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METHODS OF DETERMINING ORIGINAL COST

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NOTE: This text is subject to editorial revision.

METHODS OF DETERMINING ORIGINAL COST 1/

One of the basic objectives of regulatory accounting is to assure utility service at just and reasonable rates. During the years before the Federal Power Commission obtained jurisdiction over utilities transmitting or selling electricity at wholesale in interstate commerce, too little attention was paid to accounting control. As a result the accounts of many utilities reached the stage where they were practically worthless as a guide for determining the rate base in the regulatory process. The Federal Trade Commission in its investigation authorized by Congressional Resolution on February 15, 1928, effectively disclosed the inflation in the accounts of operating as well as holding companies.

Prior to 1937 inflation of assets was so buried in the accounts of electric utilities that most persons, including regulatory commissions, were unaware of its extent. The accounts of many utilities were in poor condition. In some instances, practically all of the utility plant was included in a lump sum account. In other instances, purchases made many years before were carried in one account, the amount of which did not change from year to year.

In such cases the actual investments in departments of the utility, such as gas, electric, street railways, water, etc., could not be ascertained. Further breakdown of the investment by electric department functions in connection with generation, transmission and distribution was, of course, out of the question. In still other instances, where a breakdown of the investment appeared to be available, it was found that the breakdown was nothing more than the result of an appraisal by the

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1/ Paper prepared for Latin American Electric Power Seminar by Gordon F. Heim, Power Utilities Accountant, Federal Power Commission. The Federal Power Commission, as a matter of policy, disclaims responsibility for material published unofficially by any of its employees. The views expressed herein are those of the author and not necessarily those of the Commission.

company based on reproduction cost. Fixed-asset values in dozens of cases investigated were found to be based on the par or stated amount of capital stock which was always greatly in excess of cost, or else the property values had been increased on the basis of engineering appraisals with resultant surpluses absorbed by stock dividends. Many holding companies had bought up independents, often ending with cash purchases of fixed assets amounting to several times their cost.

In its report to the Congress, following a five-year investigation, the Federal Trade Commission recommended drastic remedies and the establishment of a federal agency to cope with the problem, with broad powers to fix a basis of accounting for that portion of the industry doing an interstate business. The Congress followed the recommendation, and the Federal Power Act of 1935 and the Public Utility Holding Company Act of 1935 were the consequences. Since 1935 the Federal Power Commission has been charged with the responsibility of untangling and recasting the industry's valuations and valuation methods, and of establishing a simpler basis for accounting, reporting and rate-making.

The Federal Power Act of 1935 authorized the Commission to prescribe a Uniform System of Accounts for Public Utilities and Licensees. The system of accounts was adopted by the Commission, effective January 1, 1937, after conferences and hearings at which state regulatory bodies and industry were represented.

Insofar as original cost is concerned, the Uniform System of Accounts established an important criterion in requiring the reclassification and segregation of the property accounts into two main subdivisions. The amounts representing the original cost of the property when first devoted to public service were to be accounted for separately in detail plant accounts under Account 100.1, Electric Plant in Service, and amounts not representing the original cost of property, such as write-ups and payments for property in excess of original cost, were to be classified in two special accounts. Amounts in excess of cost to the accounting utility were required to be classified in Account 107, Electric Plant Adjustments, while amounts representing excess of the company's acquisition cost over cost to the company which first devoted the property to public service were classified in Account 100.5, Electric Plant Acquisition Adjustments.

In order to establish a starting point, Electric Plant Instruction 2, Classification of Electric Plant at Effective Date of System of Accounts, paragraph (D) required that:

> Not later than 2 years after the effective date of this system of accounts, each utility shall have completed the studies necessary for classifying its electric plant as of the effective date of this system of accounts in accordance with the accounts prescribed herein and it shall submit to the Commission the entries it proposes to make to carry out the provisions of this instruction. It shall submit also a comparative balance sheet showing the accounts and amounts appearing in its books as of the effective date of this system of accounts and the accounts and respective amounts as of the same date after the proposed entries shall have been made.

The Commission, by order dated May 11, 1937, in connection with the above instruction, required each electric utility company to compile statements A to I, inclusive, as follows:

Statement A - To show the origin and development of the utility.

Statement B - To show for each property acquisition, the book recorded amount, the cost to company, the original cost of the property, and other related matters, such as depreciation and amortization reserves, etc.

Statement C - To show the amounts arrived at by appraisals.

Statement D - To show electric plant as of December 31, 1936, as classified in the books immediately prior to reclassification.

Statement E - A summary of adjustments included in Accounts 100.5, Electric Plant Acquisition Adjustments, and 107, Electric Plant Adjustments.

Statement F - To show electric plant as of December 31, 1936, as reclassified.

Statement G - To show a comparative balance sheet as of January 1, 1937, before and after reclassification.

Statement H - A suggested plan for disposing of items and amounts included in Account 100.5, Electric Plant Acquisition Adjustments, and in Account 107, Electric Plant Adjustments.

Statement I - A statistical summary to show certain data for each steam, hydraulic and internal combustion production plant, and certain data for transmission, distribution and general plant.

