NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES NASUCA

April 17, 2009

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Comments on IFRS Roadmap (File Reference S7-27-08)

Dear Ms. Murphy:

The National Association of State Utility Consumer Advocates ("NASUCA") is an association of 44 consumer advocates in 40 states and the District of Columbia. NASUCA's members are designated by the laws of their respective jurisdictions to represent the interests of utility consumers[1] before state and federal regulators and in the courts. We offer the following thoughts in response to the Securities and Exchange Commission's ("Commission's") request for comments on its *Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers*. We appreciate the extension of time that the Commission has provided to offer comments on its proposed *Roadmap*.

Adoption of new financial reporting standards would have a significant impact on not only the public utilities that would be subject to them but would also impact public utility regulation and the manner of oversight performed by regulators and consumer advocates. Additionally, the transition from current reporting standards to the international standards would have a cost associated with it – a cost that would likely be paid by public utility consumers throughout the United States. As statutorily designated advocates for these consumers, we have a keen interest in the outcome of this proceeding.

[1] The terms consumer and ratepayer are used interchangeably.

Introduction and Background

The regulation of public utilities in this country has developed and evolved over the course of the last one-hundred years. Each U.S. state, commonwealth, and territory has at least one statutorily designated entity to regulate and oversee the operations of public utilities within its jurisdiction. The definition of a public utility can and does differ by jurisdiction. However, for purposes of these comments public utilities include providers of electricity, natural gas, water, wastewater, telecommunications and other similar services to end use consumers.

One of the most common regulatory schemes used for public utility price setting is cost-plus, wherein a utility is permitted the opportunity 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 prices use, price caps, price indices, or cost-plus pricing that is subject to adjustment based on certain performance measures. With most, if not all of these methods, it is common practice for regulators to monitor investments, expenses, and earnings through the submission of financial statements by the utilities. Additionally, the foundation or starting point for many of these regulatory methods is the audited financial statements of the public utility. Thus, the publicly issued financial statements are currently a critical element in the establishment of retail public utility rates. For this reason, NASUCA is very interested in the outcome of the Commission's decision on whether or not to require a fundamental change in the accounting and reporting that would be mandated for use by public utilities and other publicly-traded, investor-owned entities.

On November 14, 2008, the Commission released its *Roadmap* in which it proposed the considerations that would be part of the decision-making process for determining whether or not to mandate the use of International Financial Reporting Standards (IFRS) for U.S. entities subject to the Commission's reporting requirements. In this document, the Commission described the history of convergence between U.S. GAAP and IFRS, described a number of concerns and considerations that it intended to examine when making its decision, offered a timeline for making its decision, and then posed a number of questions upon which it sought comments. Initially, comments were due on or before February 19, 2009; however in response to a request for an extension, the comment period was extended through April 20, 2009.

With these comments, NASUCA offers a mixture of information and opinion. From the notice of the *Roadmap*, it is not clear that the Commission fully understands the implications on public utility regulation and consumer advocacy that would occur if GAAP, as it currently exists, were to be replaced with the IFRS, as it currently exists. Drawn from our concerns about the implications of such a change, we offer to you that the few benefits that may result for public utilities and their investors are quite likely to be dwarfed by the problems and costs that would result from the mandate to utilize current international standards. Furthermore, ratepayers would accrue even fewer of the benefits, if any, but may be responsible for much, if not all of the cost. This is quite troubling particularly without any empirical evidence regarding the cost and benefits of the proposed conversion to IFRS.

We understand from documents found on the Commission's website that the primary mission of the Securities and Exchange Commission is to "protect investors, maintain fair, orderly, and efficient markets, and to facilitate capital formation." Thus, most of the questions in the *Roadmap* are directed at seeking input on the impact that changes would have to investors and issuers of financial statements subject to the Commission's oversight. There is no specific inquiry of the impact on the general body of citizens (or as it relates to our interests, public utility consumers) or the impact on the overall well-being of the U.S. economy. We urge the Commission to take a broad reading of its role to "maintain fair, orderly, and efficient markets." Recent experiences of having too little information (e.g., credit default swaps) or unintelligible reporting about complicated transactions (e.g., Enron) should be a warning to the Commission that its actions, or inactions, can have a dramatic impact on the overarching economic well-being of the United States. When the country faces economic turmoil, it is difficult for markets to be fair or efficient.

