BIENNIAL REPORT OF MAJOR UTILITIES
COMPLIANCE AUDIT ISSUES

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Penelec GPU
Robert J. Vodzack

Coopers & Lybrand
Michael E. Barrett

Sponsoring Organization

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<tr>
<th>EDISON ELECTRIC INSTITUTE</th>
<th>Year of Report</th>
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<tr>
<td>AMERICAN GAS ASSOCIATION</td>
<td>May 1992</td>
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FERC SURVEY (REVISED 5-92)
PREPARED FOR AGA/EEI
CORPORATE ACCOUNTING COMMITTEE

AND

PLANT ACCOUNTING COMMITTEE

SURVEY OF FERC COMPLIANCE AUDIT ISSUES

Presented by:
Robert J. Vodzack
Pennsylvania Electric Co.

Michael E. Barrett
Coopers & Lybrand

May 1992 Edition

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This report, extracted from FERC Compliance Audits for the period 1981-1990, represents the opinions of the authors in its format and content. It does not have the specific endorsement of The Edison Electric Institute, American Gas Association or its committees. The thoughts, viewpoints and positions expressed herein are not necessarily those of the AGA, EEI, or any of their member companies.
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This is the fifth update of the Survey of FERC Compliance Audit Issues. This updated survey contains a compilation of audit findings from the most recent Federal Energy Regulatory Commission (FERC) audits of public utilities, licenses and natural gas companies. The report includes the FERC audit recommendations and findings for the period 1981 through 1990.

This survey incorporates selected audit findings from approximately 250 FERC final Audit Letter Directives issued for that period. Exit Conference Memorandum are not included in the report. The audit findings and recommendations from audits prior to 1980 were eliminated from this report. There are approximately 650 findings and recommendations for the period 1981-1990 included in this survey.

The survey is intended to serve the following purposes:

(1) Educational tool and training aid for Company's accounting staff.

(2) Source of interpretation of the Uniform System of Accounts.

(3) Guide to FERC policy, practice and position on certain issues.

(4) Guide to formulating internal accounting policy.

(5) Eliminate (reduce) surprise audit findings.

(6) Reference of acceptable and non-acceptable industry practices and FERC policy on these accounting issues.

This report has been structured by listing each finding in the subject area where the Company had recorded the improper accounting for the transaction, not in the areas where the entries should have been recorded. Central references are being maintained for each finding in the event a specific issue needs additional research. If you find contact with a Company where a particular issue was made would be beneficial, please contact us and we will assist in establishing contact. Company names and any other geographic references have been eliminated.

All findings have been presented in appropriate groupings without regard to the particular disposition of the audit findings -- that is, compliance exceptions and/or accounting adjustments. We feel this grouping is more appropriate because the disposition of similar audit findings may vary due to particular circumstances. It is important to reiterate that the primary intent of listing these findings is to highlight areas where FERC auditors will be focusing their audit efforts.

In the survey, each audit finding has been edited to eliminate any reference to the Company. The finding includes each of the following elements:

(1) Statement(s) describing the Company's existing accounting procedure.

(2) Statement(s) explaining the accounting deficiency.
(3) Accounting reference to the particular US of A requirements, generally accepted accounting principles or good internal control procedures, as appropriate.

(4) Statement(s) setting forth the FERC's recommendation(s) for corrective action.

A Simplified example of this is as follows:

<table>
<thead>
<tr>
<th>Description of Accounting</th>
<th>A review disclosed that a full year's property taxes were capitalized on projects undergoing construction on the property tax assessment date. Property taxes assessed on January 1st were applicable to the taxing authorities' fiscal year which began with that January 1st. Property taxes were recorded when paid.</th>
</tr>
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<tr>
<td>Description of Deficiency</td>
<td>Electric Plant Instruction 3(16) provides that property taxes are properly includible in construction costs only during the period of construction. No property taxes are capitalizable once the facilities become available for service. Additionally, accrual of the property tax liability over the fiscal year of the taxing authority, rather than when paid, is the preferred and generally accepted accounting practice.</td>
</tr>
<tr>
<td>Recommendation/Approval</td>
<td>The Company was required to institute procedures for the accrual of property taxes over the fiscal year of the taxing authority, and for the capitalization of only those property taxes applicable to periods of construction.</td>
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If additional copies of this survey are required, please contact R. Vodzack or M. Barrett at the following addresses:

Robert Vodzack
Pennsylvania Electric Company
1001 Broad Street
Johnstown, PA 15907
(814) 533-8207

Michael Barrett
Coopers & Lybrand
Suite 1500
101 East Kennedy Blvd.
Tampa, FL 33602
(813) 229-0221
CHAPTER 1

UTILITY PLANT ACCOUNTING

ADDITIONS/RETIREMENTS

Erosion Study Costs Improperly Capitalized

The Company capitalized in Account 332, Reservoirs, Dams and Waterways, the costs of performing an engineering study to determine the effects the operation of a pumped storage plant had on the erosion of the lake shoreline. The six pumped storage units were placed in service. No construction project or activity resulted from this study, but rather, the study was used to establish the facts about shoreline erosion.

The text of Account 537, Hydraulic Expenses, states this account shall include costs incurred in operating hydraulic works including reservoirs, dams, waterways and in activities directly relating to hydroelectric development outside the generating station.

The Company was required to record an entry to reduce electric plant for the improper capitalization of an erosion study.

Capitalization of Tube Inspections

Costs incurred relating to tube inspections and tests were capitalized on the work order for the replacement of the condenser tubes.

These costs should have been expensed since the project was already in service, based on Operating Expense Instruction No. 2 of the Uniform System of Accounts.

The Company was required to make an entry to expense the amounts incurred for condenser tube inspections which were capitalized.
Additions/Retirements

Accounting for Ice Damage

A cooling tower sustained damages from the weight of accumulated ice. After
the first winter's damages, the company installed temporary wooden louvers and
after the second winter replaced these with concrete louvers. The costs of
installing both the wooden and the concrete louvers were capitalized, as were
the costs of replacing the other parts listed above.

Per the company's listing of retirement units, all of the above parts were
minor units of property. In order to be in compliance with Electric Plant
Instruction No. 10 of the Uniform System of Accounts, these costs should have
been expensed.

The Company recorded an entry to remove from utility plant the cost of ice
damage repairs made at the cooling tower and reverse the AFUDC.

Unrecorded Retirements

The original cost of electric utility properties removed from service which
were not included in the Company's continuing property records as individual
items were based on estimates using certain vintaging and back trending
techniques.

The Company did not record a retirement for these properties until it
completed the estimating process. There were instances where the cost of
property was removed from service but not retired for accounting purposes and
often remained in Account 101, Electric Plant in Service, well over a year
after related replacements were closed to plant in service.

In the future, the Company was required to record estimated retirements on a
timely basis so that Account 101 is not overstated. There were only
insignificant amounts found to represent unrecorded retirements during the
audit period.

Spare Equipment Included in the Electric Plant Accounts

A listing of spare equipment recorded in Account 101, Electric Plant in
Service, identified numerous items which were purchased 25 or more years ago.
The Company did not have a formal inventory control procedure requiring
periodic review to determine the usefulness of spare equipment capitalized.

The staff recommended the Company perform a review of its capitalized spare
equipment and record the proper correcting entry to retire any lost or
obsolete items. The review should be updated periodically to ensure that only
the cost of spare equipment which can be used in utility service is included
in electric plant in service in the future.
UTILITY PLANT ACCOUNTING

Additions/Retirements

Improper Betterment Accounting

The Company accounted for the upgrading of two induced draft fan wheels by capitalizing the difference between the replacement cost of the fan wheels and the original cost of the fan wheels replaced.

During the installation of a substation for the purpose of increasing its capacity, the Company replaced the reconductor portion of a 120KV bus. The Company capitalized the entire cost of replacing this minor item of property.

Electric plant instruction 10C(3) states that when replacement of a minor item of depreciable property effects a substantial betterment, the excess cost of the replacement over the estimated cost at current prices of replacing without betterment shall be charged to the appropriate electric plant account.

The Company was required to record a journal entry to expense the replacement of minor items of property accounted for as a betterment.

Unrecorded Retirements

In 1973 the Company converted Power Station from coal to oil in order to meet EPA requirements. As a result of this conversion the coal related facilities were taken out of service. However, no retirements were made as the Company considered these facilities to be standby equipment to be used in the event of an oil shortage or if it was ordered to convert Power Station from oil back to coal.

The Staff is of the opinion that these coal handling facilities should be retired and charged to 108, Accumulated Provision for Depreciation of Electric Plant in Service.

The Company was required to record an entry to retire the coal handling facilities at Power Station.
Additions/Retirements

Accounting for Retirements

In certain instances, the Company used estimates to determine the original cost of plant retired because of changes in retirement units. The estimates were made by indexing current direct material costs back to the year the unit was placed in service. No other components of construction cost were included in this calculation, resulting in an understatement of the retirements.

Electric Plant Instruction No. 10D provides that the book cost of electric plant retired shall be the amount at which such property is included in the electric plant accounts, including all components of construction cost.

The Company was required to revise its procedures to ensure the entire original cost, as recorded in the electric plant accounts, is removed upon retirement and record an entry to correct the retirements associated with the retubing projects.

Cost Recorded for Replacement of ID Fan Rotors and Motors

ID fan rotors and motors were replaced, under warranty, to obtain the designed performance of the Unit's boiler. Based on the warranty agreement, the Company incurred 25% of the cost for the replacement rotors and motors. This amount was capitalized in Account 101, Electric Plant in Service. In addition, to record an estimated full value of the equipment received, the Company credited salvage and debited Account 101 for an amount which represented the original installed cost of the old rotors and motors.

The Uniform System of Accounts, Electric Plant Instruction No. 2A, states all electric plant shall be included in the accounts at the cost incurred by the utility. Cost is defined as the amount of money actually paid for property or services.

The Company was required to record an adjustment to properly reflect the actual costs incurred for the new ID fan rotors and motors.
Additions/Retirements

Inactive Generating Units Recorded in Account No. 101

The Company had 4 inactive oil fired generating units in Account No. 101 - Electric Plant in Service. The Company has discontinued the depreciation of these units, in accordance with a State Commission Order.

The units are being held in-service because their capacity may be needed should there be any delays in the completion of the New Unit No. 1, which is currently expected to go into service in 1986.

The Company has been performing a minor amount of maintenance on the inactive units and has stated that the units could be placed back in operation in a period of 6 to 18 months.

The inactive units are not properly recorded in Account No. 101 as they are not in service. Most of the units have not generated any power since prior to 1979.

According to USA requirements, the units should be recorded in Account No. 105 -Electric Plant Held for Future Use.

The Company was required to record an entry to remove the cost of four inactive generating units from the utility plant accounts.

Inadequate Support for Standard Installation Costs of Line Transformers and Meters

The Company used standard costs to capitalize the installation costs of distribution line transformers and meters. These standard costs were developed by averaging estimates of installation costs furnished by the Company's district electric operating engineers via a questionnaire in 1975. The Company's accounting is such that neither the staff nor the Company can determine the appropriateness of these standard costs, although they are adjusted annually for estimated increases in costs.

The Company was required to undertake a study to determine and document the level of the standard costs used to capitalize installation costs of distribution line transformers and meters. The study will be reviewed and revised annually so that these standard costs represent, as nearly as possible, the actual installation costs incurred.
Timely Retirements of Replaced Utility Property

The Company transfers construction work orders to Account 101, Electric Plant in Service, as unclassified plant in service when the facilities are placed in service. The plant is later unitized within Account 101; however, it is not until this time that the retirement of the replaced property is recorded.

Company procedures state that property taken out of service must be reported immediately upon being shut down or taken out of service. Retirement entries for each unit of property are subsequently prepared crediting the appropriate plant account for the item taken out of service.

The Company was required to implement corrective action to ensure more timely retirements of utility property no longer used or useful in utility operations.

Spare Equipment

The Company's Natural Gas Division had a total of $12,336,460 of spare equipment recorded in Account 101, Gas Plant in Service, and Account 106, Completed Construction Not Classified-Gas. Staff's review of the spare equipment disclosed many items which appeared to be subject to use as normal periodic replacements.

NARUC Interpretation No. 50 provides that spare parts which are subject to use as normal periodic replacement should be recorded in Account 154, Plant Materials and Operating Supplies. However, it is permissible to record in the related plant accounts the cost of spare parts which are essential for emergency needs, are associated with specific plant in-service, and are not subject to use as normal periodic replacements.

The Company was required to analyze its accounting for spare equipment, make appropriate adjustments to reclassify those items not meeting the criteria set forth in NARUC Interpretation No. 50, and report the particulars to the Chief Accountant.
Additions/Retirements

Assets and Expenses Not Used in Electric Service

The Company recorded in Account 101, Electric Plant in Service, $5,604,000 (exclusive of land and land rights) representing the cost of a switching station and fuel storage facilities. The plant has been shut down for a number of years as a result of air pollution problems. The Company does not have an operating permit to run the plant nor are any future plans being made to obtain a permit to run the facility. The Company is actively engaged in trying to find a buyer for the turbines. The Public Utility Commission has disallowed rate base and cost of service treatment for the facility in all rate filings.

The text of Account 121, Nonutility Property, states, "this account shall include the book cost of land, structures, equipment or other tangible or intangible property owned by the utility, but not used in utility service." In addition, the text of Account 418, Nonoperating Rental Income, states, this account shall include expenses of property included in Account 121.

The Company was required to record an entry to reclassify property, plant and equipment not used and useful in electric utility service to nonutility property, and, in the future, account for the expenses of this property in Account 418.

Accounting Classification of Unused Compressor Stations

From 1984 to 1987, the Company classified the original cost of the idle stations in Account 101, Gas Plant In Service. Jurisdictional gas plant facilities that are no longer providing utility service should not be classified as utility plant in service.

According to the Company, on file with the Commission is a CP Docket that will necessitate the use of two of the four stations. However, at this time, no approval has been received. The remaining two stations will be utilized at the completion of a joint project. We consider the appropriate accounting classification to be Account 105, Gas Plant Held for Future Use.

The Company was required to:

(1) perform an analysis to properly segregate the accumulated provision for depreciation related to the four projects.

(2) record a Correcting Entry to reclassify the unused compressor stations to the proper account.
Accounting for Nuclear Plant Education Center Expenditures After In-Service Date

The Company has a 4.05985 percent ownership interest in the Project. The owners constructed the education center for the purpose of improving the general public's knowledge and awareness of electric energy concepts through nuclear, solar, fusion, geothermal and magnetohydrodynamics displays. The Education center was placed in service on December 31, 1978 by the operator of the Project.

At December 31, 1985, the Company has recorded its share of the education center cost in Account 107, Construction Work in Progress--Electric. The Company continued to accrue AFUDC on the cost from January 1, 1979 through December 31, 1985. The Company also capitalized its share of the cost of operating the facility during the same period.

Electric Plant Instruction (EPI) No. 3, Components of Construction Cost, provides specific instructions on how to treat a part of a project placed in operation where the construction work as a whole is incomplete. EPI No. 3 states in part:

Note: When only a part of a plant or project is placed in operation or is completed and ready for service but the construction work as a whole is incomplete, that part of the cost of the property placed in operation or ready for service, shall be treated as "Electric Plant in Service" and allowance for funds used during construction thereon as a charge to construction shall cease....

Although the Project was still under construction as of December 31, 1978, the construction of the education center was completed and the center was performing its intended function. Therefore, the expenditures applicable to the education center were not properly classified in Account 107 after that date.

The Company should have reclassified its share of the cost of the education center from Account 107 to Account 101, Electric Plant In Service, when the facility was completed and ready for service, and ceased capitalizing AFUDC. Also, the Company should have charged the expenses of operating the facility subsequent to the in-service date of the education center in the appropriate operating expense accounts.

We recommend that the Company revise procedures to ensure future compliance with the requirements of Electric Plant Instruction No. 3.
Accounting for Costs of a Suspended Construction Project

Unit No. 2 is owned by the Company and others. The owners decreased construction activities at Unit No. 2 in order to concentrate efforts to complete construction of Unit No. 1 and common facilities on line. The owners halted construction on Unit No. 2 in order to concentrate on Unit No. 1 and to allow the companies to review alternatives for completing the second unit.

At December 31, 1988, the Company recorded its share of Unit No. 2 construction costs in Account 107. The instructions to Account 107, Construction Work in Progress-Electric, state in part:

A. This account shall include the total of the balances of work orders for electric plant in process of construction . . .  
[emphasis added]

The instructions to Account 105, Electric Plant Held for Future Use, state in part:

A. This account shall include the original cost of electric plant . . . owned and held for future use in electric service . . .

Since the owners suspended construction of the unit, the Company had incorrectly classified the costs of Unit No. 2 in Account 107 as construction work in progress. Instead, the Company should have recorded the costs of the unit in Account 105, pending a determination as to how to proceed on completing the unit.

It was recommended that the Company:

(1) revise its procedures to ensure that the costs of suspended or delayed construction projects are properly classified consistent with the requirements of the Uniform System of Accounts; and

(2) record an entry to reclassify the costs of Unit No. 2 from Account 107 to Account 105.
Retirement Units

Maintenance of Units of Property List

Although the Company stated that it used the list of property units prescribed by the FERC in CFR Title 18, Part 116, staff notes several instances in which the Company's retirements were based upon smaller units of property than those specified by the FERC. The Company did not maintain a listing of the units of property actually used when recording additions and retirements of electric plant.

A list of property units is an essential tool in accounting for additions and retirements of electric plant. If not maintained, the designation of an item as a property unit would depend solely on the discretion of the person unitizing the plant property, possibly resulting in inconsistencies. (Reference Electric Plant Instruction No. 10.)

The Company was required to compile, utilize and maintain a list of property units to be used in accounting for additions and retirements of electric plant as required by Electric Plant Instruction No. 10.

Non-Compliance with Commission Requirements Concerning Units of Property

The following inadequacies were noted during a review of the property records:

1. A turbine and generator were combined into one unit of property - "a turbogenerator." Part 116, Subchapter C of the Federal Power Act indicates that a utility can expand but not condense units of property listed in Part 116. Designating a unit of property as a "turbogenerator" is a condensation of units.

2. For several plant accounts a property unit entitled "Any similar item not included above, or a substantial portion of a large unit" was established. Maintaining such designation of a unit of property is an internal control weakness that would permit inconsistency of accounting treatment for similar items. In addition, it would allow an item that is recorded as a minor item of property to be later accounted for as a retirement unit.

The Company was required to adjust its property records to conform with the property units required by Part 116 and that all non-specific items be removed from the Company's "Units of Property" list.
Improper Capitalization of Minor Items of Property

The Company capitalized the cost of replacing minor items of property which it considered to be systems or extensive components of retirement units.

Electric Plant Instruction No. 10C(3) states that when a minor item of depreciation property is replaced independently of the retirement unit of which it is a part, the cost of replacement shall be charged to the maintenance account appropriate for the item.

It was the Company's view that it could treat "systems" or extensive components as retirement units if it so chose. However, the staff noted that the Company's list of retirement units had not been revised to delineate these items as retirement units.

The Company was required to expand its list of retirement units noting those systems or major components which it chooses to account for as retirement units.

Amounts overcapitalized as a result of the Company's procedure were not significant enough as to warrant adjustment of the plant accounts.

Accounting for Work Orders on Line Transformers

The Company accounted for the costs accumulated in line transformer work orders as follows:

(1) The cost of the original transformer was retired and the repair costs were accumulated in a work order.

(2) If the repair costs exceeded 60% of the original cost of the transformer, the repair costs were capitalized as the new original cost of the transformer.

(3) If the repair costs were less than 60% of the original cost of the transformer, the repair costs were expensed and the old original cost retired was recapitalized.

The text of Electric Plant Instruction No. 10C(3) require that when a minor item of property is replaced independently of the retirement unit of which it was part, the cost of the replacement shall be charged to the appropriate maintenance expense account. (Reference also: Operating Expense Instruction 2C(3) and 2C(8).) The Company's procedure for determining whether or not to capitalize the costs accumulated in line transformer work orders was not consistent with the above referenced instructions to the Uniform System of Accounts.

The Company was required to conform its procedures for capitalizing the costs of line transformer work orders to the Uniform System of Accounts in the future.
Retirement Units

Capitalization of Minor Items of Property

The Company's written capital vs. expense policy stated that "a minor item of property is a part, piece, section or portion of the retirement unit with which it is associated... The replacement of a group of minor items within a retirement unit when performed during a specific work program may result in a retirement and addition of the retirement unit. Note - For the purposes of the policy, a replacement of this nature will be considered as a retirement and addition when the sum cost of the minor items exceed 50% of the present day value of the retirement unit."

Electric Plant Instruction 10C(3) of the Uniform System of Accounts states that when a minor item of depreciable property is replaced independently of the retirement unit of which it is a part, the cost of the replacement shall be charged to the maintenance account appropriate for the item, except that if the replacement effects a substantial betterment, the primary aim of which is to make the property affected more useful, more efficient, of greater durability, or of greater capacity.

The Company's policy of a minor item of depreciable property being a retirement and addition when the sum cost of the minor item exceed 50% of the present day value of the retirement unit was not in accordance with section 10C(3). The Company was required to review its policy for the replacement of minor items of property specifically addressing the appropriateness of the 50% test.

Noncompliance with Commission's List of Retirement Units

The Company's Gas Plant Unit Catalog defined the retirement unit for meter station piping as "eighty (80) or more continuous lineal feet of piping." This retirement unit designation was used for meter station piping costs classified in Account 334, Field Measuring and Regulating Station Equipment, Account 355, Measuring and Regulating Equipment, and Account 369, Measuring and Regulating Station Equipment.

The List of Retirement Units included under Part 216 of the Code of Federal Regulations defines a retirement unit for meter station piping recorded in Account 334, 355 and 369 to be "a run of any system 6 inches or over in size with or without valves, between two or more units of property and/or a header." Instruction No. 2 of Part 216 states, "The lists of units may be expanded by any utility without other authorization from the Commission, but the list shall not be condensed."

The Company was required to revise its Gas Plant Unit Catalog for meter station piping recorded in Accounts 334, 355 and 369 to conform with the retirement unit prescribed under part 216 of the Commission's regulations.
Retirement Units

Maintaining Units of Property Lists

Staff review of construction work orders disclosed several authorizations for the replacement of minor items of property based on FERC's units of property. The company claimed, but was unable to provide documentation, that it had expanded the Commission's Units of Property for use in accounting for additions to and retirements of utility plant.

Gas Plant Instruction No. 10 states that "...when a minor item of depreciable property is replaced independently of the retirement unit of which it is a part, the cost of the replacement shall be charged to the maintenance account for the item..."

The creation of retirement units beyond those provided by the Commission must be documented, maintained and utilized in conjunction with Gas Plant Instruction No. 10. The company was required to record an entry to correct the accounting for retirement and replacement of minor units of property.

Improper Accounting for Replacement of a Minor Item of Property

A rupture occurred in a 36-inch loop line which, in turn, damaged a 30-inch main line. As a result of the damage to the 30-inch line, the company replace 78 feet of pipe. The company accounted for the replacement of the 78 feet of 30-inch main line as if it were a replacement of a retirement unit (e.g., a plant retirement and a plant addition).

For the purposes of unitizing the original cost of transmission pipe recorded in Account 367, Mains, the company defined a retirement unit to be "eighty (80) or more continuous lineal feet of piping." As a replacement of the 78 feet of 30-inch pipe did not constitute a replacement of a retirement unit, the company's accounting for the replacement was improper.

Gas Plant Instruction No. 10, Paragraph C, states, "When a minor item of depreciable property is replaced independently of the retirement unit of which it is a part, the cost of the replacement shall be charged to the maintenance account appropriate for the item."

In the future, the company was required to comply with the requirements of Gas Plant Instruction No. 10, Paragraph C, in accounting for replacements of minor items for property. Amounts involved were not significant enough as to warrant an adjustment of the plant accounts.
Retirement Units

Accounting Classification for Sleevng Project Costs

The Company modified a portion of the steam generator tubes at the Nuclear Generating Station to correct a corrosion problem. The Company added a "sleeve" within 6,500 of the steam generator tubes. This represented about 57% of the total number of tubes within the steam generators and 93% of the tubes for which sleeving was possible. The Company included the cost of the sleeving project in Account 107 (Construction Work in Progress–Electric) and subsequently transferred the cost to Account 101 (Electric Plant in Service). The work did not result in a substantial addition by extending the useful life, operating capacity or efficiency of the steam generator.

Electric Plant Instruction No. 10C(1), states, "When a minor item of property which did not previously exist is added to plant, the cost thereof shall be accounted for in the same manner as for the addition of a retirement unit, as set forth in Electric Plant Instruction No. 10(B)(1), above, if a substantial addition results, otherwise the charge will be to the appropriate maintenance expense account." Operating Expense Instruction No. 2, Item 3, states that the cost of maintenance includes, "Work performed specifically for the purpose of preventing failure, restoring serviceability or maintaining the life of the plant."

The Company was required to record an entry to reclassify the unamortized project costs to Account 186 in accordance with the August 24, 1986 Letter Order.

Condensation of FERC List of Retirement Units

Staff's review of the Company's property unit catalog disclosed condensations of the FERC's prescribed list of retirement units.

