

**PUBLIC UTILITY COMMISSION OF OREGON
STAFF REPORT
PUBLIC MEETING DATE: June 15, 2001**

REGULAR AGENDA X CONSENT AGENDA EFFECTIVE DATE April 1, 2001

DATE: June 6, 2001
TO: Phil Nyegaard through Lee Sparling and Ed Busch
FROM: Judy Johnson
SUBJECT: Docket No. UM 1019
PacifiCorp's Accounting Application for Treatment of Contracts Under the
Financial Accounting Standards 133 and 138

SUMMARY RECOMMENDATION:

I recommend the Commission approve PacifiCorp's application for an accounting order, with conditions, and that the accounting treatment become effective April 1, 2001.

DISCUSSION:

On April 4, 2001, PacifiCorp filed an application requesting an accounting order authorizing the establishment of a regulatory asset or liability associated with the implementation of Financial Accounting Standards 133 and 138 (FAS 133/138), Accounting for Derivative Instruments and Hedging Activities. The company further requests that the accounting treatment become effective for the financial accounting entries beginning with the company's adoption of FAS 133/138 on April 1, 2001. PacifiCorp states that its proposed accounting treatment will not affect the review and determination of prudence regarding the company's resource acquisitions. It further states that under the proposed accounting, the ratemaking treatment of contracts will be unchanged from the current practices.

Description

FAS 133, Accounting for Derivative Instruments and Hedging Activities, was issued by the Financial Accounting Standards Board (FASB) in June 1998 and was amended by FAS 138 in June 2000.

"FASB Statement No. 133 is based on four fundamental premises:

- (1).....Derivative instruments are assets or liabilities and, thus, should be reported in balance sheet.
- (2).....Fair value is the most relevant measure for financial instruments and the only relevant measure for derivative instruments. Thus derivative instruments will be measured at fair value. The FASB, therefore,

requires that mark-to-market accounting be used in measuring derivatives in the balance sheet as of each balance sheet date.

- (3).....Only assets and liabilities should be reported in these balance sheet categories.
- (4).....Special "hedge" accounting should be used only on qualifying items. A key aspect in determining whether a derivative qualifies as a hedge should be an assessment of the hedge's expected effectiveness."¹

"In today's environment, it is not uncommon for entities to enter into contracts for the purchase and sale of energy commodities. Such activities have historically been settled by physical delivery in the entity's primary operating environment (that is, that area in which an operation typically delivers energy or could physically deliver such energy in a cost-effective manner in order to earn its revenues). However, more and more frequently, these energy contracts are being entered into for speculation. Additionally, some entities enter into these energy contracts for trading using both over-the-counter contracts and exchange-traded contracts and settling them on a net cash basis or by entering into offsetting positions."²

"Based on FASB Statement No. 133, energy trading contracts that can be effectively net settled would be considered derivatives. Energy trading contracts should be marked to market with the gains and losses included in earnings and separately disclosed in the financial statements or related notes..."³

PacifiCorp states that many contracts such as certain power purchase and sales contracts, generation capacity, transmission capacity, and physical daily power purchase options, meet the definition of a derivative as defined by FAS 133/138 and that these types of contracts are entered into by virtually every utility in order to facilitate normal operations for both retail and wholesale business.

The Standards require all derivatives and certain embedded derivatives to be reported on the balance sheet at fair value. Changes in the fair value of derivatives, as defined by FAS 133/138, are to be recorded through earnings. PacifiCorp states that this will expose its earnings to significant volatility not experienced previously. The volatility is related to timing differences between when a contract is entered into and when the contract is settled. The company states that the accounting associated with FAS 133/138 will not be part of the company's regulated pricing and believes that any entries that are necessary for balance sheet recognition pursuant to FAS 133/138 should be offset by regulatory assets or liabilities, and not recorded through the company's statement of income.

¹ Paul Munter and Thomas A. Ratcliffe, *Applying GAAP and GAAS* (New York: Lexis Publishing, September 2000), p. 9.39

² Ibid, p. 9.53

³ Ibid, p. 9.54

Proposed Accounting

The company will record the fair value of various contracts according to FAS 133/138, as assets in FERC Account 182, Other Regulatory Assets, or as liabilities in FERC Account 253, Other Deferred Credits. As authorized by this application, these non-cash accounting entries will then be offset by regulatory assets or liabilities using FERC Account 182.3, Miscellaneous Regulatory Assets, and FERC Account 254, Other Regulatory Liabilities. These entries would be made simultaneously and would offset each other in the company's statements of income and comprehensive income. Under the proposed accounting, when the obligations under an affected contract are fulfilled, any gain or loss recognized under the Standard would be reversed, and the offsetting regulatory asset or liability would be reversed at the same time, resulting in no net gain or loss upon settlement of the contract.

Staff requested a written statement from PacifiCorp's outside auditors assessing the company's request in this accounting application. The following is an excerpt from that statement:

"FAS 71 provides that actions of a regulator can affect an otherwise required accounting treatment if it is probable that future revenues will result from the inclusion of a cost in allowable cost for ratemaking purposes, or if a regulator action gives rise to an obligation to the customer. With respect to the application of FAS 71 to balances arising from the implementation of FAS 133, we advise you will require an order from your regulator authorizing deferred accounting treatment. Management will also need to support that the rate treatment for subject contracts eliminates the impact of the FAS 133 fair value balances on the Company. The accounting treatment and the application of FAS 71 to a specific order will require a detailed review of the order and all relevant facts and circumstances relevant to the balance."

Staff also asked if PacifiCorp had made similar requests in its other jurisdictions and whether the company required all its jurisdictions to be in agreement on this issue. The company in its response to Staff Data Request No. 10 stated: "Paragraph 6 of FAS 71 provides that FAS 71 can be applied to a separate portion of an enterprise's operation. If the company does not receive a regulatory order in all jurisdictions, then the Company will take the position that this application of FAS 71 will be applied to all jurisdictions for which the Company does receive a deferral order based on an allocation."

Staff and PacifiCorp both acknowledge that there should be no rate change, now or in the future, associated with the application of the requested accounting change.

STAFF RECOMMENDATION:

I recommend the Commission approve PacifiCorp's application for an accounting order and that the accounting treatment become effective April 1, 2001, subject to the following conditions:

1. At the close of each quarter, PacifiCorp will provide Staff with all journal entries made under the requirements of FAS 133/138 and all journal entries made under this accounting application.
2. At any time PacifiCorp files for a rate change, including, but not limited to, a general rate filing and Power Cost Adjustment filing, the company must provide Staff with all journal entries made under the requirements of FAS 133/138, all journal entries made under this accounting application and any adjustments necessary to remove rate impacts of this accounting treatment. This condition does not apply to proposed rate changes that are not affected by the requirements for FAS 133/138, such as DSM filings.
3. The application of FAS 133/138 is evolving. As new interpretations or applications arise, PacifiCorp will notify and work with Staff to make sure there are no unintended consequences.