Furthermore, the Commission must consider the impact of its decision on both the large, institutional investor, as well as the small, average-Joe investor. Both have a need and/or desire to make money. Both have an impact on the availability of capital and the cost at which that capital is available. However, smaller investors, who number in the millions in this country, often have little time or inclination to understand significant accounting changes let alone the implications of these changes. Yet, the potential changes being discussed by the Commission are not without some impact to the balance sheet, the operating expenses, and earnings.

How Financial Statements are Used in the Process of Regulating Public Utilities

Under traditional public utility economic regulation, the determination of prices generally begins with the audited financial statements. Thanks to the wide-spread use of Statement of Financial Accounting Standard 71, *Accounting for the Effects of Certain Types of Regulation*, issued December 1982, the financial statements that are publicly issued to and used by investors are generally reflective of the operations and costs as viewed by regulators. Thus, the first look at a public utility's investment, revenues, expenses, and current earnings come from the issued financial statements or the books of account that are used in the development of those financial statements. The regulatory analysts 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, certain adjustments are made to reflect the specifics of the regulatory process. For instance, certain political and 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 to be charged retail ratepayers. However, these adjustments tend to be relatively small in the overall process, particularly when compared to the underlying capital investments that are incorporated into the ratemaking process without change. To reiterate, regulatory audits tend to verify whether or not a cost or investment should be the responsibility of the ratepayer or shareholder. Rarely do regulatory audits find fault with the figures contained in the audited financial statements.

Under traditional regulation, the rate of return on investment or return on equity will often be capped. This means that actual earnings (with or without annualizing or normalizing adjustments) will be monitored over time to see whether the authorized return is being exceeded. The audited financial statements, currently based on GAAP (including SFAS 71) are a vital piece of information relative to this monitoring process. For this monitoring to be meaningful, the accounting entries that underlie the financial statements must be relatively consistent from year-to-year. Otherwise, the comparability is lost and the ability of the public utilities to earn more than a reasonable return is increased to the detriment of the ratepayers. In addition, this lack of comparability could result in an increase in the perceived risk to the utility and that could cause an increase in the cost of capital to the utility. This would be an unnecessary cost that would likely be born by the ratepayers without providing any benefit.

A third regulatory use of financial statements relates to the monitoring of certain new investments or specific expenses. Regulators are approving the use of more and more mechanisms that allow for the recovery of one particular expense or investment. Some public utilities are permitted to change their rates periodically based only on the change in the cost for one particular matter. One example is that rates may change solely upon the addition of new renewable generation resources. This again requires that the underlying accounting for that cost or investment be comparable to the manner in which the regulator recognizes that item in the ratemaking process.

Today, there is a fairly good synchronization between the manner in which financial transactions are recognized in rates and the manner in which they are reported on the publicly issued financial statements. However, given some of the substantial differences between the accounting for certain items under IFRS compared to GAAP, the current level of synchronization between the accounting and regulation would be lost. There could be some minor revamping of the regulatory process to match the newly mandated international accounting and reporting standards. However, regulatory changes in response to the Commission's action would likely be limited in nature, as current regulatory processes are founded primarily on public interest standards. Any decision the Commission may make to move to IFRS does not in any way change the public interest mandates of the public utility regulators or the underlying transactions of the public utilities themselves. Thus, we do not anticipate a dramatic change in the ratemaking process.

Key IFRS Versus GAAP Differences Impacting Public Utilities

In response to the Commission's decision to consider mandating the use of IFRS instead of GAAP, representatives of public utilities, regulators, consumer advocates, and the accounting profession have worked together to identify some of the key differences between the two sets of standards. While the following list is not all inclusive, it is representative of the major differences and complications that have thus far been identified.