The FERC's Rules and Regulations, Subchapter C, Part 116, provides a list of retirement units to be utilized by public utilities and licensees. Instruction No. 2 to part 116 states that, "the list of units may be expanded by any utility without other authorization from this Commission, but it shall not be condensed.

The Company was required to review its property unit catalog and continuing property records in order to make the necessary revisions to assure compliance with the retirement unit list prescribed by the Commission.
Construction Overheads

Administrative and General Salaries Allocated to Construction

Administrative and general salaries of various operating departments were allocated to construction overheads based on the ratio of direct construction labor to total labor, less certain exclusions.

This method is contrary to the provision of Electric Plant Instruction No. 48 and NARUC Interpretation No. 60, which states that as far as practicable, the determination of payroll charges includable in construction shall be based on time card distributions thereof. Where this procedure is impractical, special studies shall be made periodically of the time of employees devoted to construction activities to the end that only such overhead costs as have a definite relationship to construction shall be capitalized.

In the future the Company was required to allocate administrative and general salaries to construction on the basis of the above cited requirements.

Allocation of Overhead Charges to Construction Work in Progress

Construction overhead and indirect charges are accumulated in certain work orders and are allocated to completed construction work orders on a dollar basis without consideration of the time needed to construct the facility.

For example: A work order which accumulated one million dollars over a six-month period would have the same amount of overheads allocated to it as would a work order which accumulated the same amount of dollars over a two-year period.

The Company was required to develop a new computer program to allocate overhead to construction work orders on a monthly basis.

It should be noted that in the last staff audit the staff and Company personnel spent considerable time reconciling and disposing of the costs which were allowed to accumulate and did not have a relationship to the then current construction program. Positive action should be taken immediately to preclude this from re-occuring.

(11-7581-83FR)

General and Administrative Expenses Charged to Construction

The Company allocates general and administrative expenses to construction projects with the exception of one project at a five (5) per cent rate which was not based on studies performed to determine the amounts of overhead properly chargeable to construction.

The Company was required to perform studies to support the allocation of overhead charges to construction as required by Electric Plant Instruction No. 4.
Support for Overheads Capitalized

The Company used an administrative and general time study to determine the amount of administrative and general expense to be capitalized as a construction overhead. Examination of the time study disclosed the following deficiencies:

(1) The instructions for the time analysis sheets did not adequately define the requirements for time to be charged to construction projects.

(2) The time analysis sheets did not identify specific construction related projects or activities. Very few of the time analysis sheets were signed by the individual or preparers and none of the time sheets had any indication that any review or verification was performed.

(3) The hourly rates for Company officers and other salaried employees were based on the average rate of all officers and the average rate for all other salaried employees.

(4) The study was conducted for the month of August, during the peak construction period, with no adjustment for winter months when construction activity is at a minimum level.

Electric Plant Instruction No. 4 and NARUC Interpretation No. 60 indicate that overheads capitalized must have a definite relationship to construction activities and a reasonable basis for determining the amount capitalized.

The Company was required to revise its overhead capitalization procedures to ensure that overheads capitalized are supported by a more detailed study showing the relationship between the administrative payroll expenses and construction activity.

Lack of Documentation for Overheads Capitalized

The Company used yearly studies as the basis to assign administrative and general expenses and engineering and supervision expenses to work orders included in Account 107, Construction Work in Progress-Electric. While the Company had available for review the studies used to develop rates for the current year, no documentation was available for some prior years.

According to Electric Plant Instruction No. 4 of the Uniform System of Accounts, "The records supporting the entries for overhead construction costs shall be so kept as to show the total amount of each overhead for each year, the nature and amount of each overhead expenditure charged to each construction work order and to each electric plant account, and the basis of distribution of such costs."
Construction Overheads

Allocation of Overheads to Work Orders

The Company used an overhead work order to accumulate overhead and AFUDC charges applicable to construction work orders. At the time a work order was closed to plant in service, a portion of the balance in the overhead work order was charged to the specific work order, based on the ratio of direct charges in that work order to the total of direct charges to all active work orders.

When subsequent closings to plant were made for the specific work order, an additional share of overheads and AFUDC was transferred from the overhead work order. The Company's method allowed for overheads and AFUDC to be closed to the specific work order as long as it remains "active" (i.e. additional charges were expected).

The Company's method of allocating overheads and AFUDC to work orders may result in an improper distribution of such costs to the individual work orders. This method tends to track current overhead costs to prior construction activity and, therefore, has the potential of mismatching the level of overhead costs with construction costs.

Administrative and General Expenses Capitalized

In determining the annual Administrative and General (A&G) construction overhead rate, the Company included estimates of the portion of each employee's annual labor time which was devoted to construction activity. In addition, estimates of each employee's annual hours of automobile use and annual travel expenses were included in the A&G overhead rate computation. No time studies were performed supporting the amount of A&G expenses charged to construction.

The text of NARUC Interpretation No. 60 states, "The amounts of administrative and general expenses which are capitalizable are only those which have a provable relationship to construction. The use of percentage distributions, based upon assumed relationships between operating expenses and cost of construction, either in total or restricted to labor only, is a violation of Utility Plant Instruction No. 4B, Overhead Construction Costs.

In the future, the Company was required to institute procedures to insure that the portion of administrative and general expenses charged to construction conforms to NARUC Interpretation No. 60 and Gas Plant Instruction No. 4B.
Construction Overheads

Documentation of Overheads

Staff reviewed the formulation of the rate used to allocate overhead costs to construction. This examination disclosed that certain of the documentation supporting this capitalization rate was not adequate.

The Uniform System of Accounts requires that overheads charged to construction be based upon direct charges when possible. When necessary, allocations may be used but such allocations must be derived from a formal study of costs proven to be construction related. The study is required to prove that the allocation it supports is a true representation of the construction overhead costs actually incurred. Documentation supporting the study is required to be maintained so as to be readily available for review.

The Company was required to institute procedures to accumulate and maintain documentation for all overheads capitalized consistent with the requirements of the Uniform System of Accounts noted in the above paragraph and recorded an entry to remove from the gas plant accounts overheads capitalized for which adequate documentation was not maintained by the Company.

Overhead Capitalization Procedures

The Company's overhead capitalization procedures did not directly allocate overheads to construction projects or units of property. All overheads were initially charged to three separate construction overhead work orders (Administrative and General; Engineering and Supervision; AFUDC) and were then allocated to primary plant accounts at percentages of direct costs charged to each primary plant account. No consideration was given to the length of the construction period, the amount of direct labor costs, or the amount of actual engineering or supervision time devoted to each project.

Gas Plant Instruction No. 4 of the Uniform System of Accounts requires overheads to be charged to particular jobs or units in amounts reasonably applicable thereto and in a manner that will assure that each job or unit bears its equitable share of such overheads. As noted above, several factors essential to the equitable allocation of overheads to jobs or units were omitted. In addition, Gas Plant Instruction No. 11(c) and Definition No. 8 of the Uniform System of Accounts specify that all costs be allocated to units of property.

The Company was required to revise its overhead capitalization procedures to comply with the provisions of the Uniform System of Accounts.
Construction Overheads

Allocation of Engineering and Supervision and General Overheads to the Cost of Removal

In certain instances, engineering and supervision (E&S) and general overheads were not allocated to the cost of removal of depreciable property from utility service.

Electric Plant Instruction No. 4 requires that all overhead construction costs, such as engineering, supervision, general office salaries, etc. be charged to particular jobs or units on the basis of the amounts of such overheads reasonably applicable thereto, to the end that each job or unit shall bear its equitable proportion of such costs.

The Company was required to (1) revise its procedures to ensure that an equitable amount of E&S and general overheads are charged to retirement work orders for the cost of removal; and (2) record an entry to reclassify the E&S and general overheads applicable to the cost of removal from Account 107 to Account 108.
Contributions in Aid of Construction

Improper Accounting for Contributions in Aid of Construction

The Company credited to Account 421, Miscellaneous Nonoperating Income, the portion of contributions in aid of construction received for specific construction projects which exceeded the construction costs. The amounts credited to Account 421 during the audit period were minor in nature.

The text of Electric Plant Instruction No. 2D states that, "contributions in the form of money or its equivalent toward the construction of electric plant shall be credited to accounts charged with the cost of such construction. Plant constructed from contributions of cash or its equivalent shall be shown as a reduction to gross plant constructed when assembling cost data in work orders for posting to plant ledgers of accounts. The accumulated gross costs of plant accumulated in the work order shall be recorded as a debit in the plant ledger of accounts along with the related amount of contributions concurrently being recorded as a credit."

The Company was required to revise its procedures so that, in the future, the total contribution in aid of construction is credited to Account 101, Electric Plant in Service. In instances where the application of contributions in aid of construction against the related construction costs results in negative values for property units, the excess amount of such contributions should be credited to Account 108, Accumulated Provision for Depreciation of Electric Utility Plant.

Accounting for Contributions in Aid of Construction

In several cases, the Company credited Account 108, Accumulated Provision for Depreciation of Gas Utility Plant, for amounts received from federal and state agencies related to line extensions installed at the request of such agencies.

Gas Plant Instruction 2D of the Uniform System of Accounts states, "Contributions in the form of money or its equivalent toward the construction of gas plant shall be credited to the accounts charged with the cost of such construction."

The Company was required to: (1) revise its procedures to assure that Contributions in Aid of Construction are recorded as prescribed by the Uniform System of Accounts, and (2) record an entry to properly record contributions previously received.
Contributions in Aid of Construction

Recording Contributions in Aid of Construction in the Continuing Property Records (CPR)

Staff's review of contributions in aid of construction disclosed that the Company was recording the net amount of property (cost less contribution) in its CPR.

Electric Plant Instruction No. 2D states that, "Plant constructed from contributions of cash or its equivalent shall be shown as a reduction to gross plant constructed when assembling cost data in work orders for posting to plant ledgers of accounts. The accumulated gross costs of plant accumulated in the work order shall be recorded as a debit in the plant ledger of accounts along with the related amount of contributions concurrently being recorded as a credit."

The Company was required to record in its CPR the cost of the plant constructed with a concurrent credit for any contributions in aid of construction received. Also, the CPR should be adjusted for those years in which the cost of property was recorded net of any contributions in aid of construction received.

Accounting for a Contributions in Aid of Construction

The Company received a reimbursement for electric plant facilities. The actual construction cost of $85,640 was recorded in Account 101, Electric Plant in Service. The reimbursement of $85,640 received was credited as salvage to Account 108, Accumulated Provision for Depreciation of Electric Utility Plant.

Electric Plant Instruction No. 2D states, in part, "The electric plant accounts shall not include the cost or other value of electric plant contributed to the company. Contributions toward the construction of electric plant shall be credited to accounts charged with the cost of such construction..."

The Company was required to revise its procedures to record contributions as a credit to the accounts charged with the cost of such facilities in accordance with the requirements of Electric Plant Instruction No. 2D.
Internal Controls

Strengthening Existing Internal Controls of Plant Retirements

The Company had no procedure for listing, by retirement work order, the scheduled retirements of major plant items.

A procedure requiring the listing of major items of property scheduled for retirement would strengthen existing internal controls. Such a procedure would provide greater assurance that no unrecorded retirements exist and that retirements are made in a timely manner.

The Company was required to institute a procedure whereby major scheduled retirements are listed by retirement work order in order to strengthen existing internal controls.

Budgetary Controls Over Expenditure Requisitions

The Company's procedure for handling overruns or underruns of construction work was to revise the Expenditure Requisition (ER) based on a justification of the actual cost of work performed. No written guidelines were in effect to ascertain a percentage comparison of budgeted to actual construction costs or to provide for explanations of significant overruns or underruns.

Internal control procedures dictate that an explanation be provided in ER files to justify significant overruns or underruns of budgeted costs (i.e., 10% or more).

The Company was required to establish written internal control procedures providing for explanations to be included in ER files for overruns and underruns of construction costs.

Lack of Continuing Property Records

The Company did not have completely unitized continuing property records as prescribed by Electric Plant Instructions 10 and 11C of the Uniform System of Accounts.

Compliance with the cited Plant Instructions is necessary to assure that additions, retirements and replacements of electric plant are accounted for consistently and that adequate records exist to support the recorded costs.

The Company was required to implement procedures to assure compliance with these instructions. The Company has implemented a plan of action which anticipates full compliance prospectively.
Internal Controls

Accounting for Substation Equipment

The Company retired the original installation cost and capitalized the new installation cost when accounting for transfers of substation equipment.

Electric Plant Instruction No. 12 requires that transfers of property from one electric plant account to another, from one utility department to another, or from one operating division area to another be recorded by transferring the original cost. This accounting treatment is further supported by the theoretical basis of NARUC Interpretation No. 28.

The Company was required to revise their procedures to account for the cost of substation equipment transfers as maintenance expense.

Unitization of Plant

The Company had not unitized additions to plant that were made several years ago.

Electric Plant Instruction No. 11C requires that the Company maintain records for each plant account so that the amounts of the annual additions and retirements are classified to show the number and cost of retirement units.

The Company was required to comply with the requirements of Electric Plant Instruction No. 11C in the future.

Timely Receiving of Field Completion Reports

The property department closed work orders to plant in service upon receipt of a completion report sent from the district superintendent. There were instances where work orders remained classified in Account 107, Construction Work in Progress - Electric, after the project was completed and placed in service. This weakness in internal controls was the result of completion reports not being received by the property department on a timely basis after a job was placed in or ready for service. Account 107 requires that work orders shall be cleared from this account as soon as practicable after completion of a job.

The Company was required to strengthen procedures in the area of the timely preparation of completion reports for both construction and retirement work orders. It should be noted that because of written AFUDC procedures for stopping the calculation on work orders when there are no new charges for two consecutive months, no overcapitalization of AFUDC was noted.
INTERNAL CONTROLS

Need to Maintain Books and Records on a Monthly Basis

The Company recorded contract retentions only at year end in Account 107, Construction Work in Progress - Electric. For quarterly SEC reports, the recorded balances in Account 107 must be adjusted to reflect unrecorded contract retentions.

General Instruction No. 4 states that each utility shall keep its books on a monthly basis so that for each month all transactions applicable thereto shall be entered in the books of the utility.

The Company was required to record contract retentions in Account 107 on a monthly basis.

Failure to Maintain Reconciliation Between Company Accounts and Uniform System of Accounts

The Company used different account numbers for its own purposes than those prescribed in the Uniform System of Accounts. General Instruction No. 3C states that each utility using different account numbers for its own purposes shall keep readily available a reconciliation of such account numbers with those required under the Uniform System of Accounts. The Company has not complied with Instruction No. 3C since no reconciliation was maintained between its account number and those contained in the Uniform System of Accounts.

The Company was required to comply with Instruction No. 3C of the Uniform System of Accounts.

Need for Improved Internal Controls Over Accounting Records Support

Several times during the audit, the invoices and other supporting records were not readily available due to inadequate filing procedures. Section 125.2(m) of the Regulations under the Federal Power Act provides,

"At each office of the public utility or licensee where records are kept or stored, such records as are herein required to be preserved shall be so arranged, fixed and currently indexed that they may be readily identified and made available to representatives of the Commission."

The Company was required to adopt procedures to strengthen internal controls over accounting records support so that they are both readily identifiable and available for use.
Internal Controls

Internal Controls Over Plant Accounting

The Company's procedures for budgeting and controlling retirement work orders do not require inclusion of the amount of property units to be retired, the electric plant account to be credited or a breakdown of the cost of removal and salvage value related to retirements.

Electric Plant Instruction No. 11 of the Uniform System of Accounts states, in part:

B. Each utility shall keep its work order system so as to show the nature of each addition to or retirement of electric plant, the total cost thereof, the source or sources of cost, and the electric plant accounts or accounts to which charged or credited...

The Company was required to revise its procedures for retirement work orders to conform to the requirements of the Uniform System of Accounts.

Approval of Supporting Documentation for Journal Entries

The staff's review disclosed several instances where documents supporting various journal entries had not received the proper managerial approval. One such instance resulted in the transfer of improper amounts from one depreciation reserve subaccount to another.

In the future, the Company was required to follow procedures which require the approval and/or authorization of the documentation supporting the journal entries.

Work Order Revisions

Staff review of selected work orders disclosed that in several instances the Company failed to comply with its internal control procedure that provides for the issuance of a revised work order authorization when construction or retirement costs deviate from authorized amounts by Company established criteria.

It was the staff's opinion that the above internal control procedure should be consistently applied to ensure that neither the scope of the work nor the approximate cost of the project changes significantly without prior management approval.

The Company was required to strengthen its procedures to ensure that revised work order authorizations are submitted to management for approval as soon as it becomes known that the project costs will exceed the authorized amount plus permitted variances, and/or a change in the scope of the work is necessary.
Reimbursed Construction

Accounting for Project Reimbursements

The Company was reimbursed by the Department of Highways for 98.15% of the costs of work performed in conjunction with a roadmove project. This reimbursement was accounted for by offsetting 98.15% of the following amounts:

1. Construction additions (net of betterments)
2. Maintenance expense
3. Cost of removal
4. Salvage
5. Estimated accumulated depreciation

The text of NARUC Interpretation No. 67 states in part that reimbursements received in conjunction with similar projects shall be accounted for (a) by crediting operation and maintenance expenses to the extent of actual expenses occasioned by the plant changes and (b) crediting the remainder to the reserve for depreciation, unless the contractual terms definitely characterize residual or specific amounts as applicable to the cost of replacement.

The Company was required to revise its procedures to provide that reimbursements received for work performed in conjunction with roadmove projects are accounted for in accordance with NARUC No. 67 in the future.

Plant Insurance Recovery

The Company received an insurance recovery of $369,750 for the excess cost of generation incurred during the station outage. The Company accounted for the insurance recovery by debiting Account 146, Accounts Receivable from Associated Companies, and crediting Account 557, Other Expenses.

This insurance recovery was not credited back to either the wholesale or retail fuel adjustment clause (FAC). The cost of fuel during the outage was originally collected through the wholesale FAC and, to the extent it was generated and not purchased power expense, was collected in the retail FAC as well.

The Company was required to make the appropriate credits to both the wholesale and retail FACs for the above insurance recovery.
Reimbursed Construction

Accounting for Insurance Proceeds

A fire destroyed a cooling tower and damaged other plant facilities located at the Generating Station. The Company received an insurance settlement for the destroyed and damaged facilities. After deducting the repair costs necessary to restore the damaged facilities, the remaining insurance proceeds were credited to Account 421.1, Gain on Disposition of Property. Insurance premiums related to all of these facilities had been charged to Account 924, Property Insurance.

Both the texts of Account 108, Accumulated Provision for Depreciation of Electric Utility Plant, and 924, Property Insurance, require amounts of insurance recoveries to be credited to the appropriate accumulated provision for depreciation account for retired property. It is the staff's position that both of these cited Accounts support its opinion that the ratepayer should receive the benefits accruing from the cost of insurance coverage borne.

The Company was required to record an entry to correct the recording of insurance proceeds related to a fire at the Generating Station. Future proceeds from casualty insurance for plant in service should be credited to the accumulated provision for depreciation.

Accounting for Reimbursement Received for Relocation of Facilities

At times, the Company was requested to relocate specific portions of its facilities for which it was reimbursed under a contract with authority requesting the relocation. The Company accounted for these relocations by retiring the original cost of the old facilities and capitalizing the cost of the new facilities. Reimbursements under the contract could be specifically identified with the cost of new facilities. The reimbursement received was recorded as salvage to the extent of the retirement with the excess being used to reduce the capitalized amount of the new facilities. On the continuing property records, the original cost of the installed facilities was recorded net of the excess reimbursement over the original retirement.

Gas Plant Instruction No. 2D, Uniform System of Accounts, states that plant constructed from contributions of cash or its equivalent shall be shown as a reduction to gross plant constructed when assembling cost data in work orders for posting to plant ledger of accounts. The accumulated gross costs of plant accumulated in the work order shall be recorded as a debit in the plant ledger of accounts along with the related amount of contributions concurrently being recorded as a credit.

In the future, the Company is required to record the gross cost of the installed facilities with a concurrent credit for any excess reimbursement over the related cost of the retirement in the continuing property records.
Sales/Leaseback and Leases

Capitalization of the Lease Agreement with the City

Staff's review disclosed the following concerning the capitalization of the lease agreement with the City which pertained to the operation and possible ownership of the City's electrical system.

(1) The Company did not seek approval from the Public Service Commission or the Federal Energy Regulatory Commission to assume the debt liabilities. The assumption of these liabilities was part of the lease agreement.

(2) The disclosure in the Company's financial statement concerning the lease agreement read, "Long-Term Debt Capitalized Lease Obligation Due 1981-2001."

The Company's actions pertaining to the City lease agreement were not in compliance with the following requirements:

(1) Section 204 of the Federal Power Act provides that the Commission approve the assumption of any obligation for liabilities unless the appropriate state commission regulates such liability assumptions.

(2) The disclosure requirements of FASB No. 13, Accounting For Leases, are that the assets and accumulated amortization of capitalized leases be separately identified in the lessee's balance sheet or in footnotes as should be the charge to income resulting from the amortization of the leased assets.

The Company was required to file with the Public Service Commission for approval of the assumption of the noted liabilities. If the PSC does not exercise its authority, the Company should then file for approval with the FERC. Furthermore, The Company was required to comply with the disclosure requirements of FASB Statement No. 13.

Accounting For Revenues From Leased Plant

The Company recorded revenues related to gas plant leased to others in Account 493, Rent From Gas Property. The Company recorded the original cost of the facilities in Account 104, Gas Plant Leased to Others.

The instructions to Account 412, Revenues From Gas Plant Leased to Others, and Account 413, Expenses of Gas Plant Leased to Others, state in part.

A. These accounts shall include, respectively, revenues from gas property constituting a distinct operating unit or system leased by the utility to others, and which property is properly includible in Account 104, Gas Plant Leased to Others, and the expenses attributable to such property.

The Company was required to revise procedures to ensure that revenues from plant leased to others are recorded in accordance with the instructions of the Uniform System of Accounts.
Sales/Leaseback and Leases

Approval of Lease Agreement

The Company entered into a leasing agreement for the transmission of energy. Under this agreement, the Company would:

(1) Have use of an existing transmission line.

(2) Reimburse lessee for costs incurred in the construction of a new transmission line.

The Company recorded the costs associated with the leased Transmission Line in Account 101, Electric Plant in Service.

The Company did not request Commission approval under Section 203(a) of the Federal Power Act for the above lease agreement. According to Section 203(a) of the Federal Power Act, "no public utility shall sell, lease, or otherwise dispose of the whole of its facilities subject to the jurisdiction of the Commission, or any part thereof a value in excess of $50,000, or by any means whatsoever, directly or indirectly, merge or consolidate such facilities to any part thereof with those of any other person ... without first having secured an order of the Commission authorizing it to do so."

The Company was required to comply with the provisions of Section 203(a) of the Federal Power Act by requesting Commission approval for the above lease agreement.

Accounting for Lease Plant

The Company recorded its investment in the Field Compressor Station in Account 101, Gas Plant in Service, and the related revenues and expenses in Accounts 400, Operating Revenues, and 401, Operating Expense, respectively. This compressor station had been rented (leased) to Petroleum Company under contractual agreements.

The Uniform System of Accounts provides Accounts 104, Gas Plant Leased to Others, 412, Revenues From Gas Plant Leased to Others, and 413, Expenses of Gas Plant Leased to Others, for the classification of investment, revenues and expenses of gas plant owned by the utility but leased to others as operating units or systems where the lessee has exclusive possession.

The Company was required to record the transactions related to the Field Compressor Station consistent with the cited provisions of the Uniform System of Accounts and record an entry to properly classify the investment in the Field Compressor Station in Account 104, Gas Plant Leased to Others.
Sales/Leaseback and Leases

Accounting for Property Under Capital Leases

The Company recorded the amortization of electric property under capitalized leases in Account 108, Accumulated Provision for Depreciation of Electric Utility Plant.

General Instruction No. 20 of the Uniform System of Accounts states, in part:

D. For a capital lease, for each period during the lease term, the amounts recorded for the asset and the obligation shall be reduced by an amount equal to the portion of each lease payment that would have been allocated to the reduction of the obligation..." Under the above instruction, the Company should have recorded the amortization of leased property directly to Account 101.1 (Property under capital leases).

The Company was required to (1) revise procedures to comply with General Instruction No. 20 for recording the electric property under capital leases, and (2) record an entry to reclassify the amortization on capitalized leases from Account 108 to Account 101.1.

Amortization of Leasehold Improvements

The Company recorded the amortization of leasehold improvements by crediting Account 111 (Accumulated Provision for Amortization of Electric Utility Plant) and debiting Account 184 (Clearing Accounts). The amount recorded in Account 184 was allocated to various operating expense accounts and utility plant accounts.

Electric Plant Instruction No. 6 states, in part, "A. The cost of substantial initial improvements...and the cost of subsequent substantial additions, replacements, or betterments to such property..." If the service life of the improvements is terminable by action of the lease, the cost, less net salvage, of the improvements shall be spread over the life of the lease by charges to Account 404, Amortization of Limited-Term Electric Plant..."

