intent of using them for utility service at some future point, but not currently
- As assets included in this account are not “used and useful,” these items are excluded from utility rate base for purposes of setting rates in Missouri

Materials and Supplies (Account 154)

- This account is for small dollar assets for which individual tracking for depreciation purposes would not be practical
- Utilities set a capitalization limit on assets, of \$500 to \$1,000 for most companies
- A utility will charge the entire cost of materials and supplies to expense when they are used

Fuel Inventories (Account 151)

- To ensure that the systems are continually able to generate electricity equal to the customer demand, utilities must keep a supply of the fuels on hand that it use to generate electricity
- Fuel inventories for an electric utility may include coal, natural gas (storage), and nuclear fuel
- In Missouri, the largest fuel inventory component is for electrical utilities is coal, due to the state's current heavy reliance on coal-fired generating plants

Prepayments (Account 165)

- Certain expenses are commonly prepaid by U.S. utilities, such as insurance policies and rent
- When prepaid, such costs are recorded in the Prepayment asset account, and then charged to expense over the applicable benefit period
- A utility's ongoing balance of prepayments are included in its rate base for ratemaking purposes

Regulatory Assets

- Regulators can allow utilities to capitalize the costs of natural disasters, and to seek recovery of the costs later in rates through an amortization to expense
- Currently GAAP allows a regulated utility to capitalize costs ordinarily charged to expense if the regulator provides adequate assurance that it is likely that such costs will be allowed recovery of the costs in subsequent rate cases

USOA ACCOUNTS / Liabilities

- **Liabilities** are obligations that a utility will owe to third parties now or in the future. For utilities, liabilities include:
 - Long-term debt (Accounts 221 and 224)
 - Accumulated Deferred Income Taxes (Accounts 281-283)
 - Regulatory Liabilities (Account 253)

Types of Liabilities

- “Current liabilities” are owed within the next twelve months
- “Non-current liabilities” will be owed after twelve months of time
- Liabilities will be an offset, or reduction to, rate base when included in a utility’s rate base

Long-Term Debt (Accounts 221 and 224)

- For utilities, most long-term debt is in the form of bonds issued by the utilities that are purchased by bondholders
- The bondholder purchases the instrument for a stated value, and then receives periodic payment of interest at a stated interest rate (For example, a \$100 million bond with a 3.5% annual interest rate)
- Interest on bonds is usually paid quarterly (four times a year)
- After a period of time (usually 20 years), the utility repays the bondholder for the principal provided in full

Accumulated Deferred Taxes (Accounts 281-283)

- Most utilities, including those in Missouri, pay income taxes to both the federal and state governments
- Current income tax rates: federal – 34.0%, state – 6.25%
- The federal and state governments allow businesses to deduct certain expenses for income tax purposes at a different time than when they are charged to expense for financial reporting purposes;
- These items are called “tax timing differences”

Accumulated Deferred Income Taxes

- Accumulated Deferred Income Taxes - Depreciation
 - The largest tax timing difference for utilities is usually depreciation expense
 - For financial reporting purposes, utilities will depreciate their assets on a “straight-line” base, that means in equal amounts per year over the estimated lives of the assets
 - For taxable income purposes, utilities are allowed to use various “accelerated” depreciation methods, which provide utilities with the largest tax deductions for depreciation in an asset’s first years of service

Accumulated Deferred Income Taxes - Normalization

- The amount of income tax expense calculated for ratemaking purposes for utilities is based upon book income amounts, not taxable income
- This is called “normalization” treatment of income tax expense
- This effectively means that U.S. utilities will receive recovery of more income tax expense in rates from customers than they will have to pay to federal and state taxing authorities
- Normalization treatment of tax timing differences provides utilities with additional cash flow that can be used to invest more funds in their operations to expand and improve their facilities and services

Regulatory Liabilities (Account 253)

- Similar in concept to “regulatory assets,” these are liabilities created by the actions of utility regulators that can be included on the company’s balance sheets under GAAP

USOA Accounts/Owner's Equity

- Owner's Equity is the amount of net investment in an enterprise made by the owners/equity holders of the business, plus any accumulated profits (retained earnings)
- The "Accounting Equation:" Assets minus Liabilities Equals Owner's Equity
- Almost all equity invested in U.S. utilities is in the form of common stock; some utilities also issue preferred stock
- Recorded in Accounts 201,204, 207 and 216