- Under IFRS, public utilities may not report regulatory assets and regulatory liabilities. GAAP, on the other hand, requires rate-regulated utilities to record regulatory assets and liabilities for items such as the rate adjustment mechanisms that pass-on specifically identified costs (such as wholesale natural gas costs that constitute the supply cost for providing retail natural gas services) between full regulatory reviews, and generally involve some sort of true-up mechanism. Without the regulatory asset and liability provision, many accounting conventions followed by utilities would not be permissible under GAAP. This lack of ability to continue to report regulatory assets and regulatory liabilities on the balance sheet is one of the most significant concerns expressed by public utilities, regulators and consumer advocates about the potential move to IFRS. While the International Accounting Standards Board (IASB) has agreed to review this issue and revisit its current policy, there is no assurance at this time that a change in the international standard will be implemented. We cannot overstate the amount of reliance that public utilities and regulators place on the ability to record regulatory assets and regulatory liabilities. It is a significant tool that is used to eliminate rate shock to ratepayers. Additionally, investors may benefit from the opportunity to record a deferral since costs are frequently accumulated in an account pending future recovery through public utility rates.

- Capitalization of equity based financing costs is not permitted by IFRS whereas GAAP permits utilities to capitalize the equity as part of the Accumulated Funds Used During Construction (AFUDC). Thus, unless there is a change to current international standards, the equity portion of these carrying charges incurred during a period of construction would not be capitalized as part of the plant. These carrying charges can be a substantial portion of utilities' overall investment costs. The lack of ability to capitalize and recover these costs could financially cripple the utilities. For good public policy reasons, many regulators and consumer advocates are reluctant to include these carrying charges in rates while the asset is still under construction. The likely result of this impasse is a different investment level shown on the publicly available financial statements than utilized for regulation. This would make accounting verification harder and the potential for gamesmanship easier as well as raising the perceived risk of the utility to investors.

- Last-in, first-out (LIFO) inventory accounting is widely used in the U.S. utility industry but is not permitted under IFRS. This would require a significant change in recordkeeping. The issue would be further complicated by the fact that LIFO is an acceptable method pursuant to the U.S. Tax Code. It could become much more difficult to reconcile the various records of the public utilities, making oversight by the various governmental entities (public utility regulators, taxing authorities, others) even more difficult. Additionally, public trust is often dampened when the specter of multiple sets of books is raised.

- Major overhauls and inspections are generally expensed under GAAP while IFRS would require many of these costs to be capitalized pursuant to International Accounting Standard 16. Again, this would either cause additional differences between the public financial statements and the records kept for regulatory purposes, or cause public utility regulators to essentially revamp the current regulatory processes.

- Currently GAAP permits the reporting of items as *extraordinary* in the income statement, although only in very limited circumstances. IFRS does not distinguish these extraordinary items from normal transactions. Unusual, non-recurring events are generally addressed in the ratemaking process in a manner different than recurring costs – often through the creation of regulatory assets or regulatory liabilities. It could become much more difficult for regulators and consumer advocates to identify the unusual events that require special attention if they are buried within the more routine accounts and transactions of the entity under review.

Additional differences that will impact the financial statements both in format and in substantive content include:

- componentization of plant, property, and equipment;
- asset impairment testing;
- categorization of leases;
- computation of employee benefits and pension expense;
- definition of derivatives;
- categorization of expenses on the financial statements;
- accounting for income taxes;
- recording of the cost of environmental liabilities; and
- determination of asset retirement obligations.

Regulatory Response to Changes in Accounting

So, what is the likely response to the accounting and reporting changes were they to occur? Clearly, public utilities subject to the oversight of the Commission would be required to comply with the new international standards if mandated by the Commission. However, they would also be required to comply with any regulatory standards imposed by public utility regulators. If regulation remained consistent with today's practices, but the financial reporting requirements changed, public utilities would be required to keep more records, with more on-the-side accounting (viewed by many as additional sets of books). If the Commission views this process as simplifying matters for firms, public utilities are not likely to be in that group. Additional costs accompany more recordkeeping. These costs are generally paid for by ratepayers, not shareholders, placing additional pressure on already increasing public utility rates throughout the nation, with little or no benefit.

The prospect of changing accounting for financial reporting purposes also raises the age-old question of whether accounting drives regulation or whether regulation drives accounting. Clearly, the regulatory process had enough impact that special provisions were added to GAAP through the adoption of SFAS 71, *Accounting for the Effect of Certain Types of Regulation.* We see no reason to change this now. The accounting and reporting requirements should produce financial reports that are reflective of the actual financial obligations and transactions of the reporting entity. Since many of these transactions are made pursuant to or guided by regulatory directives, the regulatory process must not be ignored in developing the financial reports and information to be shared with investors.