The Company was required to (1) revise procedures to record the amortization of leasehold improvements in Account 404 in accordance with the requirements of the Uniform System of Accounts, and (2) record an entry to expense leasehold improvements that were improperly charged to the plant accounts.
Accounting for Capital Leases

The Company accounted for property held under capital leases by debiting Account 101, Electric Plant in Service, and crediting Account 224, Other Long Term Debt, with the fair value of the property leased. The balance recorded in Account 101 was depreciated using a straight-line method over the life of the lease and recognized in the accounts by debit entries to Account 403, Depreciation Expense, and credit entries to Account 108, Accumulated Provision for Depreciation of Electric Utility Plant. When a payment was made Account 224 was debited for the amount related to the principal and Account 427, Interest on Long-Term Debt, was charged for the interest portion.

General Instruction No. 20, Accounting for Leases, of the Uniform System of Accounts, states in part:

B. The utility shall record a capital lease as an asset in Account 101.1, Property under Capital Leases...and an obligation in Account 227, Obligations under Capital Leases--Noncurrent, or Account 243, Obligations under Capital Leases--Current, at an amount equal to the present value at the beginning of the lease term of minimum lease payments during the lease term...

C. Rental payments on all leases shall be charged to rent expense...as they become payable.

D. ...the amounts recorded for the asset and obligation shall be reduced by an amount equal to the portion of each lease payment that would have been allocated to the reduction of the obligation, if the payment had been treated as a payment on an installment obligation (liability) and allocated between interest expense and a reduction of the obligation so as to produce a constant periodic rate of interest on the remaining balance.

The Company was required to (1) adopt procedures to ensure that is accounting for capital leases is in accordance with General Instruction No. 20 of the Uniform System of Accounts as described above, and (2) record a correcting entry to reclassify costs incurred for capital leases to the proper accounts at December 31, 1986.
Sales/Leaseback and Leases

Procedures for Recording the Amortization of a Gain on the Sale/Leaseback of Computer Center Facilities

In 1985, the Company recognized a $6.1 million gain on the sale and subsequent leaseback of computer center equipment. The gain was deferred in Account 253, Other Deferred Credits. The Company was amortizing the gain to Account 421, Miscellaneous Income, over the period in which rental expense for the center was incurred. The rental expense on the computer center equipment was recorded in Account 931, Rents.

In Opinion No. 118, issued to Virginia Electric Power Company on April 10, 1981, the Commission addressed the accounting and ratemaking treatment for gains on the sale and leaseback of facilities. The Commission stated:

The issue is one of fundamental fairness. It is manifestly unfair to expect the ratepayers to underwrite the rental payments that VEPCO must make on the three office buildings. and, at the same time, deprive them of any benefit from the gain VEPCO has realized as a financing method, as all concede it was, it seems patent that the net cost of securing the financing is the difference between the gain on the sale and rental payments. And that is all the ratepayers should be required to bear.

Therefore, the adjustment proposed by Staff and Electric Cities is adopted, and VEPCO is required to set off the gain against the rent when it computes its revenue requirements.

Likewise, the Company should have reduced the amounts billed for computer equipment rental with the amortized gain from the sale of computer equipment.

The Company was required to revise procedures to ensure that gains on sale-and-leaseback transactions are amortized against the related rental expense.
Accounting for Gain on Sale and Leaseback Transaction

The Company's sale and leaseback transaction involved the sale and leveraged lease of (1) 15 percent interest of certain facilities in the Company's Coal Unit No. 1 and associated transmission facilities, and (2) a percent interest in certain portions of the Transmission Intertie. This transaction resulted in an after-tax gain of $102.4 million.

In 1985 the Company requested approval from PSC to record the $102.4 million gain for the benefit of its stockholders in Account 421.1, Gain on Disposition of Property. By order issued December 23, 1985, the PSC authorized the Company to record 50 percent of the gain for the benefit of the stockholder and reserve 50 percent of the gain in Account 253, Other Deferred Credits, for later disposition. However, this order also provided that the entire after-tax gain could be subject to a different disposition in a future rate proceeding.

The Company received FERC approval for this transaction. The Company accounted for this transaction in Account 102, Electric Plant Purchased or Sold, and obtained FERC approval to defer 50 percent of the gain based upon the PSC's order.

In an Order issued on September 30, 1987, the PSC required the Company to use about $78.7 million, or about 77 percent of the sale and leaseback gain, to reduce rate base and the cost of service over the remaining 27-year life of the plant.

The PSC's order imposed a liability on the Company to amortize $78.7 million of the gain to ratepayers over future periods. Under the requirements of the Uniform System of Accounts, the Company should have adjusted its accounts to reflect the PSC imposed ratemaking liability.

On October 2, 1987, the Company appealed the PSC's order to the State Circuit Court. In its appeal, the Company argued that the PSC findings of fact was not supported by substantial evidence in the record and erred in conclusions of law with respect to the decision on the amount of the gains to be passed on to ratepayers. The court had not acted on the Company's appeal at the time of this writing.

The Company was required to make appropriate corrections to its accounts to reflect the PSC's ratemaking action on the gain on the above mentioned sale and leaseback in the event that the State Circuit Court upholds the PSC's order and the Company chooses not to appeal the ruling. The Company will notify the Office of the Chief Accountant of its accounting actions within 30 days of any subsequent court order resulting from the Company's appeal.
Accounting for Sale/Leaseback

The Company entered into two participation agreements providing for the transfer of legal title for the undivided interest to an Owner Trustee, who was acting on behalf of certain equity investors. Simultaneously, the Company entered into a leaseback from the Owner Trustee, in which it received the right to use the facilities for a term not to exceed 26.5 years, from 1989 to 2015.

The leases were net leases, conferring on the Company all responsibility for operation, maintenance, insurance, taxes, assessments and other charges or liabilities related to the undivided interest, including, without limitation, decommissioning and rebuilding.

The Company is responsible for making any necessary modifications and additions to the undivided interest at its own cost.

In its accounts and financial reporting to the FERC the Company recorded the transactions as follows:

1. It reduced Account 101, Electric Plant in Service, by an amount equal to 11.5 percent of the original cost of the facilities sold and removed the previously recorded depreciation from Account 108, Accumulated Provision for Depreciation of Electric Utility Plant.

2. It deferred the gain on the disposition of the property in Account 253, Other Deferred Credits.

3. It reversed a portion of the deferred income taxes previously recorded and assigned the additional Federal and state income taxes resulting from the transaction as a reduction of the deferred gain classified in Account 253.

4. It classified about $9 million in fees paid in connection with the sale/leaseback transactions in Account 165, Prepayments.

5. Each month it accrued rent expense for a portion of the semi-annual lease payment by charging Account 931, Rents.

The Company included the amount accrued as rent expense in Account 931 as a component of operating expense for tariff billings under the Unit Power Sales Agreement (UPSA).

In reporting to its stockholders, the Company's parent, reported the transactions as financings under the guidelines issued in Statement of Financial Accounting Standards No. 98, Accounting for Leases. Under financing accounting, the Parent continued to report the property as part of electric plant and to record depreciation and interest expense on the entire original cost of the plant. It did not report a gain on the transactions.
Accounting for Sale/Leaseback (Continued)

Furthermore, it reported the deferred income tax balances previously recorded in its accounts, increased by about $126 million to reflect the additional income taxes resulting from the transactions. Therefore, the balance sheet and income statement presentation for the sale and leaseback transactions did not agree with the financial statements the Company reported to the Commission.

Based upon the review of the circumstances surrounding the agreements, the Division of Audits concluded that the Company should have accounted for the sale/leaseback transactions as "financings" under the requirements of the Uniform System of Accounts.

The Company had a continued operating and financial interest in the portion of the property subject to the sale/leaseback transaction. The Company was responsible for all operating and maintenance costs, decommissioning costs, nuclear fuel costs, and other related operating costs for the 90 percent interest in the plant. Furthermore, it will have to incur the costs of future modifications or additions to the facilities.

In previous orders on sale and leaseback transactions with similar circumstances, the Commission stated its position that the nature of the transactions are "financings" and not "sales" of facilities subject to Commission jurisdiction.

The Company's accounting and financial reporting of the sale/leaseback transactions to the Commission was not consistent with the financial information and the results of operations reported to debtholders and stockholders under standards issued by the Financial Accounting Standards Board (FASB). Therefore, regulators, investors, the public and other users of the Company's financial statements will find a significant difference in revenues and expenses reported from information included in the Form No. 1.

The Company's classification of fees on the sale/leaseback transactions in Account 165 was not consistent with the accounting requirements of the Uniform System of Accounts. The fees were costs of securing the lease financing arrangement, properly recorded in Account 181, Unamortized Debt Expense, and amortized to Account 428, Amortization of Debt Discount and Expense, over the life of the agreements.
Accounting for Sale/Leaseback (Continued)

The Company should reflect the sale/leaseback transactions for accounting purposes as financings and not sales of facilities. Therefore, the Company's accounting for the transactions, taking into consideration the Commission's special accounting for ratemaking assets, should include the following:

1. Retain the original cost of the property, the accumulated provision for depreciation, and the accumulated deferred income taxes related to the 11.5 percent interest in the same accounts as before the refinancing.

2. Continue charging depreciation expense related to the 11.5 percent interest over the estimated service life of the facilities.

3. Classify the additional income taxes resulting from the transaction in Account 190, Accumulated Deferred Income Taxes, and include the costs of refinancing in Account 181.

4. Establish ratemaking assets or liabilities, as appropriate, to recognize the differences between depreciation and interest expenses properly recorded for accounting purposes and the amounts approved for billing under the UPSA. (The entries are properly recorded in Account 186, Miscellaneous Deferred Debits, or Account 253, Other Deferred Credits, as appropriate.)

It was recommended that the Company:

1. revise accounting procedures for classifying the effects of any future sale/leaseback transactions of facilities consistent with the above discussion of the requirements of the Uniform System of Accounts; and

2. record the appropriate journal entries to correct the balance sheet and income statement presentation so as to reflect the sales/leasebacks of the 11.5 percent undivided interest as a financing, with recognition of the special accounting approved by the Commission for ratemaking assets.
Accounting for Income Taxes Related to Sales/Leaseback of Interests in Facilities

The Company sold facilities to a number of equity investors through the use of Owners' Trusts. The Owner Trustees took title to the interest in the sold facilities. The investors entered into agreements with the Owner Trust to take and hold title to the sold facilities.

The Company's sales of portions of both units gave rise to substantial income tax obligations, a major portion of which related to the fact that the tax bases of assets sold were lower than the book cost of the facilities. A large part of the difference in bases resulted from prior recognition of income for accounting purposes of the equity component of allowance for funds used during construction (AFUDC).

The Company received approvals from the Public Utility Commission (PUC) to defer any gains and losses, and any related income taxes, of the sale/leaseback transactions on its financial statements, so that there would be no change in net income at the time of the transactions.

The Company recorded the sales proceeds from the transactions in Account 131, Cash. It directly credited the project costs recorded in Account 107, Construction Work in Progress—Electric, with the proportion of the original cost incurred to date for the units sold.

As a result of the two sales, the Company incurred Federal and state income tax obligations. It recorded the income taxes on the transactions by debiting Account 409.1, Income Taxes, Utility Operating Income, and crediting Account 236, Taxes Accrued. It reversed all previously established deferred income taxes on the portions that were sold by debiting Account 282, Accumulated Deferred Income Taxes, and crediting Account 411.1, Provision for Deferred Income Taxes - Credit, Utility Operating Income.

It established additional deferred income taxes by debiting Account 190, Accumulated Deferred Taxes, and crediting Account 410.1, Provision for Deferred Income Taxes, Utility Operating Income. In computing the amount to defer in Account 190, the Company reduced the balance of its income tax liability not previously provided by deferred income taxes by the gain on the sale. It did this so that net income for the year was not increased as a result of the sale/leaseback transaction.

The PUC permitted the Company to amortize the deferred income taxes recorded in Account 190 over the periods covered by the lease agreements.

The Company's accounting for the income taxes on the sales of interests were not in compliance with the following requirements of the Uniform System of Accounts.
Sales/Leaseback and Leases

Accounting for Income Taxes Related to Sales/Leaseback of Interests in Facilities (Continued)

Under the requirements of the Uniform System of Accounts, the Company did not have a basis to defer in Account 190 any income tax effects related to the sales transactions. The income taxes due and payable to the Internal Revenue Service that were in excess of any amounts previously recorded in Account 282 were not tax timing differences as defined by the Uniform System of Accounts and general accepted accounting principles. Therefore, it was incorrect for the Company to record the amounts in Accounts 190 and 410.1.

Based upon the approvals received from the PUC, the Company should have used the special accounting previously approved for ratemaking assets. It should have deferred the effect of the taxes on net income by crediting Account 406, Amortization of Electric Plant Acquisition Adjustments, and debiting Account 186, Miscellaneous deferred Debits. It should have amortized the regulatory assets recorded in Account 186 over the periods allowed for rate recovery by charges to Account 406.

The Commission has previously determined that a generating unit constitutes an operating unit or system. Therefore, the Company should have recorded the sale of interests in Account 102. Also, it should have filed journal entries with the Commission after making the sales of interest.

It was recommended that the Company:

(1) revise the procedures to ensure that:

(a) the accounting for income taxes is consistent with the requirements of the Uniform System of Accounts;

(b) purchases and sales of property that are operating units or systems are recorded in Account 102 and the related journal entries are submitted to the Commission for approval; and

(2) record an entry to reverse deferred income taxes included in Account 190 and to establish a ratemaking asset in Account 186 to recognize the rate actions of the regulatory commissions to permit recovery of the income taxes as part of the rates charged customers in future periods.

Also, the Company should make a memorandum entry to correct the income statement by debiting Account 410.1, Provision for Deferred Income Taxes, Utility Operating Income and credit in Account 406, Amortization of Electric Plant Acquisition Adjustments.

The Company shall amortize the amount recorded in Account 186 by charges to Account 406, Amortization of Electric Plant Acquisition Adjustments, over the period allowed for rate recovery. If any of the amounts are subsequently disallowed for rate recovery, the Company shall expense the disallowed amounts to Account 426.5, Other Deductions.
Accounting for Property Leased from Others

The Company did not comply with the criteria set forth in General Instruction No. 19 for determining whether a lease should be classified as a capital lease or as an operating lease.

In 1986, the Company adopted a policy using a $50,000 minimum equipment value as one of the criteria for determining whether a lease would qualify as a capital lease. In 1988, the Company changed its policy and began using a $100,000 minimum equipment value requirement as one of the criteria for capital lease accounting.

General Instruction No. 19 of the Uniform System of Accounts sets forth four criteria for determining whether a lease shall be classified as a capital lease. A company would classify a lease not meeting the four criteria set forth in the instruction as an operating lease.

General Instruction No. 19 does not specifically permit a utility to establish additional criteria other than that specified for determining the accounting classification of the lease. If the Company wanted to adopt a minimum equipment value as a criteria, it would need the specific approval of the Commission to depart from the criteria set forth in General Instruction No. 19.

It was recommended that the Company revise its procedures to ensure that the classification of all leases is consistent with the criteria set forth in General Instruction No. 19, unless otherwise authorized by the Commission.

Subsequent to the examination, the Company filed a request with the Commission and received a waiver of the requirement to record capital leases having annual rental charges of less than $100,000 as assets and liabilities.
Sales/Leaseback and Leases

Accounting for Property Leased from Others

The Company leased railroad cars under separate individual leases. The Company accounted for the leases as operating leases.

General Instruction No. 19 of the Uniform System of Accounts states in part:

A. If at the inception a lease meets one or more of the following criteria, the lease shall be classified as a capital lease. Otherwise, it shall be classified as an operating lease. . .
   (3) The lease term is equal to 75 percent or more of the estimated economic life of the leased property. . .

Also, General Instruction No. 20 of the Commission's Uniform System of Accounts states, in part:

B. The utility shall record a capital lease as an asset in Account 101.1, Property under Capital Leases. . . and an obligation in account 227, Obligation under Capital Leases—Noncurrent. . . .

Under the terms of the leases, the Company was required to lease the railroad cars for a period that equaled 75 percent of the useful life of the railroad cars. Therefore, the leases met the accounting criteria for capital leases. The Company should have recorded an asset and liability in Accounts 101.1 and 227 to reflect the leased railroad cars.

It was recommended that the Company:

(1) revise its procedures to comply with General Instruction Nos. 19 and 20 for the recording of the electric property under capital lease; and

(2) record an entry to establish an asset and a related liability for the leased railroad cars.
Sales/Leaseback and Leases

Accounting for the Cost of Leasehold Improvements

The Company sold the facilities to a number of equity investors through the use of Owner Trusts. The Owner Trusts took title to the interest in the sold facilities. The investors entered into agreements with the Owner Trusts to take and hold title to the sold facilities.

In connection with the sales of interests, the Owner Trust leased the facilities back to the Company. The basic terms of the leases were 29 years, and the Company has the right to renew the leases for up to two years.

The Company initially classified the additional construction costs attributable to interests sold in Account 107. Upon completion of construction, the Company transferred the additional amounts related to the interests sold, along with the cost of its ownership interests, to Account 101, Electric Plant in Service.

The Company began depreciating the additional costs included in Account 101 by entries to Accounts 403 and 108, to amortize the cost over the estimated service life.

The Company's additional construction period expenditures incurred associated with the interest sold met the requirements for capitalization as leasehold improvements. Therefore, under the requirements of Electric Plant Instruction No. 6 the Company should have amortized the leasehold interests over the life of the lease, by charging Account 404 and crediting Account 111, Accumulated Provision for Amortization of Electric Utility Plant.

The Company's approved tariffs were designed to achieve recovery of depreciation expenses related to these leasehold interests over the estimated service life of the units, which were longer than the period of the lease. Therefore, the Company may use the special accounting approved for ratemaking assets. It would defer the income statement effect of any differences between the amortization of leasehold amounts required by the accounting regulations (over the lease period) and the amounts collected in rates (over the estimated life of the plant) by an entry to Account 406, Amortization of Electric Plant Acquisition Adjustments. It should present the balance sheet effect of any ratemaking asset in Account 186, Miscellaneous Deferred debits. It should amortized the regulatory assets by charges to Account 406 over the periods allowed for rate recovery.
Sales/Leaseback and Leases

Accounting for the Cost of Leasehold Improvements (Continued)

It was recommended that the Company:

(1) revise the accounting procedures to ensure that the amortization of the cost of any leasehold improvements are recorded by charging Account 404 and crediting Account 111 over the leasehold period; and

(2) record the necessary correcting entries to:

(a) reclassify the amortization of the leasehold improvements from Account 108 to Account 111;

(b) adjust Account 404 and 111 to reflect the amortization of leasehold improvements over the life of the initial lease agreement;

(c) establish any ratemaking asset by crediting Account 406 and debiting Account 186 to reflect the differences between the amounts expensed in (b) and amounts recovered in rates.

The Company shall file a copy of the correcting entry with the Office of the Chief Accountant.
AFUDC - Allowance Base

Accounting for Construction Work in Progress (CWIP) Allowed in Rate Base

The Company used the following procedures for excluding Allowance for Funds Used During Construction (AFUDC) accruals on CWIP amounts allowed in rate base:

1. CWIP amounts allowed in rate base were identified and assigned to specific construction projects.

2. The difference between the gross AFUDC (AFUDC that would be allowed absent any CWIP in rate base) and contra AFUDC (negative AFUDC resulting from inclusion of CWIP in rate base) was allocated to specific projects.

3. Gross AFUDC and contra AFUDC accruals were terminated at the time the project went into service, during delayed construction periods, or in some instances, when a project was cancelled. As a result, the amount of CWIP used for contra AFUDC purposes was less than the level used in setting rates.

In Order No. 298, issued May 16, 1983, the Commission stated, in footnote No. 109:

The average amount of CWIP requested in rate base in the utility's rate filing should be excluded from construction balances for purposes of calculating book AFUDC accruals, beginning on the effective date of the new rates. While the actual level of CWIP will change over time, the average level of CWIP included in rate base remains unchanged until a new rate change becomes effective. Because of this, the amount of CWIP placed in rate base may exceed the actual balance of CWIP at the time of filing as when test year begins.... In these cases, a utility will record a negative AFUDC to ensure a proper charging of costs to ratepayers.

The Company's procedures did not result in excluding from the AFUDC base the average amount of CWIP allowed in rate base during the same period the rates were in effect.

The Company developed procedures to ensure that the CWIP levels allowed in rate base are properly excluded from the AFUDC computation base in determining the amount of AFUDC to capitalize in a particular period.
AFUDC - Allowance Base

Construction Work in Progress (CWIP) Allowed in Rate Base

The Company has a power sale contract that permits the inclusion of CWIP in rate base, to the extent allowed by FERC regulations. The Company did not cease accruing Allowance for Funds Used During Construction (AFUDC) on CWIP allowed in rate base. Instead, the amount of AFUDC capitalized on each project was reduced by the total revenue requirement, related to CWIP, multiplied by the reciprocal of the Company's effective income tax rate (1-effective tax rate).

Section 35.26 of the Regulations Under the Federal Power Act states, in part,

E. On the date that any proposed rate that includes CWIP in rate base become effective, the public utility must discontinue the capitalization of any AFUDC related to those amounts of CWIP in rate base.

Furthermore, in Order No. 298, issued May 16, 1983, the Commission stated, in footnote No. 109:

The average amount of CWIP requested in rate base in the utility's rate filing should be excluded from construction balances for purposes of calculating book AFUDC accruals, beginning on the effective date of the new rates. While the actual level of CWIP will change over time, the average level of CWIP included in rate base remains unchanged until a new rate change becomes effective. Because of this, the amount of CWIP place in rate base may exceed the actual balance of CWIP at the time of filing as when test year begins.... In these cases, a utility will record a negative AFUDC to ensure a proper charging of costs to ratepayers.

The Company was required to (1) adopt procedures to ensure that the CWIP levels allowed in rate base are properly excluded from the AFUDC computation base in determining the amount of AFUDC to capitalize in a particular period and (2) record an entry to correct the accounts.

AFUDC Applied on Prepaid Construction Work Orders

The Company was accruing allowance for funds used during construction (AFUDC) on construction projects that had been prepaid by the customer prior to the construction period.

Order 561 states that AFUDC gives a utility an opportunity to be compensated for the total cost of capital devoted to its construction program. Since the cost of these projects is prepaid, the Company has no capital funds devoted to these projects, and is not entitled to compensation in the form of AFUDC.

In the future, the Company was required to cease accruing AFUDC on prepaid construction projects.
AFUDC - Allowance Base

AFUDC on Contract Retentions

The Company calculated AFUDC on accrued contract retentions which were included in work orders with an estimated cost under $500,000. The Company contended that the manual effort required to exclude contract retentions from the AFUDC calculations of these work orders would not be cost justified at the present time. Future plans include mechanization of plant accounting procedures which may make the exclusion of contract retentions practical.

A necessary condition for capitalization of AFUDC is the actual expenditure of funds for plant construction. Contract retentions represent unexpended project costs and therefore should not be eligible for AFUDC.

The Company was required to re-evaluate the practicability of excluding contract retentions from AFUDC computations upon mechanization of the plant accounting system. Appropriate modification to the minimum work order dollar limits should be instituted as soon as such limits are no longer justified by practicability restrictions.

AFUDC Improperly Capitalized on Property Previously Recorded in Account 105

The Company recorded in Account 105, Electric Plant Held for Future Use, the original cost of land owned and held for future use in electric service. When construction related to the future use property began, the Company transferred the land from Account 105 to Account 107, Construction Work in Progress-Electric, and capitalized AFUDC.

The Company received rate base treatment on its investment in Account 105, Electric Plant Held for Future Use, and therefore, its policy of capitalizing AFUDC on property previously recorded in Account 105 could result in a double return on such investment.

The Company revised its procedures so as to refrain from capitalizing AFUDC on property previously recorded in Account 105, Electric Plant Held for Future Use. Excess amounts of AFUDC capitalized as a result of the Company's procedure were not of such significance as to warrant adjustment of the plant accounts.
AFUDC - Allowance Base

Accrual of AFUDC on Materials and Supplies

In the course of construction, the Company included in work orders, materials and supplies which were not used and subsequently returned to stores or transferred to other work orders. As a result, AFUDC was computed on these materials and supplies for periods up to twelve months while in the work order. Although the allowance capitalized is not considered to be significant enough to warrant adjusting the plant accounts, AFUDC will be recomputed to take into account large items of materials and supplies returned to stores or transferred to other projects.

Improper Capitalization of AFUDC Related to Injuries and Damages Reserve

The Company recorded a reserve for injuries and damages applicable to workmen's compensation claims of contract workers. The initial entry to set up the reserve was a debit to Account 107, Construction Work in Progress-Electric, and a credit to Account 262, Injuries and Damages Reserve.

The problem noted by staff with regard to this reserve was that these accrued amounts were entered into the AFUDC investment base. These accruals were not eligible for AFUDC computations since no funds had been expended. Thus, an overcapitalization of AFUDC resulted to the extent that reserve amounts in Account 107, applicable to those work orders eligible to receive AFUDC, exceeded the actual expenditures made by the Company related to the injuries and damages covered under this reserve.