Owner's Equity

- Paid-in Capital (Accounts 201, 204, 207)
 - This is the amount of funds invested in the utility by common and preferred equity shareholders
 - These amounts are associated with the original issuance of equity when the business started, as well as any ongoing equity issuances made by the utility in order to raise new capital
 - Resale of shares of stock by equity investors to third parties does not affect the balance of this account; the proceeds of the resale do not go to the utility

Owner's Equity

- Retained Earnings (Account 216)
 - On the utility's income statement, total revenues minus total expenses for a given year equals annual profit
 - A utility can choose to use its annual profit to pay out dividends to its shareholders, or to “retain” the profits to re-invest in the business
 - Most utilities choose to do both; for example, they could pay out 50% of their profits in dividends and retain the other 50%
 - The portion of a utility's profits not paid out to shareholders in dividends is booked to the “retained earnings” account; “Retained earnings” is the utility's cumulative net income

USOA Accounts/Revenues – Account 401

- **Revenues** represent the cash received by a utility in return for services provided.
- The types of revenue may be classified as follows:
 - Rate Revenues
 - Off-System Sales Revenues
 - Transmission Revenues
 - Other
- Revenues are generally booked to Account 401, but Accounts 440-456 provide a more detailed breakdown

Rate Revenues

- These revenues are typically segregated by customer class in utility subaccounts, including:
 - Residential Sales (Account 440)
 - Commercial Sales (Account 442)
 - Industrial Sales (Account 442)
 - Public Street and Highway Lighting Sales (Account 444)
 - Sales for Resale (Account 447)

Rate Revenues

- A utility will not collect all of the revenues owed to it by its customers; some portions of the customers will not pay their bills
- The utility is compensated for this failure to pay through inclusion of bad debts expense in rates
- Revenues are recorded by the utility on an accrual basis when earned

Revenues - Off-System Sales

- **“Off system sales”** occurs when utilities receive revenue for selling power from its generating system to another utility when part of the utility’s system is not needed to produce power for its retail customers
- These sales are made possible when it is less expensive for a utility to obtain power from another utility than to generate the power on its own system

Revenues - Transmission

- **“Transmission revenues”** are those received by a utility for transmitting power generated by another utility for sale to a third utility
- Because transmission transactions of this nature usually cross state boundaries, and FERC has primary responsibility for setting rates charged by utilities for transmission service to other utilities

Off-System Sale and Transmission Revenues

- Off-system sales revenues and transmission revenues are credited to retail customers.
- For example, the revenues are used to reduce the amount Missouri retail customers must pay in rates, because retail customers are responsible for the costs of the generating and transmission assets that are used to derive these revenues

Revenues – Other Revenues

- Some utility revenue relates to other items or services found in the utility's approved tariff for the utility that does not relate to provision utility service
- One example is late payment fees.
- Late payment revenues are reflected as a credit to the general body of utility ratepayers, so that utility customers as a whole are not entirely responsible for the additional costs imposed on the utility by late paying customers

USOA Accounts/Expenses

- **Expenses** are costs incurred by a utility in providing service that will not result in a long-term benefit
- For example, salary payments made to utility employees are charged to expense because the payments are made in relation to prior service by the employee, and the payments do not obligate the employee to remain with the utility in the future
- In contrast, costs incurred to construct a new generating plant are capitalized because the unit is expected to provide a benefit to the utility in the future

Expense Operating and Maintenance (O&M)

- Operating expenses are those costs incurred to provide ongoing service to customers
 - Fuel Expense - Purchased Power Expense
 - Labor and Non-Labor
- Maintenance expenses are those costs incurred to keep the utility's systems running properly, and make repairs as necessary
 - Routine Maintenance & Repair - Vegetation Management
- Non Operating and Maintenance Expense include:
 - Depreciation - Income tax - Taxes other than Income

Operating Expenses

- The largest operating expense for most utilities are:
 - **Fuel expense** (Accounts 501 and 547) is the cost of the fuel used or burned in the utility's generating stations to produce electric power for customer needs (i.e., coal, natural gas, nuclear)
 - **Purchased power expense** (Account 555) is the cost of fuel used or burned in the utility's generating stations to produce electric power provided to a neighboring utility