Regulation must take into account a balance of the needs of investors and the interests of ratepayers. There is a legally mandated need for regulators to examine the public interest. We find nothing has changed to the point where the uniqueness of the regulatory process should no longer be recognized as part of the accounting and reporting requirements of public utilities. Yet, this is precisely what would happen if the Commission were to wholly adopt IFRS. The uniqueness of regulation would be lost on users of the financial statements.

While some may argue that this loss of recognition of the uniqueness of regulatory accounting could be compensated through additional footnotes, we disagree. Footnotes have already become extremely complex and voluminous to the point of often being overwhelming for the average investor. All of the implications of significant changes in accounting policy are likely to be lost on the casual reader of financial reports. This is likely to promote more confusion, rather than less.

Furthermore, we reiterate a point made earlier in these comments. It is unlikely that regulators would modify their views and their processes to promote consistency with the international standards. Regulators have an obligation to do more than protect investors and markets. They must consider the impact on ratepayers, and that impact can be far reaching throughout the U.S. economy. For instance, when deciding whether certain costs should be expensed or capitalized, regulators look at issues such as generational equity, i.e., the fairness of imposing that expense on ratepayers throughout the life of the asset versus having only current ratepayers who benefit from the cost pay more immediately. In other words, why should ratepayers twenty years hence be paying for the cost of a plant overhaul that will need to be done again in another four or five years? That appears to be what would happen if regulators adopted the international standard of capitalizing major plant overhauls rather than expensing them over a four or five year time period.

Regulators also have an obligation to try to keep utilities financially healthy while also making sure that public input processes are respected. Many regulatory deferrals have been created as part of this balance. For example, the cost of natural gas is extremely volatile in the wholesale markets. History shows that these costs can double or drop precipitously in the course of one month. These costs often comprise as much as eighty percent of a natural gas utility's operating expenses. For this reason, most natural gas utilities in the U.S. have a provision as part of the rate setting process that allows them to collect the difference between the actually incurred costs and the level of costs contained in rates in an account. This accumulated difference is then amortized into rates over the course of some designated period of time, generally ranging from one month to one year. If these deferrals and true-ups were eliminated from the regulatory process to be consistent with international accounting, either investors or ratepayers could be seriously harmed. If prices dropped, ratepayers could lose out on those cost decreases pending regulatory notices, party interventions and discovery, and possible hearings. The opposite would occur if prices rose dramatically. Ratepayers would continue to benefit from the lower costs but shareholders would be responsible for these costs pending the workings of the regulatory due-process activities, and the financial health of the public utility could be at risk.

The likely result of the conversion to IFRS would be the existence of two completely different sets of records: one for financial reporting and one for the purpose of setting rates. Relative to regulatory deferrals, this means that the financial statements consistent with international standards would no longer recognize a regulatory asset or regulatory liability, even though for ratemaking purposes these costs are being spread over more than one accounting period. Therefore, if wholesale supply costs increased, the increase would be reflected in the income statement resulting in a lower income for the initial accounting period and a higher income in later periods. Meanwhile investors, or even boards of directors, may have no idea as to the level of costs that are not reflected in rates and are at risk of being collected into the future.

None of these options appear to be in either the best interest of public utilities, investors, or ratepayers.

Should Regulated Public Utilities be Exempt from the Mandated Use of IFRS?

In its Notice seeking comments on the proposed *Roadmap*, the Commission poses in question number 6 whether it would be appropriate to exclude investment companies and other regulated entities from the scope of the *Roadmap*. That would certainly be one solution to the potential problems that have been described above. However, that might not be as easy as it appears. Many public utilities are part of larger conglomerates which file consolidated financial statements. It is unclear how these would be treated. Would the public utility portion of the business be on a separate accounting system than the rest of the corporation? Or, would this particular public utility be subject to different financial reporting rules than the stand-alone utilities?

It is also not clear how having different accounting standards for different industries would impact the capital raising ability of the exempt industry. All public firms compete in the market for capital and, obviously, public utilities do not compete only with other public utilities for new equity or additional debt. In spite of the current state of the U.S. economy, many public utilities throughout the nation are in a position where more than modest capital expenditures will be needed in the near future. There is a need to build new transmission and new generation. If exempt from the transition to IFRS, would public utilities be advantaged or disadvantaged in the capital market compared to firms who have moved to IFRS? NASUCA does not have a clear answer to this question. However, the answer may be important to the quality and cost of public utility service into the future.

