

Regulatory Framework of US Regulated Utilities

Central European University, Ms Finance, Capstone Project Summary

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By Benjamin Dug

Supervised by Prof. Peter Szilagyi

1. Executive summary

The project was designed to provide an updated brief overview of the current regulatory environment, industry trends, and accounting and financial principles of US Regulated Utility sector. Credit professionals, who are involved in rating the credit worthiness of the utility sector are in constant need for understanding the developments within the sector and within the regulatory framework on which the sector heavily depends on. This project will provide a general overview of the mentioned topics and will also try to clarify some accounting practices which are not best described in general financial statements, i.e. meaning of Regulatory assets. Information provided will serve current credit professionals as an update to their existing knowledge on new trends and developments, while on the other hand is intended to serve as a guide to fresh starting credit professionals.

This project emphasizes electric and gas industry, but principles are also applicable to the telecommunications, water, and wastewater industries.

2. Introduction

All industries have unique problems and practices that affect their accounting, though in certain industries the unusual features might be more obvious or more common than in other industries; such industries, including the public utility industry are frequently considered fields for specialists. The accounting practices of utility companies differ in many ways from those of other businesses; the use of systems of accounts prescribed by regulatory authorities is not the least of the differences. But it is worthy to note that the GAAP principles apply to regulated utilities as well, although their application may occasionally defer.

In the project write-up we did not deal extensively with solely accounting principles, rather we focused on the nonaccounting aspects of the industry as well. This project is intended to provide credit professionals with an updated overview of the industry trends, description, basic accounting principles, and latest regulatory framework developments.

The write-up is a document that can serve as a manual for credit professional containing a total of 20 pages. It is consisted of 4 main parts, foreword and appendices. The project write-up is delivered to a faculty supervisor, as well as to client alongside with the documents used as resource/reference in the work. The project is to remain for exclusive use of the client, with copyright entitlements on both the client and the author. This 3-page summary serves as a public project summary delivered to the CEU Library.

Now, we will briefly discuss the topic (industry) overview, project objectives, write-up contents, as well as outcomes.

3. *Topic (industry) overview*

Utilities are a class of business which is considered as “affected by public interest”, and as such is subject to regulation. It is worth noting that many businesses have similar characteristics, such as railways, and they are usually classified as public utilities. As such, in many jurisdictions it is desirable for them to operate as natural monopolies, which means they are obligated to charge fair, nondiscriminatory rates, and to serve the entire public on demand. Their benefit on the other hand, is that they are usually free from competition, and are permitted a fair ROI .

Public utilities include industries such as:

- Electric
- Gas
- Telephone
- Water and sewage

Other industries may also be considered as public utilities, but the service provided by them is usually not considered utility service when conducted under private contract or when packaged as a commodity for sale in the open market.

Regulation usually attempts to enhance benefits for the public, by providing with the benefits that would be achieved by competition (accessible pricing), and the efficiency of operation as a monopoly. It is important to note that regulation is fairly focusing on rate regulation as well which rests on the concepts of fairness and equity in avoidance of price discrimination.

4. *Objectives*

Given the complexity of the space, a detailed mechanics of the Regulatory Framework was required, to improve the general understanding of the field. Accounting practices allow companies to have a unified approach with financial reporting, as mostly US Regulated Utilities are publicly listed and report to SEC, but there is some complexity related to the industry. Namely the accounting complexity arises mostly out of firm-specific accounting practices which can lead to difficulties in understanding financial statements, and sometimes the unavailability of additional explanation on accounting principles can add to the complexity of dealing with the firm’s financials for credit experts.

Regulatory framework is quite diverse within the US, which requires effort to demistify, and to simplify. Regulation is mainly divided according to levels, Federal, State, and Local. This creates diversity within the framework for different companies in the sector in respect to their location of operations.

5. *Contents*

The project starts with a foreword giving a brief introduction on the topic in general, as well as on the project.

First section deals with utilities and their regulators. As we know utilities are a business of “public interest” and as such are subject to regulation. Many businesses have close similarities to utilities, such as i.e. railroads. Those businesses are usually classified as public utilities, and it is desired for them as such, in most jurisdictions, to operate as regulated monopolies. As regulated monopolies, they are required to charge fair, nondiscriminatory rates and to provide satisfactory level of service to the entire public upon request. In return, utilities are usually

experience very little to no direct competition, and are permitted, though not guaranteed, a fair ROI. Utilities have certain characteristics, which make them different from other businesses, which we will now describe briefly. Utilities are usually seen as natural monopolies, as they are capital intensive, and usually operate most efficiently as single service provider. They are regulated in order to assure adequate service and fair pricing, and also as they are necessary and single service provider regulation is justifiable, as to avoid customer exploitation.

Second section provides an overview of the accounting terminology and methods, specific for utility sector. Most utilities that are publicly listed, or publicly owned companies are subject to regulation on either state or federal level. Rate regulation, and revenue regulation would generally affect accounting, but regulatory commissions usually have direct accounting jurisdiction as well. Therefore, many utilities are subject to accounting regulation on a federal level, and since many utilities engage in financing, they are also subject to certain requirements of the SEC. This section also dealt with topics such as how to match costs and revenues in utilities, which charge cyclically; regulatory assets and liabilities, plant accounting, allowances for funds under construction, depreciation methods, and so on.

Third section deals with the latest developments in the utility sector. The main events that were highlighted and are seen as important for the sector in 2019 are:

- November 2017: Tax Cuts and Jobs Act
- July 2018: Moody's changes the US utility sector outlook to negative from stable for 2019
- November 2018: S&P Utility trends for 2019
- January 2019: PG&E declares bankruptcy

Fourth section is on utility finance. Utility plant construction has been historically financed using external resources, due to the amount of expenditures. Within the periods of heavy expenditures, for interim financing utilities use bank loans or commercial paper, while they use bonds and stocks to finance long-term, while they also sometimes utilize other nontraditional financing forms.

Appendices include a glossary of terms, examples of financial statements of utilities, and sources used.

6. Outcome

Main outcomes of the project are to get a comprehensive view on the regulatory framework concerning the US regulated utilities, provide an overview of the industry, current trends within the industry, and accounting and financial principles of US Regulated Utility sector. The project contains a written write-up, as previously explained, and a presentation.

7. Resources

- S&P Global Ratings Research
- Moody's Research
- Thomson Reuters Eikon
- Deloitte Center for Energy Research
- Investopedia

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