The Company was required to include only amounts for injuries and damages for which expenditures have been made in the AFUDC investment base, and record an adjusting entry to eliminate from Account 107, AFUDC applicable to unexpended provisions for injuries and damages.

AFUDC on Blanket Work Orders

The Company computed AFUDC on blanket work orders less an estimated percentage of the total amount recorded in annual blanket work orders. The percentage used is assumed to represent the amount recorded in the blanket work orders which are in service. The staff was unable to determine how this percentage was derived.

Blanket work orders by nature have no measurable construction period and are not eligible for accrual of AFUDC.

The Company was required to cease the accrual of AFUDC on blanket work orders. An adjustment to the books and records of the Company was not required due to the minor amounts involved.
AFUDC – Allowance Base

Capitalization of AFUDC on Completed Work Orders

In the Company's December 1982 rate filing, the state commission did not allow the Company to include in rate base the December (only) late charges to work orders which were complete or ready for service prior to December 1982. As a result, the Company elected to compute AFUDC on one-half of the December 1982 late charges.

The Uniform System of Accounts contemplates that AFUDC should stop on the day before facilities are placed in service or are ready for service.

The Company was required, in the future, to discontinue capitalizing AFUDC on late charges incurred after a project has been placed in or is ready for service. No dollar adjustment was proposed as the amount involved was immaterial.

AFUDC Accruals on Unpaid Property Taxes

The Company accrued property taxes for approximately six months of each year and prepaid for the remaining period. Property taxes are charged to work orders included in Account 107, Construction Work in Progress – Electric. An Allowance for Funds Used During Construction (AFUDC) was computed on the work order balances in Account 107, which include accrued but unpaid property taxes.

The Company was required to revise its procedures to insure that AFUDC is not computed on unpaid property taxes included in construction work in progress.

Capitalization of AFUDC on Purchases of Equipment, Spare Parts and Land

The Company accrued an Allowance For Funds Used During Construction (AFUDC) on purchases of utility plant equipment (meters, capacitors, etc.), spare parts and land. These items were ready-for-service when purchased.

General Instruction 3(17) of the Uniform System of Accounts permits the accrual of AFUDC only during periods of construction. No AFUDC is permitted on expenditures which do not require a construction period.

The Company was required to: (1) modify its procedures to preclude accrual of AFUDC on items which do not require a construction period, and (2) record a correcting entry to reverse AFUDC accrued on those items noted above.
AFUDC — Allowance Base

AFUDC Policies and Procedures

Staff's review of the Company's policies and procedures for the calculation of Allowance for Funds Used During Construction (AFUDC) disclosed the following:

(1) The Company began to capitalize AFUDC with the first labor charge incurred for all projects that qualify for the allowance. In some instances, these labor charges resulted from preliminary engineering, surveys, and/or investigations performed prior to the beginning of construction.

The text of the Chief Accountant's Accounting Release No. 5 states that, "Interest during construction may be capitalized starting from the date that construction costs are continuously incurred on a planned progressive basis." Also, no interest should be accrued during periods of interrupted construction unless the Company can justify the interruption as being reasonable under the circumstances.

The amount of excessive AFUDC capitalized applicable to the above listed items was minor, and no adjustments were proposed. However, the Company was required to revise its procedures so that AFUDC will not be capitalized (1) until the date construction costs are incurred continuously on a planned progressive basis, and (2) during periods of suspended construction projects unless justification for the interrupted activity is documented.

Premature AFUDC Accrued on Construction Project

Staff's review of the Company's policies and procedures for the calculation of AFUDC disclosed that the Company began to capitalize AFUDC during the month in which initial charges were made to projects that qualified for the allowance. In some instances, these initial charges resulted from advance purchases of materials prior to either the beginning of construction or application for a certificate to construction facilities.

The text of Accounting Release No. 5 states that "Interest during construction may be capitalized starting from the date that construction costs are continuously incurred on a planned progressive basis. Interest should not be accrued for the period prior to: . . . (2) the date of the application to the Commission for a certificate to construction facilities by a natural gas company."
AFUDC - Allowance Base

Accounting for Allowance for Funds Used During Construction (AFUDC) on Completed Nuclear Fuel Assemblies

The Company accumulated the cost for nuclear fuel in process in Account 120.1, Nuclear Fuel in Process, Conversion, Refinement and Fabrication. On March 31, 1988, the Company completed the reload and restarted Unit 1. It then transferred the accumulated nuclear fuel costs, including accrued AFUDC, from Account 120.1 to Account 120.3, Nuclear Fuel Assemblies in Reactor.

During July 1988, the Company completed the reload and restarted Unit 2. On July 31, 1988, it then transferred the accumulated nuclear fuel costs, including accrued AFUDC, from Account 120.1 to Account 120.3.

The Company followed the practice of accruing AFUDC on balances in Account 120.1, charging the accrued amounts to a nuclear fuel subaccount within Account 120.1 that was subdivided by each unit. Since the transfer of direct costs from Account 120.1 to 120.3 did not take place until the reload was completed and the unit was restarted, the Company continued to accrue AFUDC (and assigned such amounts to the subdivisions for each unit) during the period that the reloading was in process. However, when it determined the amount of accrued AFUDC to assign to specific fuel assemblies, it used the Account 120.1 balances on the date the units were shutdown for fuel reload. Therefore, any AFUDC accrued during period of shutdown remained in the AFUDC subaccount and would be assigned to the cost of fuel assemblies currently in process of construction.

The Company's practice of accruing AFUDC on balances properly in Accounts 120.2 or 120.3 resulted in an overaccrual of AFUDC during the audit period. Under the Company's procedures for assigning accrued AFUDC to completed fuel assemblies, the overaccruled amounts remained in Account 120.1 at the end of the audit period. Therefore, the Company's practice of using the Account 120.1 balances on the date the units were shutdown for fuel reload for determining the amount of accrued AFUDC to assign to specific fuel assemblies did not result in any overstatements of nuclear fuel amounts amortized to Account 518, Nuclear Fuel Expense, during the audit period.

Staff recommended that the Company:

(1) revise its procedures to comply with Commission regulations regarding the accounting for the cost of completed and delivered nuclear fuel assemblies and the accrual of AFUDC on such assembly costs; and

(2) record correcting entry to reverse AFUDC overaccrued on the cost of completed and delivered nuclear fuel assemblies.
Accounting for AFUDC on Pollution Control Facilities

The Company included pollution control construction work in progress in rate base. The FERC approved the revised rates.

The Company continued to accrue AFUDC, without adjustment, on the level of pollution control expenditures included in wholesale rate base.

Part 35.26 of the Regulations under the Federal Power Act states, in part:

(e) . . . On the date that any proposed rate that includes CWIP in rate base becomes effective, a public utility . . . must discontinue the capitalization of any AFUDC related to those amounts of CWIP in rate base.

In Order No. 298, issued June 1, 1983, the FERC clarified its procedures for discontinuing AFUDC on projects included in rate base. The Commission stated:

In order to ensure the appropriate discontinuance of AFUDC capitalization, the Commission instructs any utility that request CWIP in rate base under this rule as follows:

1. The average amount of CWIP requested in rate base in the utility's rate filing should be excluded from construction balances for purposes of calculating book AFUDC accruals, beginning on the effective date of the new rates, except to the extent that the stipulation of the parties or the Commission's order provide for a different amount of CWIP in rate base. This will ensure that in settled cases, a utility's rates will be presumed to include CWIP in rate base to the extent requested in its rate filing, except as noted above.

2. In calculating the AFUDC rates used for book purposes under the Uniform System of Accounts (Electric Plant Instructions, No. 3(17)), the average jurisdictional amount of CWIP and nuclear fuel in process of refinement, conversion, enrichment, and fabrication requested in the utility's rate filing for rate base treatment must be excluded from the "W" component of the AFUDC formula beginning on the effective date of the new rates, except to the extent that the stipulation of the parties or the Commission's order provides for a different amount of CWIP in rate base . . .
AFUDC - Allowance Base

Accounting for AFUDC on Pollution Control Facilities (Continued)

4. As previously described, CWIP-based rates may become effective before, after, or at any time during the test period. The rule therefore requires utilities to provide accounting procedures to ensure that wholesale customers will not be charged for both capitalized AFUDC and corresponding amounts of CWIP proposed to be included in rate base. While the actual level of CWIP will change over time, the average level of CWIP included in rate base remains unchanged until a new rate change becomes effective. Because of this, the amount of CWIP placed in rate base may exceed the actual balance of CWIP at the time of filing or when the test year begins... In these cases, a utility will record a negative AFUDC to ensure a proper charging of costs to ratepayers.

The Company should have established accounting procedures to discontinue the accrual of AFUDC on the level of pollution control expenditures included in wholesale rate base.

Staff recommended that the Company:

1. revise its procedures for computing AFUDC on pollution control facilities; and

2. record the correcting entry to reverse the AFUDC accrued on the level pollution control facilities that were included in wholesale rate base.

AFUDC Charged to Work Orders on a Dollar Basis Only

AFUDC was computed on the gross amount of the authorization but was then transferred to an overhead account and did not remain in the authorization.

When the AFUDC was allocated to the authorization and work orders, it was based on the amount of dollars accumulated in the work order but did not take into consideration the length of time needed to complete the project.

For example: A work order which accumulated one million dollars over a six month period will accrue as much AFUDC as would a work order which accrued one million dollars over a two-year period.

While the total AFUDC may be reasonable, an individual project will have too much or too little AFUDC charged to it.

The Company developed a new computer program to calculate the AFUDC for each work order.
AFUDC - Allowance Base

Procedures for Determining the AFUDC Expenditure Base

The Company recorded in Account 107, Construction Work in Progress-Electric, invoices for construction work performed by outside contractors. The Company withheld a portion of the payment pending the completion of the work. The Company also recorded in Account 107 monthly accruals for property taxes related to the construction projects. The Company, on a quarterly basis, made payments to the taxing authorities.

Prior to April 1985, the Company excluded unpaid amounts such as contract retentions and property tax accruals from its AFUDC base. In April 1985, the Company changed its accounting practice and began accruing AFUDC on the amounts it withheld from contractors and the accrued property taxes.

Under the Uniform System of Accounts a utility may apply the AFUDC rate only to eligible construction expenditures included in Account 107 and Account 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment and Fabrication. Eligible expenditures are construction expenses paid during the normal business cycle.

The accrual of AFUDC is to compensate a utility for its out of pocket costs until the project is placed in service and included in rate base. The Company did not incur any out of pocket costs associated with amounts that it withheld from contractors. Similarly, the Company should not have included the monthly accruals for property tax assessments in the AFUDC base since the amounts were not paid to the taxing authority on a monthly basis.

Staff recommended that the Company:

(1) revise its procedures to exclude contract retention and unpaid real estate and personal property taxes from the AFUDC expenditure base; and

(2) record a correcting entry to reserve AFUDC accrued on contract retention and the unpaid accruals.

The Company shall file a copy of the correcting entry with the Office of Chief Accountant.
AFUDC - Computation Method and Period

Capitalization of One-Half Month's AFUDC on All Work Orders Other Than Generating Stations in the In-Service Month

The Company capitalized one half month's Allowance for Funds Used During Construction (AFUDC), in the in-service month for all work orders other than generating stations. For the latter, AFUDC was computed to the in-service date.

An averaging methodology does not lend itself to work orders involving exceptionally large expenditures on any type project since averaging could result in over or under accruals of AFUDC.

The Company was required to calculate AFUDC to the exact in-service date on construction work orders involving total construction costs exceeding $5,000,000.

Procedures Used to Calculate AFUDC Rate

When computing the allowable AFUDC rate, the Company, contrary to the intent of FERC Order No. 561, used a twelve month average of ending short-term debt balances, instead of using a daily average of short-term debt outstanding. Also, unamortized debt expense was not included in long-term debt balances, as recommended by the prior audit staff. The effect on AFUDC rates was minor.

In the future, the Company was required to comply with FERC Order No. 561.

Determination of AFUDC Rates

Two instances of noncompliance with the provisions of the Commission's regulations concerning the determination of the Allowance for Funds Used During Construction (AFUDC) were noted. First, the Company's 1979 estimated AFUDC rate was not adjusted to the actual rate even though it exceeded the actual rate by 30 basis points. Second, the Company's calculation of the 1981 AFUDC rate incorrectly used the cost rate for common equity granted in April 1981.

Commission Order No. 561 requires that the actual AFUDC rate be used when it differs from the estimated rate by 25 or more basis points. Order No. 561 also requires the use of the last approved common equity rate as of the end of the prior year in the determination of the current year's AFUDC rate.

The Company was required to comply with the provisions of Order No. 561 in the future. Due to the low level of construction activity during the audit period, the amounts of overcapitalized AFUDC were not significant. No adjustment of the plant accounts was considered necessary.
AFUDC - Computation Method and Period

Procedures Related to Capitalization for AFUDC

Beginning in 1981, the Company utilized an AFUDC rate based on a weighted average of the AFUDC rates applicable to the respective Public Service Commission and FERC jurisdictional portions of construction work in progress. Prior to 1981, the AFUDC rate was calculated using the PSC formula.

It was noted that the Federal eligible investment base for AFUDC included amounts related to the following items, which should have been excluded for the reasons as detailed below:

(1) Jobs under $50,000 - Those jobs included in this category with construction periods of less than 30 days should be exempted from the AFUDC accrual.

(2) Jobs with estimated property additions of $50,000 or more - Amounts included in this category were for purchases only, materials and supplies charges and other non-construction type charges and, therefore, should have been exempted from the AFUDC accrual.

(3) Engineering Orders (EOs) - Some of the charges to the EOs in this category represented engineering costs which were incurred before active construction on a project commenced or after a project was ready for service. Therefore, such charges should have been exempted from the AFUDC accrual.

The Company was required to exclude the above detailed items from the Federal eligible investment AFUDC base, and record an adjusting entry to eliminate from Account 107, AFUDC erroneously capitalized.

Computation of AFUDC on Large Projects

Company procedures for computing AFUDC applicable to the month completed construction go in service call for omission of interest during such month if the project is completed before the 15th day and capitalization of a full month's interest if the project is completed on or after the 15th day. Such procedures are a convenient, acceptable method of use on construction projects not involving unusually large construction expenditures, since interest on individual projects is not seriously distorted and over and underaccruals tend to offset each other. However, for unusually large expenditure projects, interest should be computed to the exact day the plant is completed or ready for service so as to avoid significant over or underaccruals of AFUDC.
AFUDC - Computation Method and Period

AFUDC Computation Method

When computing the monthly amount of AFUDC for the period of construction prior to the in-service month, the Company procedure involves taking the monthly AFUDC rate times the current cumulative balance. For the month that the work order is completed, Company procedure involves taking one half of the monthly AFUDC rate times the current cumulative balance regardless of the actual in-service date.

Although the Uniform System of Accounts does not specifically set procedures for computing AFUDC, the following is the most widely used and is recommended by the Commission staff:

\[
\text{A* Previous month's ending balance} \\
\text{Plus} + \text{B* One half current month's net expenditures} \\
\text{Times} \times \text{C} \text{ Current monthly interest rate} \\
\text{xxx AFUDC to be capitalized}
\]

*Includes only cash outlays and excludes previously charged interest, contract retentions and accruals.

The Company was required to adopt the above procedure for capitalization of AFUDC, using the actual date placed in service or ready for service as the in-service date for work orders.

Construction Completion Reports and Cut-off of AFUDC Accruals

A number of construction work orders were closed to electric plant in service several months after the in-service date of the project. Interest was capitalized by the Company until the construction work order was closed to electric plant in service. The overcapitalization of interest was due to the field personnel's failure to submit the completion reports on a timely basis and failure of the accounting personnel to reverse interest accruals when the in-service date became known.

Instruction B of Account 107, Construction Work in Progress-Electric, states, "work orders shall be cleared from this account as soon as practicable after completion of the job." FERC Accounting Release No. 5 requires that interest capitalization cease when the project is placed in or ready for service.

The Company was required to institute the necessary policies and procedures to ensure that construction work order completion reports are submitted on a timely basis and that interest capitalized on construction work orders cease at the time when the project is placed in or ready for service. No adjustment was warranted due to the minor amounts involved.
UTILITY PLANT ACCOUNTING

AFUDC - Computation Method and Period

AFUDC Capitalized Prior to Continuous Construction

It has been the Company's practice to capitalize AFUDC beginning with the first charges for all projects that qualify for the allowance. For several projects, including two transmission lines and a generating station site, AFUDC was capitalized prior to active construction.

Commission Accounting Release No. 5 provides that the allowance may be capitalized starting from the date that construction costs are continuously incurred on a planned progressive basis. Allowance for periods prior to continuous construction activity may be capitalized only under special circumstances or when justification can be shown by the Company.

The Company was required to begin capitalization of AFUDC in accordance with the requirements of Accounting Release No. 5 for all work orders in the future.

AFUDC on Expenditures Subsequent to In-Service Date

On certain construction work orders which are completed and ready for service or placed in service, the Company discontinues capitalizing AFUDC on the accumulated construction expenditures, but continues to capitalize interest on any additional current monthly expenditures made subsequent to such in-service date at one-half of the monthly interest rate. The Uniform System of Accounts contemplates that AFUDC should stop on the day before the facilities are placed in service or are ready for service.

Determination of Construction Expenditures Eligible for AFUDC Accrual

The Company computed AFUDC on the basis that all direct construction expenditures were outstanding for one month, regardless of the length of the construction period or the in-service date of a particular project.

The Company was required to revise its procedures so as to: (1) exclude capitalization of AFUDC on jobs lasting less than 30 days, since funds are normally expended subsequent to the in-service date of such jobs, (2) capitalize one half month's AFUDC on charges incurred during the month on jobs requiring more than 30 days, since such charges are outstanding on the average for one-half month, and (3) assure that no AFUDC is capitalized for periods subsequent to the in-service date.
AFUDC - Computation Method and Period

Improper Capitalization of AFUDC on Delayed and Suspended Projects

The guidelines for the computation of Allowance for Funds Used During Construction (AFUDC) were as follows:

AFUDC will be accrued on applicable work orders, excluding new generating facilities, from the date of the first charge, including survey, investigation, rights-of-way acquisition, etc., to the in-service date. AFUDC on new generating facilities will continue to be accrued from the establishment of the construction office or the start of construction of the generating facility to the in-service date.

Staff analysis of delayed and suspended projects during the audit period disclosed that AFUDC continued to be computed even though no appreciable charges were incurred on a planned progressive basis on certain work orders.

The staff is of the opinion that the Company's guidelines for AFUDC are not in accordance with Accounting Release No. AR-5, effective January 1, 1968, which states that "interest during construction (AFUDC) may be capitalized starting from the date that construction costs are continuously incurred on a planned progressive basis."

The Company was required to make an entry to remove excess Allowance for Funds Used During Construction (AFUDC) capitalized on delayed and suspended construction projects.

Recording Retroactive AFUDC Without Commission Approval

The Company followed the practice of setting up expense job orders to accumulated preliminary construction costs. Preconstruction costs such as surveys, rights-of-way, legal fees, etc. were charged to Account 850, Operation Supervision and Engineering, via the expense job order. Once the Company received a Certificate of Public Convenience and Necessity, or actual construction began, the charges to the expense account were reversed and Account 107, Construction Work in Progress, was charged. AFUDC was retroactively computed from the date of application for the certificate.

The Uniform System of Accounts provides for the recording of all expenditures for preliminary surveys, plans, investigations, etc. in Account 183.1, Preliminary Natural Gas Survey and Investigation Charges, and Account 183.2, Other Preliminary Survey and Investigation Charges, as appropriate. Fees paid to the Commission prior to the issuance of a certificate should be recorded in Account 186, Miscellaneous Deferred Debits. Recording of retroactive AFUDC is permissible only with prior approval of the Chief Accountant of the FERC.
AFUDC - Computation Method and Period

Procedures for Applying the Order No. 561 AFUDC Rate Formula

In computing the AFUDC rate the amount for "W" was the average balance of Account 107, Construction Work in Progress and Account 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment and Fabrication, less non-interest bearing CWIP and exempt CWIP. Order No. 561 provides that "W" be the average balances of Account 107 and Account 120.1 and does not provide for excluding any amounts of CWIP. The value of the "s" was the cost of short term debt taking into account the effect of compensating balance requirements while "S" was the average balance of short term debt without taking into account compensating balances.

These procedures represented departures from Order No. 561. The Order establishes a ceiling on the AFUDC rate but permits departures with prior Commission approval. The Company's procedures may result in the use of a higher AFUDC rate than permitted depending on the amounts involved.

The Company was required to obtain prior Commission approval for all departures which could result in higher AFUDC. No adjustment of the plant accounts was recommended as the effects were not considered to be significant with respect to the AFUDC rates used during the audit period.

Procedures for Applying Order No. 561 AFUDC Rate Formula

In the Company's procedures for computing the AFUDC rate using the formula in FPC Order No. 561, the amount for "W" was the average balance of Account 107, Construction Work in Progress, and Account 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment and Fabrication, less non-interest bearing CWIP and exempt CWIP. Order No. 561, provides that "W" be the average balance of Account 107 and Account 120.1 and does not provide for excluding any amounts of CWIP. The staff also noted an inconsistency in application in that the value of "s" was the cost of short term debt taking into account the effect of compensating balance requirements while "S" was the average balance of short term debt without taking into account compensating balances.

It was the staff's view that the above cited applications represented departures from Order No. 561. The Order established a ceiling on the AFUDC rate but permits departures with prior Commission approval. The Company's procedures could result in the use of a higher AFUDC rate than permitted depending on the amounts involved.

The Company was required to obtain prior Commission approval for all departures which could result in higher AFUDC. No adjustment of the plant accounts was recommended as the effects were not considered to be significant with respect to the AFUDC rates used during the audit period.
UTILITY PLANT ACCOUNTING

AFUDC - Computation Method and Period

Capitalization of AFUDC on Compressor Unit Purchases

Work Orders were issued for the purchase and subsequent upgrading of existing rental compressor units. The Company began accruing AFUDC on these work orders when the units were purchased in 1981. Construction to upgrade the compressor units purchased did not begin until October 1982, June 1983, and July 1983.

Accounting Release Number 5 (Revised) states that AFUDC may be capitalized starting from the date that construction costs are continuously incurred on a planned progressive basis. Accrual of AFUDC prior to the upgrading of the facilities was not proper as construction had not begun and the units were available to the system during the period.

Staff recommended the Company revise its procedures to ensure that AFUDC is accrued only during periods of actual construction and make an entry to eliminate the AFUDC capitalized prior to commencement of construction.

Capitalization Period of AFUDC

When computing AFUDC on projects for the month in which construction is completed, the Company assumes the last day of the month as the in-service date and accrues one-half the computed monthly AFUDC. This procedure tends to offset over and under-accruals as a whole, and AFUDC on individual projects is not seriously distorted. However, on major construction projects (ten million dollars and over), AFUDC should be computed to the exact date of completion to avoid significant over or under-accruals of AFUDC.

Accounting Release No. 5 (Revised) states that the capitalization of AFUDC stops when facilities have been tested and are placed in or are ready for service.

The Company was required to adopt procedures that ensure that AFUDC on major projects ceases the day before the plant is placed in or is ready for service. No adjustment was required due to the immateriality of the amounts involved.

Allowance for Funds Used During Construction (AFUDC)

Under procedures currently in effect, AFUDC was computed on a month end construction balance and recorded in the subsequent month. This method did not give recognition to the timing of expenditures and a full month's allowance may be taken for expenditures outstanding during a lesser period.

The Company was required to terminate this procedure and instead compute AFUDC on an average monthly construction balance by adding the beginning and ending monthly construction balances together and dividing by 2 or by using the prior month's ending balance and including, therein, only one half of the current month's additions.
AFUDC - Computation Method and Period

Monthly AFUDC Computations

The Company computes AFUDC by applying the monthly AFUDC rate to the cumulative work order balance at month-end. AFUDC is not taken for the month the work order is placed in service. This procedure results in the overcapitalization of AFUDC on the current month’s expenditures charged to the work order and may result in an overall overcapitalization of AFUDC depending upon the in-service date of the work order. This procedure is convenient and acceptable for minor work orders not involving large construction expenditures, since AFUDC on individual projects is not seriously distorted and over and under-accruals tend to offset each other. However, a more refined method should be used for major work orders.

Although the Uniform System of Accounts does not specifically set procedures for computing AFUDC, the following is the most widely used and is recommended by the Commission staff:

\[(A + B) \times C \times D = \text{AFUDC to be capitalized}\]

where:  
A = Previous month's ending balance  
B = 1/2 current month’s net expenditures  
C = Monthly AFUDC rate (adjusted for compounding)  
D = Percentage of days in the month work order in under construction

Since the Company currently is developing a new accounting system, the staff recommended the Company incorporate the above procedure for capitalization of AFUDC on major work orders in its new accounting system.
UTILITY PLANT ACCOUNTING

AFUDC - Computation Method and Period

Capitalization of the Allowance for Funds Used During Construction

The Company does not reduce its rate base by deferred income taxes related to a generation construction project. In such circumstances, the staff believes the AFUDC base should be reduced. As a result the Company over-capitalized $4,622,000 of AFUDC. The staff recommended that the Company reverse the over-capitalization of AFUDC and revise its accounting practices prospectively.