When such reports were filed by utilities pursuant to the aforementioned requirements, they were subjected to an office review to see that they were acceptable for filing. Thereafter, the vertification of these reports to the company's books was assigned to a field party of accountants and engineers. The accountants did not make a detailed voucher audit of all charges to the plant accounts, but attempted to locate any improper items by test-checks of representative periods, by scrutinizing the items of substantial size, and by examining the account balances before and after property was transferred between companies. The engineers checked the estimates of original cost where records of actual original cost were not available. The engineer also tested the reasonableness of purported recorded original costs by means of the known range of unit costs of each class of property.

Upon the conclusion of the field investigations conferences were usually held between the utility's representatives and the Chief Accountant and the principal staff members engaged on the assignment for the purpose of arriving at the agreed original cost and related adjustments. In most instances the conferences resulted in agreement as to the proper reclassification of plant costs and the segregation and accounting disposition of the amounts in excess of original cost. Following the conferences the company prepared and submitted a revised original cost study and proposed journal entries to record the elimination of the write-ups and other improper items. When this revised report was received, it was again reviewed by the field supervisor or a headquarters' staff member and a memorandum report of recommendations, after approval of the Chief Accountant, was prepared and forwarded to the Commission for approval by formal order. In those instances where complete agreement was not reached with the utility's representatives, a staff report was prepared and served upon the utility. After a response was filed by the utility, the established procedure was for the case to be set for hearing. At the hearing, both the utility and Commission's staff presented evidence, both written and oral.

It is important at this point to call attention to the fact that out of approximately 300 electric utilities which filed original cost studies, informal agreement was reached between staff and company representatives in all but 12 cases. Of the 12 cases that required formal hearings 9 of the companies accepted the Commission determination. In the remaining 3 cases which were subjected to court review, the Commission's orders were all upheld. These three cases are discussed later in this paper.

The Commission's orders dealing with accounting dispositions arising in connection with original cost reclassification matters have provided generally that inflationary amounts (Account 107 items) be written off immediately, on the theory that items of this character have no place in a utility's accounts. With respect to legitimate excess over original cost (Account 100.5 items) which arose through property acquisitions made at arm's-length, studies made by the Commission's staff to determine the nature of such amounts have usually indicated them to be intangibles, representing purchase of earning power, franchise, and similar items. The Commission's orders dealing with the latter class of items have recognized that intangibles are certainly no more significant than tangible physical property, and should not be held in the accounts in perpetuity; hence a period of years not to exceed 15 has usually been granted for such disposition.

The right of the Federal Power Commission to require the charging off of a write-up of plant was subsequently upheld by the Supreme Court in the Northwestern Electric Company case (321 U. S. 119). In the California Oregon Power Company case (150 F. (2d) 25, cert. den. 326 U.S. 781), the authority of the Commission to require the amortization of amounts paid in excess of original cost through property acquisitions made at arm's-length over 30 years prior to examination by the staff but being buried in the plant account without being depreciated or amortized, was affirmed when the Supreme Court refused to grant certiorari upon appeal from the lower court decision upholding the Federal Power Commission. In the Arkansas Power & Light Company case (185 F. 2d 751, cert. den. 341 U.S. 909), the court affirmed the Commission's paramount authority over the accounts of public utilities and licensees.

The importance of sound financial structures both to the utility and the public is manifest. Experience has shown in numerous cases that completion of the original cost reclassification by a utility is followed immediately by refinancing of its bonds and preferred stock at extremely attractive money rates because investors have the assurance that the securities to be sold are supported by sound property values. The utility reaps the advantage of such lower money costs and at least a portion of this saving is often passed on to the public in the form of rate reductions.

Under the Commission's original cost program, as of June 30, 1960, reclassification and original cost studies had been filed by 337 electric utilities and licensees, setting forth claimed original cost of electric plant in the amount of $8,926,741,374 and excess recorded cost over original cost in the amount of $854,786,488 classified in plant adjustment accounts. At the end of June 1960, the accounting staff had completed field examinations or office reviews of 295 of the filed studies; 25 studies will not be examined since Commission jurisdiction over the companies involved had been terminated due to sales of electric properties, mergers, and other reasons; 17 filed studies remain to be examined by the staff.

The office and field examinations of the 295 original cost studies completed to June 30, 1960, resulted in the reduction of the original cost of utility plant claimed by the companies from $7,397,513,349 to $6,795,015,214, and a corresponding increase in the excess of recorded cost over original cost from $1,021,287,221 to $1,623,785,356.

Formal orders and other actions of the Commission to June 30, 1960, regarding 300 companies, authorized the disposition or writing off of amounts classified as plant adjustments that aggregated $1,630,447,615. This amount included $519,129,593 representing the excess of bona fide cost over original cost of utility plant acquired through purchase, merger, etc., which has been disposed of either by immediate charges to earned surplus or amortized over periods that have varied from 3 to 15 years by charges to an income account. The remaining $1,111,318,022 was classified in plant adjustments accounts that represented write-ups and other inflationary items which have been disposed of by charges to earned or capital surplus and reserve accounts as appropriate.

While not included in this paper, the original cost program for natural gas utilities, subject to the Commission's jurisdiction, has involved the same basic types of adjustments and problems of disposal of adjustments as for electric utilities.