Maintenance Expense

- Maintenance Expenses
 - These costs include:
 - The cost of periodic routine, or scheduled, maintenance activities related to a utility's plant and equipment
 - The cost of repairs or restoration of equipment in the event of mechanical failure
 - The cost of such ongoing activities as "tree trimming," or cutting back tree foliage that may interfere with a utility's transmission or distribution lines

USOA Accounts/Expenses

- Customer Accounts Expense
 - Meter reading expenses may be associated with manual meter reading activities undertaken by utility employees, or costs associated with use of electronic meter reading devices
 - Bad debts expense is included in customer rates so that the utility is compensated for the revenues it will not be able to collect when billed to customers
 - Inclusion of bad debt expense in rates effectively means that the general body of utility ratepayers will pay slightly higher rates on account of the small percentage of utility customers that do not pay their bills

Operating and Maintenance

- Labor and Non-Labor Classifications
 - **Labor expenses** are those costs incurred to provide ongoing reimbursement to a utility's employees for their service and includes salaries/wages, pensions, retiree health benefits, other employee benefits, incentive compensation and bonuses
 - **Non-labor expenses** are all other expenses incurred by a utility
 - Labor costs do not include payments to non-employees (vendors, contractors, consultants) for services provided

Depreciation Expense – Account 403

- **Depreciation expense** is the ratable charging of the cost of plant investments to customers over the estimated life of the investments
 - Plant investments are financed upfront by a utility's equity investors and debt holders
 - The capital provided by equity investors and debt holders for this purpose is then returned to them by customers via inclusion of depreciation expense in rates

USOA Accounts/Expenses

- Depreciation Expense
 - This expense is calculated by applying authorized depreciation rates to gross plant in service balances by category
 - Depreciation rates are derived through periodic depreciation “studies”
 - Depreciation rates are developed based upon an estimate of the useful life of utility assets by category
 - Depreciation rates are established in a rate case proceeding

Depreciation

- “Cost of removal” is the cost of demolishing, dismantling or otherwise removing an asset from service after it has been retired
 - Especially due to environmental considerations, the amount of cost of removal has recently increased for some categories of assets
- “Salvage” is the resale value for asset materials at this point of retirement for the asset
- “Net Salvage” is salvage less the cost of removal for an asset

Depreciation cont'd

- Summary:
 - Depreciation rates are developed using:
 - An estimate of an asset's useful life; plus
 - An estimate of the cost to remove an asset from service at the end of its useful life; minus
 - An estimate of any salvage value that may be obtained by the utility at the end of the asset's useful life

Depreciation Studies

- Depreciation Studies
 - Depreciation studies are required to be conducted by utilities no less often than every five years by Commission rule
 - If a utility files a rate case three years or more later than its last depreciation study, it must submit a new depreciation study as part of its rate case filing
 - Missouri PSC Staff will examine the utility's depreciation study when it is submitted, and may conduct its own study
 - If there is disagreement concerning appropriate calculation of depreciation rates, the Missouri PSC will make a decision in the rate case

Income Tax Expense (Accounts 409.1, 410.1, 411.1)

- Income tax expense is reflected on a utility's books based upon application of the current effective federal and state income tax rates to a utility's book net income
- For reasons previously discussed, a utility's booked income tax expense calculated per the USOA will not equal the amount of its tax payments to federal and state taxing authorities due to the existence of "tax timing differences" and use of "tax normalization"

Taxes other than Income – Account 408.1

- **Property Taxes** are based upon the calculated value of a utility's assets primarily its Plant in Service accounts
 - Property taxes are generally assessed by the county in which the utility's assets are physically located
- **Payroll taxes** are taxes paid to the federal and state taxing authorities based upon the amount of payroll expense paid out to employees
 - These taxes are used to fund social security (retirement) and Medicare (health) benefits
 - In the U.S., both the employee and the employer are responsible for a portion of these taxes

USOA Accounts/Expenses

- Functional Classification of Expenses
 - In the USOA, all expenses are categorized in the following manner:
 - Generation
 - Transmission
 - Distribution
 - Customer Accounting
 - Sales
 - General