The FERC requires utilities to deduct all construction related deferred income taxes from rate base. In this manner, the Commission carries out its policy of providing ratepayers with the time value benefit of accumulated deferred income taxes by reducing the base on which the utility is entitled to earn a return.

The staff's examination disclosed that although the Company was precluded from reducing its rate base by these construction related deferred income taxes it failed to reduce its AFUDC base by such amounts. In this regard, a utility is entitled to earn a return on its rate base and its AFUDC base. The return applicable to rate base is earned and collected currently from customers while the return on the AFUDC base is earned currently but collected in future periods. In order to provide the customer with the time value of construction related deferred income taxes one of these bases must be reduced by such amounts. The staff was of the opinion that under the circumstances the Company should reduce its AFUDC base by the deferred income taxes generated during the construction period.

Absent a reduction in the AFUDC base, the Company will earn a return (through excessive capitalization of AFUDC) on no cost funds available from the tax benefits of accelerated tax deductions applicable to the construction program.

The Company was required to (1) reverse all AFUDC capitalized in its construction project above the amounts which would have been capitalized had the Company reduced its AFUDC base by accumulated deferred income tax balances related thereto and, (2) reduce its AFUDC base in the future by the deferred income taxes related to construction timing differences which are not deducted from rate base.
AFUDC – Computation Method and Period

Accounting for Allowance for Funds Used During Construction

The Company accrued AFUDC on Work Authorization after the in-service date.

Electric Plant Instruction No. 3(17) of the Uniform System of Accounts states in part:

Allowance for funds used during construction includes the net cost for the period under construction . . .

Also, an Accounting Release issued by the Chief Accountant on January 1, 1968, requires that a company cease the accrual of AFUDC when facilities are tested and are placed in or ready for service.

Staff recommended that the Company:

(1) strengthen procedures to ensure that the accrual of AFUDC on all projects is stopped when facilities are tested and placed in or ready for service;

(2) record correcting entry to reverse the excess accrual of AFUDC; and

(3) recalculate billings by excluding the overaccrued AFUDC from utility plant and depreciation expense accruals and make refunds, with interest, for any overbilled amounts.
AFUDC - Rate Calculation and Debt/Equity Split

AFUDC Rate Calculations

During the review of the AFUDC rates used by the Company for the period 1978-1981, the following weaknesses were noted:

(1) In determining the AFUDC rate to be used, the CWIP and nuclear fuel components were based on a 12-month average rather than a 13-month average as required by Commission Order No. 561. A 13-month average balance will be utilized in the future.

(2) The Company had been allowed by the PUC to include a portion of its CWIP in rate base. When computing the AFUDC rate to be used, CWIP in rate base should not be included in the amounts used in determining the CWIP 13-month average. The Company was required to exclude CWIP in rate base from the 13-month average calculation in the future.

(3) In determining the AFUDC rate to be used, the cost of common equity component was based on a retail rate of return granted during the middle of the year. Commission Order No. 561 requires that this component be based on the last rate of return granted as of the beginning of the year. The Company was required to comply with this requirement in the future or obtain a waiver from the Chief Accountant.

(4) During the audit period, the Company used an AFUDC rate which was lower than the rate allowed under Order No. 561 methodology. The Company recorded the debt/equity split between accounts 432.1 and 419.1 based on the actual AFUDC rate used each year. Order No. 561 requires that this split be based on the following: The debt portion of the AFUDC rate should be at the rate derived through the Order No. 561 formula, with the equity portion being the difference between the debt portion so derived and the total AFUDC rate used. The Company was required to compute the debt/equity split using the Order No. 561 methodology in the future.
AFUDC – Rate Calculation and Debt/Equity Split

Improper Calculation of AFUDC Rate

The review of rates used to capitalize AFUDC during the audit period disclosed the following:

(1) The cost rates used for common equity were the most currently approved rates as of the end of the current year rather than those approved as of the end of the prior year.

(2) In the determination of the weighted average cost of long term debt, the principal amounts outstanding as of the end of the current year were used rather than the amounts outstanding as of the end of the prior year. In addition, the amortization amounts of the gain on reacquired debt were those applicable to the succeeding year rather than those applicable to the year of the weighted cost of debt computation.

The Commission’s regulations describe how and which elements of cost are to be utilized in the determination of AFUDC rates. The above cited instances are deviations from these regulations.

Accounting for Tax Effects of AFUDC Accrual

The Company employed a net of tax AFUDC rate to capitalize AFUDC on certain portions of its construction work in progress. The tax effect normalized was accounted for by a charge to Account 409.1, Income Taxes, Utility Operating Income, and a credit to Account 432, Allowance for Borrowed Funds Used During Construction.

The accounting contemplated by Commission Order No. 561 was that Account 432 be shown net of tax. Account 409.2, Income Taxes – Other Income and Deductions, would reflect the tax savings credit with a contra debit to Account 409.1.

Recognizing that comparable reporting with other utilities is desirable, the staff recommended that for reporting purposes, Account 410.1, Provision for Deferred Income Taxes, Utility Operating Income, be debited for the tax effects and Account 432 be credited. This will eliminate all charges to Account 409.1 and 409.2. (An optional treatment would be to utilize a gross AFUDC rate and credit Account 107, Construction Work in Progress and debit Account 410.1 for the tax effects.)
AFUDC - Rate Calculation and Debt/Equity Split

Recording of AFUDC

The Company utilized a gross AFUDC rate to accrue AFUDC which was less than the gross maximum rate allowable under Order No. 561. The debt component of the AFUDC accrued during these years was less than the debt component of Order No. 561. The applicable tax effects the AFUDC were flowed through by the Public Service Commission.

In the staff's opinion, when a Company chooses to use an AFUDC rate less than that allowable under Order No. 561, the debt component yields by Order No. 561 should be held constant with the equity component absorbing the short fall caused by the use of a less than maximum AFUDC rate.

In the future, if the Company chooses to use an AFUDC rate which is less than the maximum allowable under Order No. 561, the debt/equity components of the rate used will be recorded as stated in the above paragraph.

Allocation of AFUDC to Conform With Commission Requirements

The staff's examination disclosed that the Company allocated AFUDC between Account 419.1, Allowance for Other Funds Used During Construction, and Account 432, Allowance for Borrowed Funds Used During Construction - Credit, based upon an AFUDC rate calculated in accordance with the Public Service Commission requirements. While the determination of the AFUDC rate and the calculation of the AFUDC amount capitalized using the PSC methodology were proper, the allocation of AFUDC using the PSC rate resulted in significantly lesser amounts of AFUDC being credited to Account 432 than would have been credited had the methodology prescribed by Commission Order No. 561 been used. The Order No. 561 methodology would have resulted in significantly more AFUDC credited to Account 432 than was actually credited to that account during the period.

The debt component of the Order No. 561 rate is determined by using the debt amounts and cost rates of only long-term and short-term debt. When the AFUDC rate utilized by the Company is less than the maximum AFUDC rate calculated using Order No. 561 methodology, the difference between these rates is to be considered a reduction of the equity component of AFUDC. In calculating the debt component of the AFUDC using the PSC methodology, the amounts and cost rates of accumulated deferred income taxes, deferred investment tax credits, and customer deposits, as well as long-term and short-term debt, were included.

In the future, the Company was required to credit the amounts to Account 419.1 and 432 based on Order No. 561 methodology for purposes of financial accounting and reporting to FERC and to stockholders.
AFUDC - Rate Calculation and Debt/Equity Split

Improper Calculation of AFUDC Rate

The Company did not consider Account 207, Premium on Capital Stock, in determining the cost rate for preferred stock.

The Uniform System of Accounts, Electric Plant Instruction No. 3(17) states that the cost rates for long-term debt and preferred stock shall be the weighted average cost determined in the manner indicated in Section 35.13 of the Commission's regulations. Therein, it is provided that the cost rate for preferred stock be determined on a net proceeds basis.

The Company was required to determine cost rates applicable to preferred stock by giving recognition to the related premiums recorded in Account 207 when computing AFUDC rates. Recomputation of AFUDC rates disclosed that the actual rates used by the Company did not exceed the maximum allowed under the formula prescribed in Electric Plant Instruction No. 3(17).

Computation of AFUDC in Accordance with Order No. 561 and the Split Between Debt and Equity

The Company used an AFUDC rate which was lower than the rate produced under the Order No. 561 methodology. The Company recorded the debt/equity split in Account 419.1, Allowance for Other Funds Used During Construction and Account 432, Allowance for Borrowed Funds Used During Construction - Credit, based on the AFUDC rate used. Also, the Company included Account 216.1, Unappropriated Undistributed Subsidiary Earnings, in the common equity component when calculating the AFUDC rate.

When less than the Order No. 561 rate is used, the difference between the maximum rate and the actual rate used is considered to be the result of using less than the maximum equity rate. In addition, Order No. 561 does not contemplate amounts recorded in Account 216.1 to be included in the common equity component.

The Company was required to use the Order No. 561 cost of debt to compute the debt/equity split when a rate lower than the Order No. 561 rate is used and not include Account 216.1 in the calculation of the AFUDC rate.
AFUDC - Rate Calculation and Debt/Equity Split

AFUDC Debt Equity Split

The Company used an AFUDC debt/equity split based on the ratio of the rates estimated at the beginning of the year. No adjustments to actual were made during the year. For the last three years, the AFUDC rate used was less than the maximum formula rate.

The Uniform System of Accounts, Electric Plant Instruction No. 3(17) states estimates should be adjusted as actual data becomes available. When the AFUDC rate utilized is less than the maximum AFUDC rate calculated using Order No. 561, the difference between these rates is to be considered a reduction of the equity component of AFUDC.

In the future the Company was required to adjust estimated ratios to actual for the debt/equity split. If the AFUDC rate used is less than the maximum rate the Company should use the actual Order 561 cost of debt to compute the debt/equity split.

Allocation of Annual AFUDC Rates Between Debt/Other Funds

In determining the maximum allowance for funds used during construction (AFUDC) rate allowed by Order No. 561, the Company calculated the weighted average cost rate of each source to the nearest hundredth of one percent. The computed maximum allowable AFUDC rate was rounded up/down to the nearest quarter of one percent. This was the annual AFUDC rate used by the Company to capitalize AFUDC. The allocation of AFUDC capitalized between debt and other funds was done on a rounded basis.

In staff's opinion, the assignment of the overall AFUDC rate between debt and other funds on a rounded basis was inconsistent with the methodology prescribed by Order No. 561. The weighted average cost of debt, computed to the nearest hundredth of one percent, should be first applied against the AFUDC rate used by the Company and the remainder assigned to the other funds cost component.

By use of the above procedures, the AFUDC capitalized by the Company was within the limits prescribed by Order No. 561. However, use of these procedures did result in a minor misallocation of AFUDC capitalized between Account 419.1, and Account 432.

In the future, the Company was required to institute procedures whereby AFUDC capitalized will be properly allocated between debt and other funds in accordance with the methodology prescribed by Order No. 561.
UTILITY PLANT ACCOUNTING

AFUDC - Rate Calculation and Debt/Equity Split

Improper Computation of the AFUDC Rate

In the computation of the AFUDC rate used to determine the debt/equity split between Accounts 419.1 and 432, the Company’s procedures were in violation of Order No. 561 requirements as follows:

(1) The Company utilized the latest approved wholesale common equity rate. Order No. 561 requires use of the common equity rate approved by the primary rate jurisdiction.

(2) The cost rates utilized for long-term debt and preferred stock capital were computed on stated value and interest rates. Order No. 561 requires the computation of these cost rates in accordance with Part 35.13 of the Code of Federal Regulations.

(3) The long-term debt balance used was the beginning of the year balance less current maturities of the long-term debt. Order No. 561 requires use of this balance net of unamortized debt discount, premium and expense.

In the future, the Company was required to comply with Order No. 561 requirements in the computation of the AFUDC rate.

AFUDC Rate Calculation

During the review of the AFUDC rates used by the Company, the following weaknesses were noted in the Company's method of determining the maximum rate allowable under Commission Order No. 561 for Form 1 reporting purposes:

(1) In the calculation of the 1982 AFUDC rate, the "cost of common equity" component was based on a retail rate of return granted in February 1982. Commission Order No. 561 requires that this component be based on the last rate of return granted as of the beginning of the year.

(2) In computing the CWIP and nuclear fuel component ("W" Factor), the Company simply divided the total AFUDC accrued each year by the AFUDC rate used during the year. Order No. 561 specifies that a 13-month average of actual balances in Accounts 107 and 120.1 be used in determining the "W" Factor.

(3) In computing the "W" Factor, the Company included the portion of CWIP allowed in rates by the State Commission. Order No. 298 requires that CWIP balances added to rate base be excluded from the "W" component of the AFUDC formula beginning on the effective date of the new rates.

The Company was required to comply with the requirements of Order No. 561 and Order No. 298 when calculating the maximum AFUDC rate allowable. No adjustment was proposed as the AFUDC rate utilized by the Company was less than the maximum allowable under Order No. 561.
UTILITY PLANT ACCOUNTING

AFUDC - Rate Calculation and Debt/Equity Split

Failure to Adjust Account 432, Allowance for Borrowed Funds Used During Construction-Credit, to Actual

The Company capitalized AFUDC at an estimated rate during the audit period. At year-end, the Company prepared a schedule reflecting the actual AFUDC rates in effect for the borrowed and other funds components but no adjustments were made to the books to reflect Account 432 at actual.

Gas Plant Instruction No. 3(17) requires AFUDC capitalized to be adjusted where corrections of estimates used in developing the AFUDC rate are necessary. In the Company's case, the correction of estimates to actual did not result in any significant difference in the cost of borrowed funds capitalized during the audit period. However, the corrections should be made in the future since the information necessary to reflect the adjustment is readily available and would result in more accurate reporting.

The Company was required to revise its accounting practices to adjust the net cost of borrowed funds to actual at year-end with the remaining AFUDC reflected in Account 419.1, Allowance for Other Funds Used During Construction.

Calculation of Accounting for Funds Used During Construction (AFUDC) Rate

Supply Company is a subsidiary of Gas Company, a registered public utility holding company. To determine the rate used for allowance for funds used during construction (AFUDC), Supply utilized the formula outlined in the Gas Plant Instruction No. 3(17) applied to its own capitalization structure and cost. Since all of Supply's capital is provided by its parent, the parent company's capitalization structure and cost rates are used for rate purposes in determining Supply's rate of return. Such structure and cost rates should also be used in calculating AFUDC rates. The Company's practice of utilizing its own capitalization structure and cost rates resulted in only a minor difference between rates based on the parents capital structure and costs.

In the future, the Company was required to determine the appropriate AFUDC rates utilizing the parent's capitalization structure in order to provide consistency between the costs used for ratemaking and costs used for AFUDC purposes.
AFUDC - Rate Calculation and Debt/Equity Split

Computation of AFUDC Rates

The review of the Company’s procedures for calculating AFUDC rates disclosed the following inconsistencies with the methodology set forth in Electric Plant Instruction 3(17), as amended by Order 561 (issued on February 1, 1977):

The common equity balance was reduced by the amounts recorded in Account 121, Nonutility Property, Account 122, Accumulated Provision for Depreciation and Amortization of Nonutility Property, Account 123.1, Investment in Subsidiary Companies, and an amount for unbilled revenues. The common equity balance should include amounts recorded in Account 216, Unappropriated Retained Earnings, without reduction for the amounts recorded in the above mentioned accounts.

The proceeds from pollution control bonds held in trust and not currently expended for construction were not included in the computations of or the application of AFUDC. Under the requirements of Accounting Release No. 13 (AR-13), the unexpended portion of pollution control bond funding together with any interest income should be recognized in the determination of and the accrual of AFUDC.

The Company was required to revise its procedures for the development of the AFUDC rate to conform with the requirements of Electric Plant Instruction 3(17). The misapplication of the formula did not result in an over-capitalization of AFUDC.

Calculation of Maximum Allowable AFUDC Rate

The staff’s review of the Company’s procedures for calculating the maximum allowable rate to capitalize Allowable for Funds Used During Construction (AFUDC) disclosed the following inconsistencies with the methodology set forth in Electric Plant Instruction No. 3(17), as amended by Order No. 561, issued February 2, 1977:

1. The long-term debt cost rate did not include amounts recorded in Account 226, Unamortized Discount on Long-Term Debt - Debit and Account 181, Unamortized Debt Expense. Order 561 states, in part, "With respect to long-term debt, the cost of such capital should be the yield to maturity determined in the same manner as set forth in Part 35.13(b)(4)(iii), Statement C - Rate of Return, of the Commission's Regulations under the Federal Power Act." The calculation of the cost rates for debt capital should include debt discount and expense.

2. The preferred stock cost rate (p) used was a weighted average of the preferred stock dividend rates. However, the cost rate should be determined by dividing the dividend rate by the ratio of net proceeds to gross proceeds for each issue.

The Company was required to revise its procedures for determining the maximum allowable AFUDC to conform to the formula set forth in Electric Plant Instruction No. 3(17). No adjusting entry was recommended due to immaterial amounts involved.
AFUDC - Rate Calculation and Debt/Equity Split

Cost Rate for Short-Term Debt Not Actual for AFUDC Rate Calculation

The Company calculates the weighted average short-term debt balance in computing the Allowance for Funds Used During Construction (AFUDC) rate by combining the notes payable and commercial paper less any temporary cash investments. The cost rate of the short-term debt used by the Company is a statistical rate provided for 6-month commercial paper.

Order No. 561 states that the short-term debt balances and related cost shall be estimated for the current year with appropriate adjustments as actual data becomes available. The Company did not adjust the estimated short-term debt component to actual when the facts became known.

The Company was required to adjust the cost rate for short-term debt to actual when the quarterly review of its AFUDC rate is performed. No adjustment was required as the Company did not capitalize AFUDC in excess of that allowed under Order No. 561.

Procedures for Determining the AFUDC Rate

The Company used an allowance for funds used during construction (AFUDC) rate in excess of that permitted under Electric Plant Instruction (EPI) No. 3(17).

The difference in the AFUDC rates was primarily caused by the Company's procedure of excluding short-term debt in the AFUDC rate calculation, and resulted in an overaccrual of AFUDC estimated at $3.5 million for the years 1985 and 1986.

The Company's procedure of excluding short-term debt from the AFUDC calculation was not consistent with the Commission's regulations. The formula set forth in EPI No. 3(17) considers short-term debt as the first source of funds for construction purposes, with the balance of construction funding derived pro rata from the Company's overall capitalization.

In a rate order issued to the Company, the State Commission rejected the method for calculating AFUDC as prescribed by Order 561. The method ordered by the State Commission assumes that the AFUDC accrual rate is based upon the Company's imbedded cost of long-term capital allowed in its most recent rate of return. Therefore, to the extent that the State methodology yields a rate in excess of the rate computed under Order 561, the excess is considered a regulatory asset created by the State Commission. The Company should record the regulatory created asset in Account 186, Miscellaneous Deferred Debits.

The Company was required to (1) revise procedures for computing the AFUDC rate to ensure that such procedures comply with Electric Plant Instruction No. 3(17); (2) reverse the wholesale portion of the AFUDC overaccrued during 1985 and 1986, and record a regulatory asset in Account 186 for the retail portion.
AFUDC - Rate Calculation and Debt/Equity Split

Procedures For Calculating the AFUDC Rate

The Company did not use the consolidated capital structure of its parent to compute its AFUDC rate.

The Company is a subsidiary of a registered public utility holding company. The parent, in general, provides the financing for the system companies. The Company's rate of return for retail purposes is determined by using the capital structure, including short-term debt, of the parent. The Company has no wholesale rates subject to the jurisdiction of the FERC. However, the wholesale and retail rates of its sister companies were also set using the consolidated capital structure of the parent.

One objective of the AFUDC formula is to give recognition to the interrelationship between the capital utilized for rate purposes and the capital components of AFUDC in a manner that permits a utility to achieve a rate of return on its total utility operations, including its construction program, at approximately the same rate allowed in rates. The Company should have therefore, used the consolidated capital structure used in ratemaking in its AFUDC computations.

During the audit period the AFUDC accrued by the Company did not exceed the amount that could have been capitalized had the consolidated capital structure, including short term debt, been used in the AFUDC computation.

The staff recommended that the Company revise procedures for computing its AFUDC rate and use the consolidated capital structure and cost rates used for ratemaking purposes.
AFUDC - Rate Calculation and Debt/Equity Split

Accounting for Allowance for Funds Used During Construction (AFUDC)

The Company used a 12.00 percent AFUDC rate for the period from January through August 1986 and a 11.00 percent AFUDC rate for the remaining portion of the 1986 year. The maximum allowable AFUDC rate pursuant to Electric Plant Instruction (EPI) No. 3(17) for 1986 was 10.20 percent. The Company did not adjust its AFUDC accrued for the year to reflect the maximum permitted under the requirements of EPI No. 3(17).

The Commission established guidelines for determining the maximum allowable AFUDC rate in Order No. 561, issued February 2, 1977. In Order No. 561, the Commission stated:

"We shall require, however, that public utilities ... monitor their actual experience and adjust to actual at year-end if a significant deviation from the estimate should occur. For this purpose we shall consider a significant deviation to exist if the gross AFUDC rate exceeds by more than one quarter of a percentage point (25 basis points) the rate that is derived from the formula by use of actual thirteen monthly balances of construction work in progress and the actual weighted average cost and balances for short-term debt outstanding during the year.

The AFUDC rate used by the Company for 1986 was more than 25 basis points higher than the maximum rate permitted by EPI No. 3(17). The difference between the maximum allowable AFUDC rate pursuant to EPI No. 3(17) and the rate utilized by the Company for 1986 amounted to approximately $1.8 million. Under the requirements of the Uniform System of Accounts, the Company should have adjusted the total amount of AFUDC capitalized for 1986 so as not to exceed the maximum permitted by the formula set forth in EPI No. 3(17).

We recommend that the Company adopt the necessary procedures for determining and monitoring the components of the AFUDC rate to ensure the total the AFUDC accrued in any year does not exceed the maximum amount permitted under the formula set forth in EPI No. 3(17).
AFUDC – Rate Calculation and Debt/Equity Split

Procedures for Calculating the Maximum Allowance for Funds Used During Construction (AFUDC) Rates

The Company's procedures that it applied during the years 1985 through 1989 in determining the maximum AFUDC rate were not in accordance with the provisions of Electric Plant Instruction (EPI) No. 3(17) of the Uniform System of Accounts in the following respects:

(1) The Company reduced the short-term debt balances by the balances of short-term investments and by amounts the Company assigned to gas utility operations.

(2) In 1989 the Company excluded all short-term debt in calculating the AFUDC rate.

(3) The Company deducted the balances of Accounts 121 through Account 128 (collectively termed other property and investments) from the common stock component and excluded Construction Work in Progress (CWIP) of the gas and water utility operations from the average CWIP component of the AFUDC rate calculation.

On January 20, 1978, the Commission issued Order No. 561-A. The Order addressed the subject of the short-term debt component of AFUDC rates as follows:

It is generally impossible to specifically trace the source of funds used for various corporate purposes. The cost of short-term debt can be effectively measured and capitalized for subsequent recovery since under our formula the balances and rates for the forthcoming year are estimated annually. Therefore, we do not believe that we should modify Order No. 561 with respect to the weight given short-term debt in the formula.

The Company should have used the full amount of short-term debt, without any reduction for short-term investments, in determining the AFUDC.

The Company's AFUDC rates for the audit period did not exceed the maximum amounts permitted under the formula in EPI No. 3(17) and therefore, no corrections of the Company's accounts were necessary.

Staff recommended that the Company revise its procedures for determining the maximum AFUDC rate to ensure adherence to the formula prescribed by EPI No. 3(17).
AFUDC - Rate Calculation and Debt/Equity Split

Accounting Procedures for Determining the Rate for Allowance for Funds Used During Construction

The Company used rates for accruing AFUDC that were ordered by the state PSC that were not in compliance with the U.S. of A. The amounts of AFUDC calculated using these rates were included in Account 107, Construction Work in Progress.

Electric Plant Instruction (EPI) 3(17) of the Uniform System of Accounts states in part:

Allowance for funds used during construction includes the net cost for the period of construction of borrowed funds used for construction purposes and a reasonable rate on other funds when so used, not to exceed, without prior approval of the Commission, allowances computed in accordance with the formula prescribed in paragraph (a) of this subparagraph.

The Commission has approved special accounting to recognize an asset where the action of a regulator provides sufficient assurance that amounts are recoverable in future rates. The action of the PSC provided the Company with sufficient assurance that it will recover these amounts in future rates.

Under the Commission's accounting for regulatory created assets, the Company should have recorded the PSC allowed amounts in excess of that capitalized pursuant to EPI 3(17) by debiting Account 186, Miscellaneous Deferred Debits and crediting Account 421, Miscellaneous Nonoperating Income. The amounts recorded in Account 186 should then be amortized to Account 406, Amortization of Electric Plant Acquisition Adjustments, over the period the amounts are recoverable in rates.

