State of Florida

Public Service Commission

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DATE: November 18, 2004

TO: Director, Division of the Commission Clerk & Administrative Services (Bayó)

FROM: Division of Economic Regulation (Romig, Lester) JS
Office of the General Counsel (Vining) ALM

RE: Docket No. 040816-EI – Petition for authority to use deferral accounting for creation of a regulatory asset in recognition of minimum pension liability established in accordance with Financial Accounting Standards (FAS) 87, by Progress Energy Florida, Inc.

AGENDA: 11/30/04 – Regular Agenda – Proposed Agency Action - Interested Persons May Participate

CRITICAL DATES: None

SPECIAL INSTRUCTIONS: None

FILE NAME AND LOCATION: S:\PSC\ECR\WP\040816.RCM.DOC

Case Background

Progress Energy Florida, Inc. (Progress Energy or the Company) requests authority from the Commission to use deferral accounting to create a regulatory asset to recognize and offset the minimum pension liability the Company must record in accordance with Statement of Financial Accounting Standards (FAS) 87. The Company's financial reporting is governed by Generally Accepted Accounting Principles of which Financial Accounting Standards are a part. FAS 87 prescribes accrual accounting for the cost of defined benefit pension plans.

FAS 71 allows regulated companies to defer costs and create regulatory assets provided the regulatory agency grants authority for such a deferral. The regulator must be a third party regulator and the Company's rates must be based on cost. A regulatory asset may be recovered in the future through regulated rates.

The Commission has jurisdiction pursuant to Chapter 366, Florida Statutes.

Discussion of Issues

Issue 1: Should the Commission authorize Progress Energy Florida, Inc. to use deferral accounting and to create a regulatory asset as an offset to the Company's minimum pension liability?

Recommendation: Yes. The Commission should authorize Progress Energy to use deferral accounting and to create a regulatory asset as an offset to its minimum pension liability. Further, the Commission should find that the approval to record the regulatory asset for accounting purposes does not limit the Commission's ability to review the amounts for reasonableness in future rate proceedings. (Romig, Lester)

Staff Analysis: The Company accounts for pension costs in accordance with Financial Accounting Standard 87 (FAS 87). Under FAS 87, an actuarial study is undertaken to determine the accumulated pension benefit obligation (APBO). The APBO is the "earned" pension or the present value of the plan's accrued benefits, without pay projections, using the discount rate chosen for the year-end. If the value of the pension plan assets exceeds the APBO, no adjustment is recorded for financial reporting. However, if the value of the pension plan assets is less than the APBO, then the difference between the two is compared to the accrued pension cost and that difference must be recorded as an additional liability, the minimum pension liability. Absent Commission approval, the offset is to other comprehensive income, which reduces common equity.

The Commission has recognized FAS 87 for ratemaking purposes. In Progress Energy's 1992 rate case, in Order No. PSC-92-1197-FOF-EI, issued October 22, 1992, in Docket No. 910890-EI, <u>In Re: Petition for a rate increase by Florida Power Corporation</u>, the Commission stated that, "... we have decided to use FAS No. 87 to determine pension expense." Further, it states that,

> The purpose of FAS No. 87 is to accrue pension expense over the time employees earn benefits. While FPC will not make a cash contribution until 1993, the benefits earned by today's employees should be paid by today's ratepayers. Therefore, we shall use FAS No. 87 for ratemaking purposes. We approve FPC's request to set its pension expense at a level equal to the expense calculated for accounting purposes under the provisions of FAS No. 87.

As stated above, the minimum pension liability depends on how much the APBO exceeds the market value of the assets in the pension trust fund and the accrued pension cost recorded for financial reporting. Declines in long-term interest rates have resulted in lower discount rates, which cause a company's APBO to be higher. Further, the market value of plan assets fluctuates with stock and bond prices.

FAS 71 allows regulated companies to defer costs and create regulatory assets. To create a regulatory asset, a regulated company must have the approval of its regulator. This concept of deferral accounting allows companies to defer costs due to events beyond their control and seek recovery through rates at a later time. The alternative would be for the Company to seek a rate case each time it experiences an exogenous event. According to Progress Energy's petition, the minimum pension liability and the regulatory asset will be included in working capital for ratemaking and surveillance purposes. Since these offsetting amounts would cancel one another, the impact on ratepayers will be neutralized. Without the deferral, working capital, other comprehensive income, and common equity would be reduced.

As noted in Progress Energy's petition, the regulatory asset requested by the Company in this petition is unlike the Company's request in its 1992 rate case that the Commission denied on procedural grounds in Order No. PSC-92-1197-FOF-EI, issued October 22, 1992, in Docket No. 910890-EI, In Re: Petition for a rate increase by Florida Power Corporation. In that order, the Commission stated, that,

> We believe the regulatory asset and its amortization should be disallowed for ratemaking purposes. First, in order to record an asset or a liability under FAS No. 71, there must be an indication from us that the asset or liability will be recoverable. In this case, there was no such indication. It was inappropriate for FPC to use FAS No. 71 without our prior approval.
>
> Second, we do not believe pension expense should be "tracked." Pension expense will be run through earnings and will fluctuate. Earnings should be reviewed in aggregate with no true-up provision for certain expenses. If a true-up is allowed for one expense, it can easily be argued that all the expenses should be trued-up. Other expenses also change, but the change itself does not justify deferring the expenses. Utilities are given an opportunity to recover their costs, not a guarantee. If costs change, the entire cost to serve must be reevaluated. Individual changes in costs should not be deferred for future recovery in another case.

In this case, the requested regulatory asset does not attempt to recognize realized pension expense that has been deferred from prior periods, but rather seeks to neutralize for ratemaking purposes an unrealized future obligation that FAS 87 requires the Company to recognize for financial reporting purposes. The minimum pension liability and any related regulatory asset are not amortized over future periods. At each measurement date, Progress Energy will reverse the previous entry and repeat the computation. The Company will recognize a new minimum pension liability and related regulatory asset, if required.

For 2004, the Company will not know the amount of its minimum pension liability until it closes its books at the end of the year. The value of pension plan assets at the end of the year is used to determine the minimum pension liability.

Staff notes that the Federal Energy Regulatory Commission (FERC), through an accounting guideline, allows the creation of a regulatory asset as an offset to the minimum pension liability. The FERC guideline notes that a regulator can still review the amounts for reasonableness in future rate proceedings.

In summary, staff believes that the FAS 87 requirement to record a minimum pension liability when its pension trust fund becomes under-funded conflicts with the theory that the cost of employee pension benefits included in utility rates should be recognized as the benefits are earned by employees, gradually and systematically over their years of service. For this reason, staff recommends that the Commission authorize Progress Energy to use deferral accounting according to FAS 71 and to create a regulatory asset that will offset the minimum pension liability. Staff also recommends that the Commission find that the approval to record the regulatory asset for accounting purposes does not limit the Commission's ability to review the amounts for reasonableness in future rate proceedings.

Issue 2: Should this docket be closed?

Recommendation: Yes. If no person whose substantial interests are affected by the proposed agency action files a protest within 21 days of the issuance of the Order, this docket should be closed upon the issuance of a Consummating Order. (Vining)

Staff Analysis: If no person whose substantial interests are affected by the proposed agency action files a protest within 21 days of the issuance of the Order, this docket should be closed upon the issuance of a Consummating Order.