USOA Accounts/Expenses

- Functional Classification of Expenses
 - Generation expenses are those costs incurred in relation to the generation of electric power by the utility
 - Transmission expenses are those costs incurred in the relation to the transmission of electric power over long distances by the utility
 - Distribution expenses are those costs incurred in relation to the provision of electric power to end-use customers in their homes and businesses

USOA Accounts/Expenses

- Functional Classification of Expenses
 - Customer accounting expenses are those costs incurred in relation to obtaining payment from customers for services received
 - Sales expense are those costs incurred in relation to promoting use of the utility service to customers (Advertising expense)
 - Administrative & general expenses are those costs incurred in relation to the necessary support activities carried out by a utility in providing service to customers

USOA Accounts/Expenses

- Functional Classification of Expenses
 - Administrative & General Expenses include:
 - Executive Salaries
 - Legal Costs and Payment of Legal Claims
 - Payment for Consulting and Other Outside Services
 - Costs of Rate Cases and Other Regulatory Proceedings
 - Pension and Benefit Costs
 - Maintenance of General Office Buildings
 - These expenses are made up primarily of costs associated with what is known as “overhead” or “support” functions

USOA Accounts/Expenses

- Functional Classification of Expenses
 - Why functional classification?
 - Functional classification allows the utility, regulators and other users of financial information to more specifically identify the cause of positive and negative trends in overall earnings results
 - Functional classification allows for a focused comparison of the efficiency of utility operations between utilities in each of their core functions
 - Functional classification allow for easier “unbundling” of customer rates if a portion of a utility’s operations are deregulated or structurally separated from other core functions

USOA Accounts/Expenses

- Functional Classification of Expenses
 - Bundled rates: when all generation, transmission distribution costs are bundled together in one customer bill, instead of being charged separately
 - Example of rate unbundling: some states deregulated electric generation operations in the 1990s, by allowing customers to choose between competitive generation alternatives (Missouri did not do this!)
 - In states that did deregulate generation operations, separation of plant costs and expenses by functional classification allowed the generation portion of the bundled electric rate to be removed from the incumbent utility rate

Regulatory Reporting

- Annual Reports/Income Statement
 - The income statement is the financial report that summarizes the utility's earnings results for a given year
 - Format of the Income Statement:
 - Operating Revenues
 - Less Operating Expenses
 - Equals Net Operating Income
 - Less Non-Operating Results
 - Equals Net Income

Regulatory Reports

- Annual Reports/Balance Sheet
 - A balance sheet is the financial report showing the financial status of a utility at a point in time
 - For an annual report covering a full calendar year, the balance sheet submitted by the utility will show its asset, liability and owners equity balances as of calendar year-end
 - Format:
 - Assets will be listed in a column on the left-hand side
 - Liabilities and Owners Equity components will be listed in a column on the right hand side
 - The two columns must equal!

Regulatory Reports – cont’d

- Annual Reports/Balance Sheet
 - The higher the balance of total assets compared to total liabilities, the more financially healthy the utility
 - The schedules in the annual report supporting the balance sheet include detailed breakdowns of the following items:
 - Plant in service
 - Accumulated depreciation
 - Accumulated deferred taxes
 - Paid-in capital
 - Retained earnings

Regulatory Reports – cont'd

- Annual Reports/Statement of Changes in Financial Position (SCFP)
 - This schedule summarizes the utility's cash flow position in the year being examined
 - The SCFP measures both total cash generated or obtained by the utility, and the total cash expended by the utility – the two totals must match

Regulatory Reports – cont’d

- Format of the SCFP
 - Funds from Operations
 - Net Income Earned
 - Depreciation Expense Rate Recovery (non-cash expense)
 - Deferred Tax Rate Recovery (non-cash expense)
 - Funds from Outside Sources
 - Long-term Debt Issuances
 - Stock Issuances
 - These items add up to “Total Sources of Funds”

Regulatory Reports cont'd

- Format of the SCFP
 - Uses of Funds
 - Additions to Plant in Service and Other Assets
 - Construction Expenditures
 - Dividends Paid on Common and Preferred Stock
 - Funds Used to Retire Debt
 - These items add up to “Total Uses of Funds”