Staff recommended that the Company:

(1) revise accounting and financial reporting procedures to ensure that it records the PSC allowed amounts in excess of that capitalized pursuant to EPI 3(17) in Accounts 186, 421, and 406 consistent with the Commission approved special accounting for regulatory created assets; and

(2) record the correcting entry to reclassify the regulatory created asset to the appropriate accounts.
AFUDC - Other

Accounting for Income Tax Benefits Utilized by Partners in AFUDC Rate

During the construction of the pipeline, the Company incurred interest expenses and sales taxes which were capitalized as construction costs on the partnership books. These costs were utilized by the partners to reduce their income taxes payable by expensing these items on the partners' income tax returns. The Company was not paid for the benefits of reduced income taxes payable by the partners.

The portion of the cash contributed to the Company by the partners during the construction period which represented the reduction of the partners' income taxes payable, was not an outlay of the partners' cash and therefore was cost-free to the partners. A cost of constructing a pipeline is the time value of the partners cash contributed to fund the construction. Recognition of this cost is through the accrual of an Allowance for Funds Used During Construction (AFUDC). Therefore, the accrual of AFUDC on contributions which do not represent outlays of the partners' cash is inappropriate.

Furthermore, the Commission in Order No. 144 stated, "...The Commission believes in such circumstances that it would be appropriate to reduce the balance that is utilized for the calculation of AFUDC by the construction related deferred taxes in order that future customers will properly receive the benefit of the time value of deferred taxes generated during the construction period." The construction related deferred taxes, noted by the Commission, equate to the benefits of reduced income taxes payable enjoyed by the partners resulting from the construction of the Company.

The Company was required to revise its procedures for accruing AFUDC to give recognition to the cost-free use of capital by the partners of tax benefits attributable to construction which are not passed onto customers under current rates. Also, the Company was required to record an entry to reduce the allowance for other funds capitalized during construction by recognizing the cost-free capital, generated by available income tax deductions during construction, that was available to the Company's partners.
AFUDC - Other

AFUDC Computed on Pollution Control Facilities

In a FERC rate filing, the Commission allowed the Company to include pollution control facilities in rate base. Although rates were effective on May 22, 1983, the Company continued to accrue AFUDC on the pollution control facilities.

Part, 35 Section 35.26 (f) of the Federal Power Act (18 CFR) states, "On the date that any proposed rate that included CWIP in rate base becomes effective, the public utility must discontinue the capitalization of any AFUDC related to those amounts of CWIP in rate base."

The Company was required to record an entry to reverse the amount of AFUDC capitalized on pollution control facilities to the extent that they were included in rate base.

AFUDC Allocation to Appropriate Rate Jurisdiction

The Company has been permitted to include levels of CWIP in rate base. The base upon which AFUDC was capitalized was properly reduced for the effects of CWIP in rate base. The reduction of AFUDC was spread to individual work orders through the use of an effective AFUDC rate. The Company did not maintain records or have in effect procedures to allocate the benefits of CWIP in rate base to the retail customers.

The institution of accounting procedures and the establishment of subsidiary and memorandum records to allocate the benefits of CWIP in rate base are necessary to assure that the cost of service is properly allocated among various classes of customers.

The Company was required to institute accounting procedures and establish such subsidiary and memorandum records to properly allocate the reduction in AFUDC arising from CWIP in rate base to the appropriate class(es) of customers.
CALCULATION OF DEBT AND EQUITY COMPONENTS OF THE ALLOWANCE FOR FUNDS USED DURING CONSTRUCTION (AFUDC) RATE

The State Commission has allowed a level of Construction Work in Progress (CWIP) in the Company's rate base. The 13-month average CWIP balance used by the Company to calculate its AFUDC rate included the levels of CWIP in rate base. The effect of the Company's failure to reduce the 13-month average CWIP by the level of CWIP in rate base was to change the debt to equity ratio of the AFUDC rate. The effect on the gross AFUDC rate was not significant and did not warrant adjustment.

Commission Order No. 561 set forth the formula for computing the AFUDC rate. This Order contemplated that the CWIP component of the formula be adjusted to exclude CWIP included in rate base from the formula when calculating the AFUDC rate. In Order No. 298, issued May 16, 1983, the Commission clarified its position on this issue by stating in footnote No. 109 that CWIP, when included in rate base, shall be excluded from both the computation of the AFUDC rate and the AFUDC accrual.

In the future, the 13-month average CWIP balance used to compute an AFUDC rate was to be reduced by the level of CWIP included in the Company's rate base as contemplated by Order No. 561 and specifically required by Order No. 298.

ACCOUNTING PROCEDURES FOR POLLUTION CONTROL FACILITIES ALLOWED IN WHOLESALE RATE BASE

The Company had not established accounting procedures to discontinue the capitalization of AFUDC on expenditures for pollution control facilities recorded in Account 107, Construction Work in Progress-Electric (CWIP) and included in wholesale rates.

Part 35, Section 35.26(f) of the Commission Regulations under the Federal Power Act (18CFR) states, "On the date that any proposed rate that includes CWIP in rate base becomes effective, the public utility must discontinue the capitalization of any AFUDC related to those amounts of CWIP in rate base."

The Company was required to: (1) exclude pollution control expenditures from the CWIP balance for AFUDC purposes to the extent that the facilities are included in rate base and (2) make an entry to reverse the AFUDC capitalized on pollution control facilities included in CWIP and allowed in wholesale rates.
AFUDC - Other

AFUDC on Future Use Property

The Company recorded expenditures for certain lignite and coal leases and projects in Account 107, Construction Work in Progress, as directed by the Public Utility Commission. The Company computed an Allowance for Funds Used During Construction (AFUDC) in the amount on the expenditures. The accrued AFUDC was subsequently allowed as part of rate base in a rate order issued by the PUC.

Under the requirements of the Uniform System of Accounts, the expenditures should have been recorded in Account 105, Electric Plant Held for Future Use, with an accrual of a carrying charge to represent the regulatory asset created by the action of the PUC. The Company was required to make an entry to reclassify the carrying charge to Account 186. The balance in Account 186 should be amortized to Account 406, Amortization of Electric Plant Acquisitions Adjustments, over a period directed by the PUC.

Computation of Deferred Income Taxes on Equity AFUDC

The Company improperly computed the provision for deferred income taxes included in Account 282, Accumulated Deferred Income Taxes Other. The Company computed the provision as though the equity component of Allowance for Funds Used During Construction (AFUDC), which is to be recovered in revenues and in effect is taxed as depreciation is charged to income, constituted a timing difference.

Paragraph (a) of Generation Instruction No. 18, Comprehensive Interperiod Income Tax Allocation, of the Uniform System of Accounts, indicates that income tax allocation should be applied only to timing differences between the periods in which transactions affect taxable income and the period in which they enter into the determination of pre-tax accounting income.

In periods when equity allowances are capitalized as plant construction cost, they do not enter into the determination of taxable income. However, they have the effect of increasing taxable income over the plant life. This is true because as the allowances are depreciated for book purposes and recovered in revenues, tax deductions are not allowed for the equity component of book depreciation expense. As a consequence, the revenues for recovery of the equity component and the related income tax effects of such revenues enter into the determination of taxable income and pre-tax accounting income in the same accounting period. For this reason, the calculation of interperiod income tax provisions should exclude the equity component of AFUDC included in book depreciation.

The Company was required to (1) revise its procedures to ensure that deferred income taxes are not provided for the difference between book and tax depreciation attributable to equity AFUDC, and (2) record an entry to adjust deferred income taxes incorrectly computed on equity AFUDC capitalized:
AFUDC – Other

Accrual of Allowance For Funds Used During Construction on No-Cost Capital

The Company participated along with the other subsidiaries of the Group in filing consolidated federal income tax returns. During the period of construction of storage facilities various expenses were capitalized as construction costs for accounting purposes that were expensed on the consolidated income tax returns resulting in a related reduction in income taxes payable being realized by the Group. Under the tax allocation procedures used by the Group, the benefits realized from use of the Company’s deductions were not passed along currently to the Company. Instead, the benefits of the deductions were allocated to those associated companies that would have received the tax benefits if they had filed a "separate" tax return. Under this tax allocation method, the Company did not include in the calculation of AFUDC, the cost-free capital realized from the use of its tax deductions on the consolidated income tax returns.

If the Company had computed the AFUDC under the method set forth by the staff, the total AFUDC accrued during the construction period would have been reduced. The reduction was caused by staff including in the calculation of AFUDC the realized benefit of cost-free capital generated by the Company.

The staff supported a tax allocation method that assigns the benefits to those companies whose deductions were actually utilized on the consolidated tax return. The staff’s method is consistent with the Commission’s "stand-alone" policy for the allocation of income tax benefits. The Commission developed a "stand-alone" method in order to give effect to the "benefits/burdens" principle that underlies its ratemaking methods. Furthermore, the staff’s method is consistent with the following views expressed by the Commission on May 6, 1981, in Order No. 144, Docket No. RM80-et al:

Deferred taxes arising from construction related taxes and pensions, for example, reduce the financing requirements to be met from other sources during the construction period of a plant. Having the use of these interest-free funds results in benefits that the Commission has traditionally passed immediately through to customers by deducting the associated accumulated deferred income taxes from rate base. But since these benefits arise from costs associated with the new plant, it is more equitable to allocate them over the service life of the plant. By using the construction-related accumulated deferred taxes as an offset to the balance used in the calculation of AFUDC (rather than rate base), the net plant value going into rate base when the new plant goes on line is reduced. In this way the benefits a company receives from having the use of deferred tax funds during the plant construction period would be reflected in lower costs to be allocated over the plant’s operating life.

The staff concluded that the tax benefits that were realized by the consolidated group represent a cost-free source of funds derived from the use of the Company’s assets. In order to provide the Company’s ratepayers a time value credit for use of the assets, the staff concluded that the realized tax benefits should be considered a source of funds for construction and assigned a zero cost.
Assignment of AFUDC to Construction Projects

The Company accrued AFUDC on a monthly basis on construction charges eligible for AFUDC. The accrued AFUDC was assigned to a blanket overhead work order and subsequently allocated to completed construction projects. In allocating the AFUDC to specific projects, the Company improperly assigned AFUDC to some projects that were not eligible for AFUDC. The Company's procedure therefore resulted in an incorrect allocation of AFUDC among the work orders recorded in Account 107, Construction Work in Progress--Electric.

The instructions to Electric Plant Instruction No. 4, state in part:

A. All overhead construction costs...shall be charged to particular jobs or units on the basis of the amounts of such overheads reasonably applicable thereto, to the end that each job or unit shall bear its equitable proportion of such costs and that the entire cost of the unit, both direct and overhead, shall be deducted from the plant accounts at the time the property is retired.

The Company's procedures resulted in an improper assignment of allowance for funds used during construction (AFUDC) to certain construction projects.

The Company was required to revise procedures to ensure that AFUDC is allocated only to construction projects eligible for AFUDC.
Accounting and Tariff Billing Procedures for Accruing AFUDC on Nuclear Fuel

In September 1986, the Company purchased yellowcake for four nuclear fuel assemblies. Under the terms of the purchase agreement, the Company was not to pay the fuel supplier for the purchase until September 1989.

At the time of the transaction the Company recorded an accrual to reflect the purchase of the yellowcake in Account 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment and Fabrication. Also, it recorded AFUDC (on the debt portion only) on the wholesale jurisdictional portion of the accrued cost until it received the completed assemblies.

The purpose of AFUDC is to recognize as a construction cost the funds used during construction. Since the Company did not expend any fund under the terms of the contract, it was inappropriate for the Company to record AFUDC on the unexpended amounts recorded in Account 120.1.

The Company's improper accounting resulted in an overaccrual of AFUDC included in the nuclear plant accounts, which was subsequently recovered from wholesale customers through fuel adjustment clause billings.

Staff recommended that the Company:

(1) revise procedures to ensure that AFUDC is accrued only on funds expended during construction;

(2) record an appropriate correcting entry to eliminate any overaccrued AFUDC remaining in the nuclear fuel accounts at the end of the audit period; and

(3) recompute FAC billings to wholesale customers and make appropriate refunds, with interest, for any overbilled amounts.
AFUDC - Other

Accounting for AFUDC on the Cost of Land Purchases

The Company followed the practice of acquiring land for construction projects on separate work orders from the construction work orders. The cost charged to the land acquisition work orders consisted of the land cost, including related purchasing costs, appraisals and survey costs. As charges entered into the land acquisition work orders, the Company began to accrue AFUDC. The costs accumulated in the land acquisition work orders were transferred from the work orders to Account 101, Electric Plant In Service, or Account 105, Electric Plant Held For Future Use, pending the commencement of construction. When construction on the related project commenced on a progressive basis, the Company transferred the cost of land, including AFUDC, to the construction work order.

Under the above requirements, the Company procedure of accruing AFUDC on the land acquisitions at the date of purchase and prior to the active use in construction was not in accordance with the Commission's accounting requirements.

Staff recommended that the Company:

(1) revise its AFUDC accrual procedures to ensure that AFUDC is not accrued on expenditures until active construction begins; and

(2) record correcting entry to reverse the AFUDC improperly accrued on the land acquisition prior to commencement of construction.
Earnings and Expenses During Construction

Computation of Power Used in Construction

The Company capitalized the cost of electric power used at station construction sites based upon the rate charged to industrial customer. The rate was calculated by dividing the revenues received from the Industrial Power Service and Interruptible Industrial Service customers by the applicable KWH sales during a twelve month base period.

The Company's accounting was not in compliance with Electric Plant Instruction No. 2 which provides that, "electric plant shall be included in the accounts at the cost incurred by the utility." Staff was of the opinion that power provided for use at construction sites should have been charged at the incremental cost incurred by the utility.

The Company was to begin to charge power charged to construction work orders at the incremental cost to the Company. No adjustment was necessary since the power charged to construction was treated as industrial sales in setting rates by the State Commission.

Approval of Test Period

The station went into commercial operation after a test period of 233 days. The long test period resulted from inherent and unique design problems with the low pressure turbine blading and the potential fatigue failure of the generator blower stationary blades.

The Company did not notify the Commission of the extensive testing period nor seek Commission authorization to continue the test period beyond 90 days. The causes and reasons for the extended test period were reviewed by the Commission and the test period was determined to be justified.

Per Electric Plant Instruction No. 9 of the Uniform System of Accounts, the utility shall furnish the Commission with full particulars of, and justification for, any test or experimental run extending beyond a period of 90 days for all non-nuclear plant.
Earnings and Expenses During Construction

Improper Method of Determining the Fair Value of Power Credited to the Cost of Construction

During the test period the Company capitalized the cost of fuel burned. In addition, the Company passed the cost of such fuel through its wholesale and retail fuel adjustment clauses.

The Company credited the construction work order with a value of the power generated during the test period. Such power was valued at the cost of the power which it had displaced.

Electric Plant Instruction No. 3(18a) states that where the power generated by a plant under construction is delivered to the utility's electric system for sale, the credit to the construction work order shall be the fair value of the energy so delivered.

Since the cost of the fuel consumed during the test period was passed through the Company's fuel adjustment clauses, it is possible to determine the revenue generated by the operations of the plant. This revenue is a more acceptable fair value to be placed on the power generated than is the cost of the power displaced.

The Company was required to record an entry to properly state the fair value of energy generated during the test period.

Earnings and Expenses During Construction

Electric Plant Instruction No. 3(18a) of the Uniform System of Accounts states that test period generation shall be credited to a work order at its "fair value."

There has been much inconsistency over the years in the methods used to value power generated during test periods. The following is a summary of the methods the companies were using which were considered incorrect:

(a) Prior month's cost per KWH at the most comparable generating station.

(b) Average fuel cost of the system steam plants.

(c) Operating costs of generation for the unit being tested.

(d) Production cost of the next most comparable unit.

(e) Average production cost data.

(f) Average system production cost of fossil fuel generation units.
Earnings and Expenses During Construction

Earnings and Expenses During Construction - Continued

(g) Production cost of fossil fuel generation at their base load stations.

(h) Cost of fuel required to produce a like amount of energy at a plant or unit most comparable in operating efficiency to the unit being tested.

(i) Average steam production costs for the previous month.

(j) Average Southern System cost per KWH adjusted to reflect the cost of delivery.

(k) Actual cost of fuel plus the average system operating costs.

(l) Use of Power Pool Running Rate.

(m) The value of energy generated during Unit No. 3 test period was determined on a displacement basis for the entire System. The value of energy credits was on a systemwide basis, rather than on an individual company basis.

It is staff policy that:

(1) Where sales of test energy can be specifically identified, the value should be based on the actual revenues received from such sales.

(2) Where there are no specific sales of test energy, and fuel adjustment clauses are not applicable to such energy, the value be based on the cost of energy displaced by the test energy.

(3) Where there are no specific sales of test energy and the fuel cost of the test energy enter into cost subject to fuel adjustment clauses, the value of the test energy be based on the cost.

In the future the Company was required to follow the above procedure in valuing test period generation.

Step 3 has recently been revised and expanded to include the following:

(3) Where there are no specific sales of test energy and the utility is not precluded from recovering displacement cost through base rates and/or fuel or energy adjustment clauses, the value be based on the displacement cost.

(4) Where the utility is specifically precluded from recovering displacement cost through fuel and/or energy adjustment clauses, the value be based on the amount actually recovered for the test energy.
Earnings and Expenses During Construction

Value of Test Energy

The value of energy generated during Unit 1 and Unit 2 test periods was determined on the average system fuel costs for these oil-fired generating units. The Public Service Commission's fuel adjustment clause did not apply to Unit 1 and Unit 2 test energy. During Unit 1's test period the fuel adjustment clause disallowed energy costs associated with oil generating plants, and during Unit 2's test periods, the MPSC did not have a fuel adjustment clause.

It is staff's policy that, where there are not specific sales of test energy and fuel adjustment clauses are not applicable to such energy, the value should be based on the costs of energy displaced by the test energy.

The Company was required to utilize the displacement methodology to compute the value of power generated during test periods in the future. Correcting entries were not recommended because of the insignificance of the amounts involved.

Valuation of Test Energy

The Company used two methods for valuing the energy generated during the testing periods for units placed in service. When considered together with the applicable rate or fuel adjustment clause treatment of the test energy, all of the methods appeared to result in a fair valuation of the power produced during the test periods. However, the Company should have a consistent policy for valuing energy generated during testing periods.

It is staff policy that:

1. Where sales of test energy can be specifically identified, the value be based on the actual revenues received from such sales,

2. Where there are no specific sales of test energy and fuel adjustment clauses are not applicable to such energy, the value be based on the cost of energy displaced by the test energy,

3. Where there are no specific sales of test energy and the utility is not precluded from recovering displacement cost through base rates and/or fuel or energy adjustment clauses, the value be based on the displacement cost, and

4. Where the utility is specifically precluded from recovering displacement cost through fuel and/or energy adjustment clauses, the value be based on the amount actually recovered for the test energy.

In the future, the Company was required to follow the above procedures in valuing test period generation.
Earnings and Expenses During Construction

Tariff Billing for the Cost of Test Energy

The Company improperly included the fair value of test energy in wholesale FAC billings.

The Company used a displacement cost method to determine the fair value of the test energy. The displacement cost was determined based on the cost of fuel that would have been burned at the unit from which the next incremental source of power would have been generated.

For accounting purposes during the testing periods of the unit, the Company credited Account 107, Construction Work in Progress-Electric, and debited Account 501, Fuel. For billings under wholesale and retail fuel adjustment clauses, the Company included the fair value, rather than the actual cost of fuel, as a component of fuel cost. The Company did not request a modification of its wholesale fuel adjustment clause to include the test energy at its fair value.

Section 35.14(a)(2)(i) of the Commission's Regulations defines the elements of allowable fuel cost that may be included in the computation of FAC billings. Only the actual cost of fuel is allowed in the computation of FAC billings. Since the displacement cost method used by the Company produced a higher than actual cost of fuel, the Company's FAC billings were overstated.

In several cases the Commission has approved jurisdictional companies' requested amendments to wholesale FAC tariffs to allow the use of the displacement method of valuing test energy for wholesale FAC billings. Since the Company did not request an amendment to its FAC tariff before including the displacement cost of test energy in billings to wholesale customers, such action was in violation of the tariff.

The Company was required to recalculate wholesale FAC billings for the periods that test energy was generated eliminating the fair value and including the actual incurred fuel cost of test energy and refund any overcollected amounts, including interest computed in accordance with Section 35.19a of the Commission's Regulations, to the affected customers.
Earnings and Expenses During Construction

Accounting and Tariff Billing of Revenues and Expenses During the Testing Period of a Generating Unit

During the testing period, the Company capitalized the actual cost for the nuclear fuel burned in generating the test energy by debiting Account 107, Construction Work in Progress-Electric, and crediting Account 120.5, Accumulated Provision for Amortization of Nuclear Fuel Assemblies. Also, the Company credited the construction project with the fair value of power produced during the test period, determined using the "cost displacement" method. It recorded the offsetting entry to Account 555, Purchased Power.

For tariff billings purposes, the Company included the cost as a component of fuel cost for FAC billings to wholesale customers.

The Company's accounting classification for the "fair value" of the test energy was not consistent with the requirements of the Uniform System of Accounts.

While it was appropriate for the Company to use the displacement approach to determine the "fair value," it was not appropriate to classify the amount in Account 555, Purchased Power.

The Company could include in Account 555 only the actual cost of purchased power received by the utility and not the hypothetical cost of displaced energy. The proper classification of the "fair value" credit was Account 557, Other Expenses.

Furthermore, the Company's including of displaced fuel cost in FAC billings was not in compliance with the Commission's FAC regulations.

Section 35.14(a) of the Commission's Regulations under the Federal Power Act provides the following definition of the elements of allowable fuel costs that are properly included in FAC billings.

It is the intent of the Commission's regulations to permit recovery in FAC billings of the actual cost of nuclear fuel used in the production of energy and charged to Account 518.

The Commission has made it clear in several decisions that an advance waiver is required before a utility can include such amounts in FAC billings. The Commission first addressed the requirement for a waiver for displaced fuel cost in FAC billings in Opinion No. 176 (Docket Nos. ER82-493 and ER82-494) issued on June 22, 1983 (23 FERC 61,395.) In an opinion issued to Pennsylvania Power & Light (PP&L) Company.
Earnings and Expenses During Construction

Accounting and Tariff Billing of Revenues and Expenses During the Testing Period of a Generating Unit (Continued)

The Commission again addressed the subject of recovery of displacement cost in FAC billings in Opinion No. 279, issued to Union Electric Company on July 20, 1987 (Docket No. ER84-560-000, 40 FERC ¶ 61,046.). The Commission ruled:

Although the Commission has granted requests for waiver of Section 35.14 of its regulations to permit companies to retain, rather than flow through the fuel adjustment clause, test energy fuel cost savings, the Commission had required that a specific request for waiver be made before such treatment is accepted. Accordingly, where a company did not request waiver until after commencement of test energy sales, the Commission required the company to make refunds to reflect flow-through of the fuel cost savings. Absent a waiver, test energy savings should have been flowed through the fuel adjustment clause.

On July 25, 1988, the Commission issued an order to Louisiana Power and Light Company in Docket Nos. ER88-398-000 and FA86-063-000 denying a request to modify its FAC retroactively. The Commission stated:

... Louisiana Power states that it failed to file the modification in a more timely manner because Louisiana Power did not consider the filing to be necessary. This does not excuse Louisiana Power from its obligation to flow through fuel adjustment clause test energy fuel cost savings in the absence of a specific request for waiver.

Absent a waiver, the actual cost of nuclear fuel generated during the test period should have been flowed through the fuel adjustment clause.

It was recommended that the Company:

(1) revise procedures to ensure that future charges for displacement costs are classified in Account 557 consistent with the above mentioned regulations; and

(2) recalculate FAC billings to wholesale customers during the testing period by eliminating the displacement cost included in such billings, and including the actual cost of nuclear fuel burned during testing and make appropriate refunds, with interest computed according to Section 35.19(a) of the Commission's regulations, for any overcollected amounts.
Utility Plant Accounting

Earnings and Expenses During Construction

Accounting and Tariff Billing of Revenues and Expenses During the Testing Period of a Generation Unit

The Company capitalized $1,556,904 of actual cost for the coal and oil burned in generating the test energy by debiting Account 107, Construction Work in Progress-Electric, and crediting Account 151, Fuel Stock.

The Company credited Account 107 with $2,055,621, representing the fair value of power produced during the test period, determined using the "cost displacement" method. It recorded the offsetting entry to Account 555, Purchased Power. Also, it included the $2,055,620 as a component of fuel cost for FAC billings to wholesale customers.

The Company's accounting classification for the cost of test energy was not consistent with the requirements of the Uniform System of Accounts.

The amounts included in Account 555 should reflect the actual cost of electricity purchased, and not the hypothetical cost of displaced energy. The Company should have classified the "fair value" amount in Account 557, Other Expenses.

The Company's procedure of including displaced amounts in FAC billings was not in compliance with its wholesale FAC tariff.

It was the intent of the Company's tariff to permit recovery in wholesale FAC billings of the actual cost of fossil fuel used in the production of energy, which is otherwise credited from Account 151.

The Commission has made it clear in several decisions that an advance waiver is required before a utility can include a displacement amount in FAC billings. The Commission first addressed the need for a waiver in Opinion No. 176, Dockets Nos. ER82-493 and ER82-494, issued to Pennsylvania Power & Light on June 22, 1983 (23 FERC ¶ 61,395).