Similar issues and concerns relate to question number 4 the Commission raised regarding whether the mandated use of IFRS should be staged or transitioned in by size of company or by some other differentiating aspect. The Commission needs to be able to provide assurance that the capital market will not be skewed either toward or against those who have transitioned versus those who have not.

The Timing of the Commission's Decision

In the *Roadmap*, the Commission has proposed making its decision in 2011 on whether or not to mandate the movement from GAAP to IFRS. It also suggests that if it determines that it would be in the public interest to move to IFRS, it would mandate the first set of IFRS financial statements be filed in 2014. However, the *Roadmap* goes on to state that the 2014 financial statements would have to include three years of financial information, such that 2012 and 2013 data would also need to be presented in a manner consistent with IFRS. In question number 3 the Commission seeks comments on whether this timing is acceptable and appropriate.

We have several concerns about this proposed timing. First, it is difficult to actually begin the transition preparation process until the actual decision is made to convert to IFRS. If a public utility begins the process of transitioning, let's say by converting its internal accounting system, and the decision is made to stay with existing U.S. GAAP, there is a problem and money has been wasted. Yet, if a public utility takes no affirmative action until after the decision is made, then it faces not being able to acquire adequate resources to assist in its transition, particularly given that the demand for access to those who can assist in the transition is likely to exceed the limited supply. We anticipate that this demand and supply problem could arise in a number of areas ranging from auditors and accountants who understand IFRS to accounting software providers. It is a clear example of Catch-22. Additionally, when demand exceeds supply, supply costs are usually driven higher. As stated earlier, these costs are likely to be paid by ratepayers, not investors.

Second, the transition period is very limited given that the public utility would need to have data available to provide 2012 financial information in IFRS form by 2014. Certainly this is better than having to provide 2012 information in IFRS format by 2012. However, this will require not only a substantial amount of time and effort to be able to have systems in place to use IFRS on a going forward basis beginning 2014, but will also require time and effort to restate financial data that has already been issued. Restating and reconciling can be as time consuming, if not more so, than the original preparation of financial statements. And, all this is likely to occur when the economy is still in the process of recovering from its current market difficulties, and when the public utilities industry as a whole is engaged in one of the most capital intensive building eras that it has seen in decades.

Third, the regulatory process tends to be slow moving, in part because of the need to allow for a wide variety of input. Once the Commission makes its decision, there are a number of additional actions that must be taken, or at least considered, by other regulatory bodies. For example, the Federal Energy Regulatory Commission, the Federal Communications Commission, and the USDA Rural Development's Rural Utilities Program each has its own uniform system of accounts that the public utilities subject to its respective jurisdiction must use. In general, each of these mandated charts of accounts is consistent with today's GAAP for public utilities. Yet, if GAAP were no longer the standard to be used, it would be important to revisit these existing accounting systems. If history is a guide, it could take years to modify these uniform systems of account to properly reflect IFRS as it applies to public utilities.

Conclusion

NASUCA understands that the world is shrinking such that financial markets have now become international. We also understand the difficulty that some multinational firms face having to file financial information based upon different standards for each country. We understand their desire to simplify their process. Furthermore, we understand the Commission's frustration with the slow conversion process that the Financial Accounting Standards Board (FASB) and the IASB have undertaken. However, we are concerned that the Commission's view of the implications of its potential decision to move to IFRS may be too narrow. A broader view of the Commission's role in maintaining fair, orderly, and efficient markets is warranted in this case.

The Commission's decision to mandate the use of IFRS instead of GAAP for public utilities would likely result in increased costs with poorer information. Public utilities' financial reports filed with the Commission would become less usable and reliable for both regulators and investors. There appears to be no public interest basis for mandating the move to IFRS at this time, or foreseeable future, for the public utility industry.

We appreciate the opportunity to provide our thoughts and input relative to this important matter. We would be pleased to discuss our views with you at your convenience.

Sincerely,

Charles A. Acquard
Executive Director