Regulatory Reports cont'd

- Annual Reports/SCFP
 - The greater the proportion of internally generated funds to total sources of funds, the more financially healthy the utility will be
 - In other words, the less a utility must rely on the debt and equity markets to obtain funding for capital improvements, the better off the utility is financially

Maintenance vs. Capital

- In general, if an expenditure is intended to improve in some manner the operability of the asset in question, the cost should be capitalized
- In general, if an expenditure is intended to maintain the asset so it provides service as anticipated over its estimated useful life, the cost should be charged to expense as maintenance
- In real life, the distinction between these two criteria may not always be clear

Maintenance vs. Capital

- Regulators should be aware of possible adverse utility incentives in this area:
 - If a utility is earning poorly and intends to seek a rate increase in the short-term, that company **may** have an incentive to charge expenditures to maintenance expense, and not capitalize the costs, so as to maximize recovery of the costs in rates in the short-term
 - If a utility is earning well and does not intend to seek rate relief in the short-term, the utility **may** have an incentive to capitalize costs, and not charge them to expense, so as to maximize recovery of the costs in rates in the long-term

Maintenance vs. Capital

- Regulatory Practice in Missouri
 - It is initially up to the utility to determine whether a cost should be capitalized or expensed at the time the cost is incurred
 - That decision may be reviewed in a subsequent rate proceeding
 - Utilities are free to seek advice and guidance from their regulators on this and similar questions, and sometimes do

Maintenance vs. Capital

- Regulatory Practice in Missouri
 - Some situations that might trigger regulatory concern in rate cases regarding the capital vs. maintenance question:
 - If a utility shows recent large increases in maintenance expenditures, or shows consistently large year-to-year fluctuations in maintenance expenditures, the reasons for these occurrences may be investigated in rate proceedings
 - If a utility makes unexpectedly large capital additions to existing plant, that may trigger a review of those additions in a rate proceeding

Regulatory Accounting and Ratemaking

- Past reported utility financial results will be based in part on obsolete information that may no longer be relevant in setting utility rates, such as:
 - Outdated numbers of customers
 - Outdated numbers of utility employees, and pay rates
 - Outdated fuel prices
 - Outdated levels of depreciation expense, if plant balances are increasing

Regulatory Accounting and Ratemaking

- Past financial results may also be based in part of abnormal levels of revenues or expenses caused by:
 - The impact of unusual weather on customer consumption of utility services and, accordingly, rate revenues
 - Unusually large fluctuations upward or downward in incurred maintenance expenses, due to unanticipated equipment failures or generator outages, or the lack of them
 - Unusually large receipts or payouts related to legal claims and lawsuits
- For all of these reasons, past financial results for a utility may not be indicative of future financial needs

Regulatory Accounting and Ratemaking

- However, in setting rates prospectively, regulatory accounting results are indispensable as a starting point for analysis of rate increase requests
- For every rate case filed in Missouri, the Commission selects a “test year,” 12 months of recent prior financial results for the utility
- Both the utility and the Commission Staff examines test year financial results in rate case audits to determine to what extent those historical results need to be “adjusted” in order to set appropriate rates

Regulatory Accounting and Ratemaking

- Rate Case Adjustments
 - Annualization Adjustments: To restate test year financial results to reflect the last known cost trends
 - Examples: Adjustment to rate revenues to reflect last known customer numbers; adjustments to payroll expense to reflect last known salary rates and employee numbers
 - Normalization Adjustments: To restate test year financial results to reflect normal levels of revenue and expense
 - Examples: Adjustments to normalize maintenance expenditures; adjustments to eliminate the impact of abnormal test year weather on rate revenues

Regulatory Accounting and Ratemaking

- Types of Rate Case Adjustments
 - Rate base (asset and liability) amounts are stated at their end-of-period values for ratemaking purposes, not at their average value during the test year.
 - Use of end-of-period valuation of rate base items better reflects current trends in those elements than using past average values
 - The rate of return calculation for utilities also reflects updated information as of the end of the test year for debt cost rates, and the proportion of debt and equity in the utility's capital structure

Regulatory Accounting and Ratemaking

- Much of the controversy and many of the disputes between the Commission Staff, the utilities, and other parties in rate cases arises from different opinions regarding how and whether past financial results of a utility should be adjusted for purposes of setting the company's rates prospectively