The Commission again addressed the subject of recovery of displacement amounts in FAC billings in Opinion No. 279, issued to Union Electric Company on July 20, 1987 (Docket No. ER84-560-000, 40 FERC ¶ 61,046). The Commission ruled:

Although the Commission has granted requests for waiver of Section 35.14 of its regulations to permit companies to retain, rather than flow through the fuel adjustment clause, test energy fuel cost savings, the Commission has required that a specific request for waiver be made before such treatment is accepted. Accordingly, where a company did not request waiver until after commencement of test energy sales, the Commission required the company to make refunds to reflect flow-through of the fuel cost savings. Absent a waiver, test energy savings should have been flowed through the fuel adjustment clause. [emphasis added]
Earnings and Expenses During Construction

Accounting and Tariff Billing of Revenues and Expenses During the Testing Period of a Generation Unit (Continued)

On July 15, 1988, the Commission issued an order to Louisiana Power and Light Company in Docket Nos. ER88-398-000 and FA86-063-000 denying a request to modify its FAC retroactively. The Commission stated:

... Louisiana Power states that it failed to file the modification in a more timely manner because Louisiana Power did not consider the filing to be necessary. This does not excuse Louisiana Power from its obligation to flow through fuel adjustment clause test energy fuel cost savings in the absence of a specific request for waiver. Absent a waiver, test energy savings should have been flowed through the fuel adjustment clause.

Without the necessary waiver, the Company could not include any displacement amounts in FAC billings to wholesale customer during the testing.

It was recommended that the Company:

1. revise procedures to ensure that it charges any future earnings and expenses during construction to the appropriate accounts, consistent with the above mentioned regulations;

2. revise procedures to ensure that it includes only the actual costs of fuel used during testing of generating units in FAC tariff billings; and

3. recalculate FAC billings to wholesale customers during the test period by including only the actual cost of fossil fuel in such billings and make appropriate refunds, with interest computed according to Section 35.19a of the Commission's regulations, for any overcollected amounts.
Classification of Common Facilities

The Company has included its investment in the common facilities in Account 105, Electric Plant Held for Future Use. The investment arises because the Company was a participant in Generating Units No. 2 and No. 3 which were abandoned in January 1980. The Company expects to recover its investment in the common facilities which amounted to $11,396,623, by sale to the owners of the Generating Unit No. 1.

Paragraph A to Account 105 provides that electric plant owned and held for future use in electric service under a definite plan for such use be classified to Account 105. The Staff's opinion was that the investment in the common facilities should be classified to Account 186, Miscellaneous Deferred Debits, until the sale occurs.

The Company was required to make an entry to reclassify the investment of common facilities from Account 105 to Account 186.

Common Utility Plant

The Company included certain utility plant which is used in common by the electric, gas and steam heat departments, in Account 101, Electric Plant in Service. The plant is comprised primarily of office buildings and transportation equipment.

Electric Plant Instruction 13, Common Utility Plant, provides that "If a utility is engaged in more than one utility service.... and any of its utility plant is used in common for several utility services,.... such property, with the approval of the Commission, may be designated and classified as 'common utility plant'."

The Company was required to adopt common plant accounting as prescribed by Electric Plant Instruction 13 and record an entry to classify utility plant and related accumulated depreciation and amortization used in common by the electric, gas and steam heat departments to Account 118, Other Utility Plant.
Common Plant

Accounting for the Cost of Common Facilities

For ratemaking purposes, the PSC approved rates that included 78 percent of the Company's investment in Coal Unit common facilities, effective with the in-service of Unit No. 3. In a subsequent rate action on September 30, 1987, the PSC approved rates for Unit No. 4 that included (1) the remaining 22 percent of the Coal Unit common facilities, (2) AFUDC accrued on the 22 percent of common facilities included in Account 107 subsequent to January 10, 1984, (the in-service date of Unit No. 3), and (3) 22 percent of the property taxes and depreciation associated with the Coal Unit common facilities, included in Account 107 subsequent to January 10, 1984.

For accounting purposes, on January 10, 1984, the Company transferred the cost of Unit No. 3 and about 78 percent of the cost of common facilities related to Coal Unit Nos. 3 and 4 to Account 101, Electric Plant in Service. Also, on this date the Company ceased the accrual of Allowance for Funds Used During Construction (AFUDC) and began accruing depreciation on Unit No. 3 and on 78 percent of the related common facilities transferred to Account 101. The Company continued to accrue AFUDC and property taxes and did not recognize depreciation on the 22 percent of the Coal Unit common facilities costs that it recorded in Account 107, Construction Work in Progress-Electric.

The Company ceased accruing AFUDC, capitalizing property taxes and began accruing depreciation on the remaining 22 percent of the Coal Unit common facility when it placed Unit No. 4 in service on April 1, 1986.

Under the general requirements of the Commission's Uniform System of Accounts, the Company should have transferred its entire investment related to Coal Unit common facilities from Account 107 to Account 101, ceased capitalizing AFUDC and operating expenses and commenced recording depreciation expense when Coal Unit No. 3 was placed in service on January 10, 1984.

The instructions to Account 107 state in part:

A. This account shall include the total of the balances of work orders for electric plant in process of construction. [emphasis added]

Since the Coal Unit common facilities were in service on January 10, 1984, the common facilities no longer met the requirements for the construction work in progress classification. Therefore, the Company should have recorded all expenses in operating the common facilities in the appropriate operating expense accounts.

With respect to the accounting for AFUDC, Electric Plant Instruction No. 3(17) of the Uniform System of Accounts states in part:

Allowance for funds used during construction includes the net cost for the period of construction.... [emphasis added]

Note: When a part only of a plant or project is placed in operation or is completed and ready for service...shall be treated as Electric Plant in Service and allowance for funds used during construction shall cease....
Common Plant

Accounting for the Cost of Common Facilities (Continued)

Accounting Release No. AR-5, issued by the Chief Accountant on January 1, 1968, requires a company to cease the accrual of AFUDC when facilities are tested and are placed in or ready for service.

The Commission has issued orders in the following cases affirming its policy that AFUDC shall cease at the in-service date of a facility: Union Electric Company, Opinion No. 279, Docket No. ER84-560, dated July 20, 1987, 40 FERC ¶ 61,046; Southern California Edison Company, 26 FERC ¶ 61,419 at 61,393 (1984); Gulf States Utilities Company, 36 FERC ¶ 61,232 at 65,566 (1966); and Kentucky Utilities Company, 25 FERC ¶ 61,397 (1983).

The Commission has approved special accounting to accommodate the ratemaking orders of public utility regulatory commissions in instances when there was sufficient assurance that such actions created regulatory assets that the company would recover in future rates.

Under the Commission's special accounting, a company is required to use the following accounting procedures:

1. Transfer the entire investment related to a completed project from Account 107 to Account 101 at the in-service date.

2. Compute and record depreciation on the entire cost of the common facility by charges to Account 403, Depreciation Expense and credits to Account 108, Accumulated Provision for Depreciation of Electric Utility Plant.

3. Record property taxes in Account 408.1, Taxes Other than Income Taxes, Utility Operating Income.

4. Record operation and maintenance expenses in Accounts 401, Operation Expense and 402, Maintenance Expense.

5. If also permitted by the regulatory commission, accrue a carrying charge (and not AFUDC) by debiting Account 186, Miscellaneous Deferred Debits, and crediting Account 421, Miscellaneous Nonoperating Income, for any regulatory commission approved carrying costs.

6. Recognize the effects of the regulatory created asset by debiting Account 186, Miscellaneous Deferred Debits, and crediting Account 406, Amortization of Electric Plant Acquisition Adjustments, in an amount equal to the depreciation expense, property taxes and operation and maintenance expenses deferred for future collection.

7. Amortize the amount deferred in Account 186 to Account 406 over the period recovered in rate levels. If in the event the cost deferrals are subsequently disallowed, the unamortized cost included in Account 186 should be charged to Account 428.5, Other Deductions.
Common Plant

Accounting for the Cost of Common Facilities (Continued)

The staff concluded that the PSC provided the Company with sufficient guarantees for collection of the deferred amounts in future rates. Therefore, the Company should have used the special accounting discussed above with respect to the deferred costs and carrying charges computed on Coal Unit common facilities from January 10, 1984 (the in-service date), until the PSC placed the revised rates in effect.

The Company was required to revise procedures to record carrying charges and to defer costs approved by the PSC in accordance with the above mentioned accounting for regulatory created assets.

Accounting for the Investment in Common Generating Facilities

The Company followed the procedure of assigning its investment in the common facilities between Unit Nos. 1, 2 and 3. At the in-service date of Unit No. 1, the Company transferred one-third of the retail portion and the entire wholesale portion of its investment in the common facilities from Account 107, Construction Work in Progress-Electric, to Account 106, Completed Construction Not Classified. It stopped the accrual of allowance for funds used during construction (AFUDC) and began recording depreciation and operating expenses on the portion of the investment that it transferred to Account 106.

The Company continued to accrue AFUDC, defer operating expenses and not record depreciation expense on the remaining amount of the cost of common facilities that it assigned to Units 2 and 3. The Company recorded the accrual of AFUDC by debiting Account 186, Miscellaneous Deferred Debits, and crediting Account 419.1, Allowance for Other Funds Used During Construction and Account 432, Allowance for Borrowed Funds Used During Construction-Credit. It transferred the operating costs included from the operating and maintenance expense accounts to Account 186.

The PUC authorized rates that included the common facilities allocated to Unit No. 2 and 3. When retail rates became effective that included the PUC portion of common facilities allocated to Unit Nos. 2 and 3, the Company transferred that portion of the common facilities from Account 107, Construction Work in Progress-Electric to Account 106, Completed Construction Not Classified-Electric, and discontinued the accrual of AFUDC and the deferral of operating costs and commenced recording depreciation expense in its operating accounts.

Under the instructions to Account 107, the Company should have transferred its investment in the common facilities from Account 107 to Account 106 at the in-service date of Unit No. 1.

Since both the common facilities no longer met the requirements for inclusion in construction work in progress after the in-service dates, the Company should have recorded all expenses in operating the facilities in the appropriate operating expense accounts. Also, the Company should have begun accruing depreciation expense on the common facilities at the in-service date of Unit No. 1.
Common Plant

Accounting for the Investment in Common Generating Facilities (Continued)

With respect to the accounting for AFUDC, Electric Plant Instruction No. 3(17) of the Uniform System of Accounts, states in part:

Allowance for funds used during construction includes the net cost for the period of construction . . .

Accounting Release No. AR-5, issued by the Chief Accountant on January 1, 1968, requires a company to cease the capitalizing AFUDC when facilities have been tested and are placed in or ready for service.

In a decision issued to Union Electric Company on July 20, 1987 (Opinion No. 279, Docket No. ER84-560-000) the Commission stated:

Commission policy dictates that the in-service date up to which AFUDC may be accrued should be the date of commencement of commercial operation of the plant, regardless of the effective dates of any related wholesale or retail increases . . . .

Therefore, the Company should have stopped accruing AFUDC on the common facilities at the in-service date of Unit No. 1.

The Commission has approved special accounting to accommodate the ratemaking orders of public utility regulatory commissions in instances when there was sufficient assurance that such actions created assets that the company would recover in future rates.

The special accounting would require a company to adopt the following procedures:

1. Transfer the entire investment related to the completed common facilities from Account 107 to Account 106 at the time of the in-service date of the first unit. Also, transfer the investment related to Unit No. 3 from Account 107 to Account 106 at the time of the in-service date of Unit No. 3.

2. Compute and record depreciation on the entire cost of the common facilities by charges to Account 403, Depreciation Expense and credits to Account 108, Accumulated Provision for Depreciation of Electric Utility Plant, beginning on the in-service date of the first unit.

3. Record property taxes in Account 408.1, Taxes Other Than Income Taxes, Utility Operating Income.

4. Record operation and maintenance expenses in Accounts 401, Operation Expense and 402, Maintenance Expense.
Accounting for the Investment in Common Generating Facilities (Continued)

(5) Recognize the effects of the regulatory created asset by debiting Account 186, Miscellaneous Deferred Debits, and crediting Account 406, Amortization of Electric Plant Acquisition Adjustments, in an amount equal to the depreciation expense, property taxes and operation and maintenance expenses deferred for future collection.

(6) If also permitted by the regulatory commission, accrue a carrying charge (and not AFUDC) by debiting Account 186, Miscellaneous Deferred Debits, and crediting Account 421, Miscellaneous Nonoperating Income, for any regulatory commission approved carrying costs.

(7) Amortize the amounts deferred in Account 186 to Account 406 over the period recoverable in rate levels. In the event the costs deferred are subsequently disallowed, the unamortized costs included in Account 186 should be charged to Account 426.5, Other Deductions.

Based upon the actions of the PUC, the Company should have used the Commission approved special accounting to record the deferred costs and carrying charges on the portion of the investment the PUC regulates from the in-service dates of the facilities until the dates the PUC placed rates in effect covering those facilities.

It was recommended that the Company:

(1) revise procedures to ensure that:

(a) completed common facilities are transferred from Account 107 to Account 106 according to the requirements of the Uniform System of Accounts;

(b) the accrual of depreciation expense begins at the in-service date of major generating facilities; and

(c) carrying charges and deferred operating costs resulting from actions of regulatory commissions are recorded in the accounts approved by the Commission for ratemaking assets.
Purchases and Sales of Utility Plant

Sale of Electric Utility Property

In 1979, the Company sold a portion of a transmission line. The Company did not obtain Commission approval to dispose of the facilities.

Section 203(a) of the Federal Power Act provides in part, "No public utility shall sell, lease, or otherwise dispose of the whole of its facilities subject to the jurisdiction of the Commission, or any part thereof of a value in excess of $50,000,....without first having secured an order of the Commission authorizing it to do so."

The Company was required to obtain Commission approval for the sale of the facilities noted above and comply with Section 203(a) of the Federal Power Act in the future.

Improper Accounting for Gain on Sale of Future Use Property

The Company recorded the gain from the sale of disposed properties in FERC Account 421.1, Gain on Disposition of Property.

The Uniform System of Accounts requires that gains or losses from the sale or disposition of property previously recorded in Account 105 be recorded in Account 411.6 or 411.7, Gains/Losses from Disposition of Utility Plant, as appropriate.

The Company was required to comply with the requirements of the Uniform System of Accounts in the future.

Accounting for Proceeds Received on Sale of Generating Station Facilities and Site

The Company recorded in Account 421.1, Gain on Disposition of Property, a gain on the sale of a portion of a Station Site and common facilities, not constituting an operating unit or system. The gain recognized represented an allocated portion of a fee paid by the Public Power Authority for an interest in these facilities and site. Commission approval was not obtained for this sale.

Electric Plant Instruction No. 5 and No. 10 require that gains or losses on the sale of depreciable plant are not to be recognized unless the property constitutes an operating unit or system. Further, the identified fee was for the purchase of an interest in all generating station site facilities which should reduce the cost of such facilities.

The Company was required to revise its accounting procedures for the sale of utility property to comply with Electric Plant Instruction No. 10 in the future, and record a correcting entry to appropriately recognize the proceeds of this sale in Account 108.
Purchases and Sales of Utility Plant

Sale of Diesel Generators

The Company retired several diesel generating plants. The diesel electric generators from these retired generating plants were sold for and the Company recorded the sales proceeds in Account 421, Miscellaneous Nonoperating Income.

Electric Plant Instruction No. 1OF of the Uniform System of Accounts, states in part, "The book cost less net salvage of depreciable electric plant retired shall be charged in its entirety to Account 108, Accumulated Provision for Depreciation of Electric Plant in Service."

The Company was required to record an entry reclassifying the salvage proceeds from the retired diesel electric generators from Account 421 to Account 108.

Sale of a Service Center

The Company recorded a loss on the sale of a Service Center. The loss included:

(1) the excess of the cost of land over the sale proceeds,
(2) the excess of the cost of depreciable building and improvements over the sales proceeds, and
(3) an amount of land previously donated to the City but not removed from the accounting records - $899.

The Electric Plant Instructions provide for the recognition of gains or losses only on the disposition of land or operating units or systems. Any proceeds from the disposition of depreciable property should be credited to Account 108, Accumulated Provision for Depreciation of Electric Utility Plant. The Uniform System of Accounts provides that donations be recorded to Account 426.1.

The Company was required to record an entry to correct the improper recording of this sale and charge Account 108 and credit Account 421 with the gain.

Improper Accounting for the Sale of a Building

The Company accounted for the sale of a building by charging Account 108, Accumulated Provision for Depreciation, Electric Utility Plant, with the original cost of the building and land and crediting this account for the sales price as salvage.

The Company's accounting was improper, in that Account 108 was charged with the cost of land, which is non-depreciable. Also a loss should be recognized on the sale of the building, since it constitutes a distinct, unique unit of property, unlike other electric plant where the related depreciation reserve would not be distorted by normal retirement accounting.

The Company recorded an entry to transfer the loss recognized on the disposition of the building from Account 108 to Account 421.2.
Purchases and Sales of Utility Plant

Sale of Transmission Facilities

The Company sold all transmission and distribution facilities in a County, to the Co-op. The Company accounted for the disposition as a normal retirement.

The Company's accounting for the above described sale did not conform to the requirements of the Uniform System of Accounts for the following reasons:

(1) The Company failed to obtain FERC approval to dispose of jurisdictional transmission facilities as required by Section 203 of the Federal Power Act.

(2) In Staff's opinion, the facilities sold constitute an operating unit or system. Accordingly, the Company should have used Account 102, Electric Plant Purchased or Sold, to account for the disposition as required by Electric Plant Instruction No. 5.

In the future, the Company was required to seek Commission approval for the sale of transmission facilities as required by Section 203 of the Federal Power Act and comply with the requirements of Electric Plant Instruction No. 5.

Accounting for Property Acquisitions

The Company recorded acquisitions of utility plant that were not operating units or systems directly in Account 107, Construction Work in Progress—Electric. The Company also allocated overheads, from its construction overhead clearing account, to the original cost of acquired property.

Instruction A to Account 107 states, "This account shall include the total of balances of work orders for electric plant in process of construction." The acquired property did not include any construction work in progress. Under the requirements of the Uniform System of Accounts, the original cost of property acquired that does not constitute an operating unit or system should be recorded directly in Account 101, Electric Plant in Service.

In addition, Electric Plant Instruction No. 4A states, in part, "All overhead construction costs ... shall be charged to particular jobs or units on the basis of the amounts of such overheads reasonably applicable thereto, to the end that each job or unit shall bear its equitable proportion of such costs...." The Company did not support the reasonableness of the allocation of overheads to plant acquisitions.

The Company was required to revise its procedures for the acquisition of utility plant to conform to the requirements of the Uniform System of Accounts.
Purchases and Sales of Utility Plant

Gains and Losses on Dispositions of Assets

The Company recorded gains and losses on sales of Company owned vehicles in Account 421.1, Gains on Disposition of Property, and Account 421.2, Loss on Disposition of Property, respectively. Such accounting would be appropriate for sales of operating units or systems but is not applicable to ordinary disposition of depreciable property at the end of its useful life.

The Uniform System of Accounts provides that at the time of retirement of depreciable gas plant, Account 108, Accumulated Provision for Depreciation of Gas Utility Plant, be charged with the book cost of property retired and the cost of removal and be credited with salvage value and other amounts recovered. No gain or loss is to be recognized on normal retirements.

The Company was required to comply with the provisions of the Uniform System of Accounts in the future.

Gas Lease Cost Incorrectly Included in Fuel Adjustment

On July 1, 1981 certain gas leases were sold from the Company's gas exploration program for a gain of $47 million. Prior to this sale a proportionate share of the cost of these gas leases were billed to the wholesale customers under a Fuel Adjustment Clause Tariff. The amount to be billed each month was determined by the Company's modified full cost accounting procedure. The recording of the $47 million gain was not consistent with the Company's modified full cost accounting for gas leases and therefore was determined to be in error insofar as that portion of the gain was related to the wholesale customers. The Company was required to make an entry to correct for this error consistent with the principles of comprehensive interperiod tax allocation. The balances in Account 253 and Account 190 should be amortized on a monthly basis. Account 253 should be amortized to Account 501, Fuel, over the remainder of the life of the gas reserves, and Account 190 should be amortized to Account 410.1, Provision for Deferred Income Tax, Utility Operating Income. The gas reserve had a life of approximately 20 years.
Accounting For the Purchase and Exchange of Generation and Transmission Facilities

In accounting for the purchase and exchange of certain utility property, the Company overstated the acquisition adjustment related to the property acquired and did not use Account 102, Electric Plant Purchased or Sold to record the transaction.

The Company recorded the original cost of the acquired interest in the station in Account 101, Electric Plant in Service, the associated accumulated provision for depreciation in Account 108, Accumulated Provision for Depreciation of Electric Utility Plant, and a resulting acquisition adjustment in Account 114, Electric Plant Acquisition Adjustments. The original cost and associated accumulated provision for depreciation of the transmission facilities transferred were properly removed from Accounts 101 and 108.

The amounts recorded in Account 114 improperly included the value of future tax deductions that would result if taxing authorities disagree with the Company's treatment of the transaction as a tax-free exchange.

According to the Company, it has a potential but unpaid $4,200,000 income tax liability if the Internal Revenue Service determines that a taxable gain should be recognized on the disposition of the transmission property based on its fair market value. If such a determination is made, the tax basis of the property received in exchange would be increased by the amount of the gain thereby giving rise to increased future tax depreciation not properly includible in Account 114. Rather, these amounts should have been recorded in Account 186, Miscellaneous Deferred Debits, pending a final determination as to the taxability of the transaction.

Furthermore, the purchase of the additional station interest constitutes the acquisition of an operating unit or system. Under Electric Plant Instruction No. 5 of the Uniform System of Accounts, the Company should have recorded the costs of acquisition in Account 102 and filed with the Commission the proposed journal entries distributing the amounts to the appropriate accounts.

The Company was required to record the potential unpaid income tax liability in Account 186, Miscellaneous Deferred Debits, pending a formal determination as to the Taxability of the Transaction.
Purchases and Sales of Utility Plant

Accounting for Sale of Utility Property

In June 1985, the Company sold a 69,000 volt distribution substation to the City. The equipment sold included a transformer and oil circuit breaker foundations, main substation structure, oil circuit breaker, air brake and disconnect switches, insulators and other equipment. The Company recorded the gain on the sale in Account 421.1, Gain on Disposition of Property. The Company sought and received approval for this sale from the PUC. However, the sale was not recorded in Account 102, Electric Plant Purchased or Sold, nor were journal entries to clear amounts from Account 102 filed with the Commission within six months as required.

In June 1987, the Company sold two additional substations. The facilities sold included a substation, one transformer and related facilities, and distribution facilities associated with both substations. The Company recorded the gain on the sale in Account 421.1.

The Company sought and received permission for the sale from both FERC and PUC. However, the Company did not record the transaction in Account 102, as required by the Commission Order Authorizing Sale of Facilities.

Electric Plant Instruction 5 states in part:

F. When electric plant constituting an operating unit or system is sold, . . . the book cost of the property sold or transferred to another shall be credited to the appropriate utility plant accounts, . . . and contra entries made to Account 102, Electric Plant Purchased or Sold . . .

The instructions to Account 102, Electric Plant Purchased or Sold, state in part;

B. Within six months from the date of acquisition or sale or property recorded herein, the utility shall file with the Commission the proposed journal entries to clear from this account the amounts recorded herein.

The sale of property to the City did not require FERC approval under Section 203 of the Federal Power Act because the facilities were not subject to the jurisdiction of the FERC. However, the sale should have been recorded in Account 102 and the journal entries to clear the amounts from Account 102 should have been submitted to the Commission for approval.

The Company should have recorded the 1987 sales in Account 102 as directed by the Commission's order approving the sale. In addition, the Company should have submitted the journal entries to clear the amounts from Account 102 to the Commission for approval.
Purchases and Sales of Utility Plant

Accounting for Sale of Utility Property (Continued)

It was recommended that the Company adopt procedures to:

(1) record the purchase and sale of electric plant that is considered an operating unit or system in Account 102; and

(2) assure proposed journal entries to clear amounts recorded in Account 102 are submitted to the Commission within six months of the date of the sale.

Accounting for the Sale of Future Use Property

In May 1985, the Company transferred the cost of two parcels of land from Account 105 to Account 121, Nonutility Property. In 1986, the Company sold the two parcels, recording a gain of $493,866 on the transactions. It recorded the gain in Account 421.1, Gain on Disposition of Property.

The instructions to Account 105 of the Uniform System of Accounts state in part:

C. In the event that property recorded in this account shall no longer be needed or appropriate for future utility operations, the Company shall request Commission approval of journal entries to remove such property from this account when the gain realized from the sale or other disposition of the property is $100,000 or more, prior to their being filed . . .

D. Gains or losses from the sale of land and land rights or other disposition of such property previously recorded in this account and not placed in utility service shall be recorded directly in 411.6, Gains from Disposition of Utility Plant or 411.7, Losses from Disposition of Utility Plant, as appropriate, except when determined to be significant by the Commission . . .

We concluded that the Company should have submitted the journal entries for Commission approval to remove these parcels from Account 105. Also, we concluded that the Company should have classified the gains in Account 411.6.

It was recommended that the Company revise its procedures to properly account for the gain from the sale of land held for future use in accordance with the requirements of the Uniform System of Accounts.
Purchases and Sales of Utility Plant

Accounting for Sales and Cost of Leasing Railroad Cars

In 1988, the Company entered into a leasing agreement with a Credit Corporation for 495 aluminum railroad coal cars.

Also, the Company and Credit Corporation entered into a sales agreement for 455 steel coal cars. Credit Corporation assigned the sales agreement to Railcar Management Services (RMS). Under the agreement, the parties agreed to a purchase price for each coal car based on the Company's undepreciated book value of the car. The undepreciated book value for all the cars exceeded the fair market value by $1,631,035.

Credit Corporation paid RMS an amount equal to the $1,631,035 difference between the purchased price and market value of the coal cars. As part of the lease agreement, RMS included in the lease rental payments it billed the Company an amount to collect the $1,631,035, plus a return, over the life of the lease.

The Company accounted for the sale of the coal cars as follows. It retired the original cost of the coal cars by crediting Account 101, Electric Plant in Service, and debiting Account 108, Accumulated Provision for Depreciation of Electric Utility Plant. It included the proceeds from the sale by debiting Account 131, Cash and crediting Account 108.

The Company accounted for the lease payments by charging the entire amount to Account 151, Fuel Stock.

We concluded that the Company's accounting for the proceeds of the sale of the railroad cars was deficient in a number of respects.

The Company should have treated the sale of the used railroad cars as a sale of an operating unit or system and recognized a loss on the sale in Account 421.2. Under such accounting the Company should not have credited the proceeds from the lease arrangement to Account 108.

Next, the Company incorrectly credited $815,517.50 of the proceeds received on the sale of the railroad cars to Account 108. The $815,517.50 was in the nature of a borrowing of an amount equal to the financing of the loss on the sale through the lease of the new railroad cars. Therefore, the Company should have established a liability to cover the additional future lease payments by crediting Account 253, Other Deferred Credits, rather than as a credit to Account 108.

The lease arrangement in effect was used as a means of (1) renting the new railroad cars, (2) borrowing funds equivalent to the loss on sale of the old cars, and (3) repayment through lease payments of the amount borrowed with carrying charges (interest).
Purchases and Sales of Utility Plant

Accounting for Sales and Cost of Leasing Railroad Cars (Continued)

Under the circumstances, the Company should have adopted a procedure whereby it would apportion the monthly lease payments among the accounts as follows:

(1) record in Account 151, Fuel Stock, the portion applicable solely to the rental of the new cars, that is, the amounts necessary to finance the expenditures for the new cars and the carrying charges related thereto.

(2) record as a charge to Account 253, the portion applicable to repayment of the proceeds of $815,517.50, which the Company should transfer from Account 108 to Account 253.

(3) record in Account 431, Other Interest Expense, the portion applicable to the carrying charges on the monthly balance included in Account 253.

The Company's inclusion of the entire lease payment as a component of the cost of fuel for billings to wholesale customers had the indirect effect of including the loss on the sale of the old railroad cars in such billings without specific approval contrary to the Commission's requirements.

It was recommended that the Company:

(1) revise accounting procedures to ensure that gains or losses on the sale or other disposition of operating units or systems are recorded according to the EPI No. 5;

(2) record correcting entries to recognize the loss on the sale of the coal cars and reclassify from Account 108 to Account 253 the proceeds received from the lease transaction equal to the loss on the sale of the coal cars; and

(3) revise procedures for recording the lease payments made to Credit Corporation so as to:

(a) record in Account 151, Fuel Stock, the portion applicable solely to the rental of the new cars;

(b) record as a charge to Account 253, the portion applicable to repayment of the proceeds of $815,517.50 credited to that account under (2) above; and

(c) record in Account 431, Other Interest Expense, the portion applicable to the carrying charges on the monthly balance included in Account 253.

(4) recompute tariff billings to wholesale customers to reflect the accounting entries recorded from No. 2 preceding and make refunds, with interest computed in accordance with Section 35.19(a) of the Commission's regulations, for any overcollected amounts.
Plant Held for Future Use

Classification of Land Held for Future Use

Certain parcels of land at the Company's three generating stations were being held for future use. The costs of these parcels, estimated by the Company to be $1,224,656, were classified in Account 101, Electric Plant in Service.

The Uniform System of Accounts provides Account 105, Electric Plant Held for Future Use, for the recording of the original cost of land and land rights owned and held for future use.

The Company was required to record an entry to classify certain parcels of land at three generating stations in Account 105.

Future Use Properties For Which No Definite Plan Exists

The Company recorded in Account 105, Electric Plant Held for Future Use, certain parcels of land or rights-of-way for which no definite plan for use in the future existed. The text of Account 105 states that "this account shall include the original cost of electric plant owned and held for future use in electric service under a definite plan.

As no definite plans exist for these properties, the Company was required to record an entry to transfer property recorded in Account 105 to Account 121. The Company had no plans to use this property in future utility operations.

Detailed Classification of Account 105, Electric Plant Held for Future Use

The Company has not classified, by detailed electric plant in service accounts (301-399) the property included in Account 105, Electric Plant Held for Future Use. The properties involved are production plant land, substation land, various lines, and rights of way.

The text of Paragraph E of Account 105 states that, "The property included in this account shall be classified according to the detail accounts (301-399) prescribed for electric plant in service, and the account shall be maintained in such detail as though the property were in service."

The Company was required to classify the property included in Account 105 according to the detailed electric plant in service accounts.
Gas Well Cost Improperly Included in Account 105

The Company recorded the cost of various wells previously used for production purposes in the production primary plant accounts within Account 105, Gas Plant Held for Future Use, and 105.1, Production Properties Held for Future Use.

These wells were accounted for as future use property because the Company did not want to surrender the related leases, as it considered the leases as possible future storage sites.

The Company had not filed an application for a certificate of public convenience and necessity to construct a storage field in the area where these wells were located and did not have a timetable for the construction of such facilities. In addition, the Company could not definitely state that such storage facilities would ever be built.

The instructions to Account 105 and 105.1, provide that the cost of gas plant owned and held for future use in gas service under a definite plan for such use be included therein.

The Company was required to reclassify from Accounts 105 and 105.1, the wells previously used for production for which the Company has no definite plan for such use.

Failure to Obtain Commission Approval for Transfers from Account 105

The Company transferred from Account 105, Gas Plant Held for Future Use, to Account 123.1, Investment in Subsidiary Companies, $1,807,123 representing subsidiary companies' interest in preliminary terminal construction costs as plans for constructing the terminal were terminated. The Company neither requested nor obtained Commission approval of the journal entry recording this transfer.

The text of Account 105, Paragraph C, in effect during the audit period stated, "In the event that the property recorded in this account shall no longer be needed or appropriate for future utility operations, the Company shall notify the Commission of such condition and request approval of journal entries to remove such property from this account." It should be noted that Order No. 390, issued August 3, 1984, amended the instructions for Account 105, Paragraph C as follows: "...the company shall request Commission approval of journal entries to remove property from this account when the gain realized from the sale or disposition of the property is $100,000 or more, prior to their being recorded."

The Company was required to implement procedures to insure that in the future it complies with the text of Account 105, Paragraph C.
Plant Held for Future Use

Land Improperly Recorded in Account 105

The cost of land from the abandoned Nuclear Power Project was recorded in Account 105, Electric Plant Held for Future Use. The Company had no plan for future use of this property in electric service.

The text of Account 105 states this account shall include the original cost of land owned and held for future use in electric service under a plan for such use. The Uniform System of Accounts provides for the use of Account 121, Nonutility property, to record the book cost of land owned by the utility, but not used in utility service and not properly includible in Account 105.

The Company was required to record an entry to transfer the cost of land from the abandoned project to Account 121.

Electric Plant Held for Future Use

During the audit period, the Company recorded three retirements of property classified in Account 105, Electric Plant Held for Future Use. The Company did not notify the Commission that these properties were no longer needed or appropriate for future utility operations nor request approval of the related accounting entries as required by the instructions of paragraph C for Account 105.

In the future, the Company was required to comply with requirements of paragraph C of Account 105 for dispositions of future use property.

It should be noted that Commission Order No. 390, issued August 3, 1984, amended the requirements of paragraph C of Account 105 effective January 1, 1984, as follows:

"In the event that property recorded in this account shall no longer be needed or appropriate for future utility operations, the company shall request Commission approval of journal entries to remove such property from this account when the gain realized from the sale or other disposition of the property is $100,000 or more, prior to their being recorded."
UTILITY PLANT ACCOUNTING

Plant Held for Future Use

FERC Approval Required for Gains and Losses on Property Disposition

The Company began deferring the gains and losses on disposition of various parcels of property recorded in Account 105, Electric Plant Held for Future Use. The deferrals to Account 253, Other Deferred Credits, and Account 186, Miscellaneous Deferred Debits, were directed by the State Commission. Deferred gains totalled $746,283 and losses $337,872. The parcels were transferred from Account 105 to Account 121, Nonutility Property, before being sold. FERC approvals were received for the transfers from Account 105 to Account 121.

Paragraph D of Account 105 requires that gains and losses on sale of future use property not previously used in utility service be recorded to Accounts 411.6 or 411.7, as appropriate. Departure from this instruction requires prior approval from the FERC.

The Company was required to request approval of the Commission for the above noted accounting and to adhere to the requirements of the Uniform System of Accounts in the future.

Transfer of Future Use Property

The Company transferred drilling costs for No. 1 well from Account 105, Gas Properties Held for Future Use, to Account 338, Unsuccessful Exploration and Development Costs. The related lease was acquired prior to October 7, 1969 and no Commission approval was obtained for this transfer.

The text of Account 338 states, "this account shall include unsuccessful exploration and development costs incurred on or related to hydrocarbon leases, on properties in the contiguous 48 states and the state of Alaska, acquired after October 7, 1969." Also, the text of Account 105, Paragraph C, states, "in the event that property recorded in this account shall no longer be needed or appropriate for future utility operations, the Company shall notify the Commission of such condition and request approval of journal entries to remove such property from this account."

The Company was required to seek Commission approval to dispose of these costs and reclassify these amounts to Account 186, Miscellaneous Deferred Debits, until such approval is obtained.
Licensed Projects

Improper Calculation of Return on Licensed Projects

Order No. 550 provides a formula with which to compute the annual specified return on licensed projects. The specified return as computed is then used in determining the amount to be recorded in the amortization reserve each year.

The cost of long-term debt is one element used in the computation of the specified return. Order 550 indicates that this cost should be determined in accordance with Section 12.15, paragraph (a), of the Code of Federal Regulations which states "...an average of 13 monthly balances of amounts properly includible in the licensee's long-term debt..." and "The cost rate for such ratios shall be the weighted average cost of long-term debt... for the year..."

The Company computed the cost of long-term debt based on the year-end balance and the weighted interest obligation of the year's balance.

Improper Calculation of Amortization Reserve

Staff noted four errors in the computations required for the amortization reserves. All errors were minor in nature and did not require adjustment to the Company records.

(1) An error was made in the computation of net investment for system-wide plant. The Company did not deduct advances of various types from the investment base although such amounts are normally deducted in Company rate cases. These amounts are recorded in Account 253, Other Deferred Credits, and represent customer contributions not yet credited to construction, cash held pending distribution, and cash advances from cablevision companies for work associated with pole attachments. The methodology of net plant investment calculations require the deduction of plant related advances from the investment base.

(2) The company did not include in the system-wide accrued depreciation and amortization calculation the accumulated amortization of a plant acquisition adjustment included in plant (and rate base by the primary rate jurisdiction).

(3) The Company did not include in system-wide investment base for the projects, the Construction Work In Progress (CWIP) allowed in rate base. The CWIP is earning a return and should be included in system-wide investment base.

The Company was required to take into consideration items 1, 2, and 3 above in future amortization reserve calculations.
Licensed Projects

Classification of Deferred Income Taxes for Licensed Projects

The Company began recording deferred income taxes resulting from accelerated tax depreciation on ADR property as a component of book depreciation expense pursuant to a directive of the Public Service Commission. This accounting began with respect to 1979 additions reflecting the first year that ADR was elected. The Company had not established records setting forth the amounts of deferred income taxes in Account 108 for each licensed project.

General Instruction No. 16, paragraph (c), of the Uniform System of Accounts requires companies to maintain records of the net original cost of each licensed project. Since the deferred income taxes are a component of the accumulated provision for depreciation, records should be established to designate the amounts for each project.

The Company was required to establish records of the accumulated amounts on the basis of the individual projects and that the amounts for each project at December 31, 1980, be forwarded to the Washington Office.

Licensed Project Amortization Reserves

The Company did not establish or maintain in Account 215.1, Appropriated Retained Earnings - Amortization Reserve, Federal, amortization reserves applicable to certain licensed projects.

Section 10 (d) of the Federal Power Act, the various licenses and General Instruction Nos. 16 (c) and 16 (d) of the Uniform System of Accounts require that annual computations of excess earnings be made and appropriate entries, if any, be recorded in Account 215.1

The Company was required to prepare its amortization reserve requirement schedules for the above projects through December 31, 1983, record the appropriate amount in Account 215.1, and submit all such information with its initial response to the audit findings. In the future, the Company should maintain amortization reserves for each licensed project consistent with the terms of their licenses.
Licensed Projects

Amortization Reserve Requirements

For the period under audit, the licensee did not make annual calculations of excess earnings for four individual licensed projects.

The Commission in its Statement of Policy, Order No. 387, issued August 4, 1969, (42 FPC 329), and Commission Opinion Nos. 596 and 596A, issued June 7, 1971, and August 31, 1976, ordered all licensees to compute for each licensed project subject to the provisions of Section 10(d) of the Federal Power Act, annual project earnings after the first twenty years of operation under the license and the effects on project amortization reserves.

The licensee was required to compute and record the annual credit amount, if any, in accordance with Commission Order 387 and Commission Opinion Nos. 596 and 596-A. In addition, the Company should submit copies of its computations for review by the Office of the Chief Accountant. It should be noted that the Company has made the necessary filings to the Commission requesting a change in the licenses issued to the Company for these hydroelectric projects in response to Order No. 550.

Amortization Reserve, Federal

During the period 1977 through 1980 the annual federal amortization reserve computations of excess earnings produced deficits rather than excess earnings. The Company deducted one-half of these deficit earnings from previously computed and recorded excess earnings. Federal amortization reserve computations of excess earnings are to be made in accordance with the requirements of Section 10(d) of the Federal Power Act, Commission Order No. 387, Statement of Policy, issued August 4, 1969, and the respective articles of the projects' specific license, which provided that any deficiencies computed shall be deducted from the amount of any surplus earnings accumulated thereafter, but shall not be used to reduce previously recorded excess.

In the future, the Company was required to compute the amortization reserve, Federal, in accordance with the applicable regulations and specific license requirements, and record the necessary correcting entry to properly state the amortization reserve, Federal.
Licensed Projects

Letter of Notification Required Under Subchapter B of the Regulations Under the Federal Power Act

The Company filed an application for a Major License under the Federal Power Act for the constructed River Project. The project consists of four developments. The Commission issued the Major License in accordance with Sections 4(e) and 23(b) of the Act.

Subchapter B of the Regulations Under the Federal Power Act, Part 4 - Licenses, Permits, Exemptions and Determination of Project Costs, Subpart C, Section 4.20, requires the Company to file a letter of notification to the Commission within six months after the date of issuance of the license containing a statement to the effect that an inventory in detail of all property included under the license, as of the effective date of the license, has been completed. The letter shall also include a statement to the effect that actual legitimate original cost, or if not known, the estimated original cost, and accrued depreciation of the property, classified by prime accounts as prescribed in the Commission's Uniform System of Accounts, have been established. The Company had not filed the notification required by the above referenced regulations.

The Company was required to comply with the regulations under the Federal Power Act, Subchapter B, Part 4, Subpart C, Section 4.20, by filing a letter of notification to the Commission for the River Project.

Separate Records or Accounts Required for Each Licensed Project

The staff's examination disclosed that the Company did not maintain separate records or accounts for each licensed project.

General Instruction 16 requires separate accounts or records for each licensed project. The accounts or records of each licensee shall be kept as to show for each project under license:

(a) The actual legitimate original cost of the project;

(b) the charges for operation and maintenance of the project property directly assignable to the project;

(c) the credits and debits to the depreciation and amortization accounts, and the balances in such accounts;

(d) the credits and debits to operating revenue, income, and retained earnings accounts that can be identified with and directly assigned to the project.

The Company was required to maintain separate accounts or records for each licensed project as prescribed by General Instruction 16 of the Uniform System of Accounts.
Licensed Projects

Procedures for Calculating Amortization Reserves for Licensed Hydroelectric Projects

The Company made several errors in computing amortization reserves for the licensed hydroelectric projects:

(1) In certain years the Company realized excess earnings on the licensed projects that required the establishment of amortization reserve amounts in Account 215.1, Appropriated Retained Earnings-Amortization Reserve, Federal, as set forth under the requirements of the Uniform System of Accounts. In other years the Company's earnings on licensed projects were deficient. When the project earnings were deficient, the Company followed the procedure of offsetting the deficit earnings against any excess earning accumulations related to prior years.

The Commission established the principle of the "offset method". Under the "offset method" current earnings deficiencies cannot be offset against prior excess earnings accumulation but must be offset against future excess licensed project earnings. The Company's method of determining amortization reserve requirements was contrary to the off-setting procedure approved and adopted by the Commission. The Company's method had the effect of reducing the balances recorded in Account 215.1.

(2) In computing the amortization reserves in certain years, the Company improperly adjusted various income tax account balances that it had recorded in its financial statements to reflect comprehensive interperiod income tax accounting procedures. The adjusted tax amounts were not consistent with both the flow-through income tax policies that were used by the regulatory commissions in establishing the Company's rates and the Company's accounting procedures that were based upon such ratemaking policies.

The application of the normalized tax procedures for the amortization reserve computations produced lower project earnings than actually realized. The books and records, Form 1 and other published financial statements showed higher earnings amounts than those determined under the Company's amortization reserve computations. In certain years the adjustments made by the Company to the recorded income tax accounts balances for amortization reserve purposes reduced project earnings to the level that the Company did not make any accretions to the amortization reserves.

Under the Commission regulations, the computation of amortization reserves must be made directly from the amounts included in the Company's books and records.

The Company was required to (1) revise procedures to ensure that the amortization reserves are computed annually in accordance with the requirements of Section 10(d) of the Federal Power Act, Commission Order No. 387, Statement of Policy and Opinion Nos. 596 and 596A, and (2) make revised computations reflecting the proper levels of deferred taxes covering the amortization reserve period for each license and establish the necessary amortization reserves in Account 215.1, consistent with the Commission Order No. 387.
Licensed Projects

Procedures For Computing Amortization Reserves

In computing the amortization reserve provision for the Project, the Company beginning in 1982 determined the overall rate of return using the monthly average interest rate on 10-year government bonds plus four hundred basis points.

In a letter order dated March 16, 1982, the Acting Director of the FERC's Office of Electric Power Regulation (OEPR) stated:

... the annual specified reasonable rate of return for the project shall be the sum of the weighted cost components of long-term debt, preferred stock, and the cost of common equity, as defined herein.

The cost of common equity component was specified as the monthly average interest rate on 10-year government bonds plus four hundred basis points.

The Company use of the wrong overall rate of return resulted in an understatement in Account 215.1, Appropriated Retained Earnings-Amortization Reserve, Federal.

The Company was required to (1) revise procedures to calculate the overall rate of return in accordance with the requirements of the Commission's letter order and (2) record a Correcting Entry to correct the balance in Account 215.1 as of December 31, 1986.

Accounting For License Project Amortization Reserves

The Company has five licensed projects. The licenses for these projects, which conform to Section 10(d) of the Federal Power Act, require the Company to make an excess earning calculation to determine if it must set aside a portion of earnings from the projects in an amortization reserve.

The Company made the appropriate calculations for each year under audit and determined that there were excess earnings. However, it did not record the excess earnings in its equity accounts.

The Company was required to:

(1) revise procedures to ensure that the appropriate amounts of excess earnings are recorded in Account 215.1 as required by the Federal Power Act and the Uniform System of Accounts.

(2) record an Entry to properly state the amount of excess earnings as of December 31, 1987.
Licensed Projects

Procedures for Calculating Amortization Reserves

The Company has four major licensed projects that were licensed effective May 1, 1965. Each license requires the calculation of an amortization reserve after the first twenty years of operation.

Beginning in 1985, the Company was required to begin calculation of the amortization reserve for each of the projects. A review of the Company's calculations disclosed that the rate base figure derived included the addition of construction work in progress and compensating bank balances and the deduction of customers deposits and postpayments (Account 236, Taxes Accrued).

Order No. 387 issued on August 4, 1969, sets forth the requirements for calculating the amortization reserves for the licensed projects. Order No. 387 states in part,

In computing licensees earned rate of return for its entire electric department utility operations for a given fiscal period included in the earnings base of the electric department the average of the beginning and ending year end balances of electric plant in service (original cost) less related accumulated provisions for depreciation...similarly averaged plus an allowance for working capital. Omit the construction work in progress balance...all as required by applicable precedents and relevant provisions of the Uniform System of Accounts.

The Company should have calculated the reserves within the guidelines and intent of Order No. 387 and applicable ratemaking principles set forth by the FERC's rate regulations and not have included the items in rate base. A corrected calculation showed no excess earnings for the projects through 1986.

The Company was required to revise procedures to ensure that the amortization reserves are computed annually and that such computations are in accordance with the requirements of Section 10(d) of the Federal Power Act, Commission Order 387, State of Policy and Opinion Nos. 596 and 596A.
Acquisition Adjustments

Accounting and Tariff Billing for an Acquisition Adjustment

In 1987, the Company purchased a portion of the common facilities of a plant. The Company recorded an acquisition adjustment in Account 114, Electric Plant Acquisition Adjustments, as a result of the purchase.

The Company recorded the amortization of the acquisition adjustment by charges to Account 406, Amortization of Utility Plant Acquisition Adjustments.

On November 2, 1988, the Company received a response letter from the FERC's Chief Accountant on the proposed journal entries it submitted to clear Account 102, Electric Plant Purchased or Sold, related to the acquisition. The Chief Accountant ordered the Company to amortize the acquisition adjustment to Account 425, Miscellaneous Amortization. Also, the Chief Accountant indicated that the Company could resubmit its request to amortize the acquisition adjustment to Account 406 if it could demonstrate specific offsetting benefits and/or if it was granted above-the-line treatment in retail and wholesale rate proceedings.

Based upon available information, we concluded that the Company was not granted specific approval of the Public Service Commission to include the amortization of the acquisition adjustment in utility rates.

The Company did not include in tariff billings the amortization of the acquisition adjustment, except for those customers receiving energy from the Plant under the Unit Power Sales Agreement.

It was recommended that the Company refund amounts of the acquisition adjustment collected in billing absent a Commission waiver and adopt procedures to ensure that the amortization of acquisition adjustments are recorded consistent with the requirements of the Uniform System of Accounts in the future.

On July 30, 1990, the FERC approved amendments to the Unit Power Sales Agreement (UPSA) between the Company and other members. The amendments permitted the Company to include in tariff billings to those customers the costs recorded in Account 114, along with the corresponding amortization, as components of allowable costs in determining billings under the UPSA.
Acquisition Adjustments

Accounting for an Electric Plant Acquisition Adjustment

The Company filed an application pursuant to Section 203 of the Federal Power Act for authorization to purchase two transmission substations. The Commission approved the transaction based upon the terms and conditions set forth in the Company's filing. The difference between the purchase price and the net book value of the facilities resulted in an acquisition adjustment.

The Company's proposed journal entries in its approved filing showed the acquisition adjustment recorded in Account 114. However, the Company recorded the acquisition adjustment in Account 108.

It was recommended that the Company:

(1) revise procedures to ensure that proposed journal entries are recorded as authorized by the Commission; and

(2) record an entry to correct the accounting for the acquisition adjustment.

Also, the Company should amortize the acquisition adjustment to Account 425, Miscellaneous Amortization, over a period no longer than the estimated remaining life of the property to which it relates.
Acquisition Adjustments

Accounting for Transfers of Property Between Affiliated Companies

The Company purchased a 25 percent undivided interest in a facility. At the time of the purchase, the facility was still under construction.

The transfer price reflected an increase over actual construction costs for the percentage of the generating unit transferred to the Company.

In addition, the Company did not record any deferred income taxes related to the transferred assets.

The Company included the amounts capitalized in its billings to wholesale customers that have contracts for the sale of energy from the facility.

The Company's accounting for the transfer of property between affiliates was not consistent with the requirements of the Uniform System of Accounts in the following respects:

(1) The Company should not have recorded the excess of the amount paid over the original cost in Account 107.

It is a well established Commission policy that transfers of plant properties among members of a corporate family cannot result in increases in the original cost of such property. As observed by the court in South Carolina Generating Company v. FPC, (261 F. 2nd 915, 920-4th Cir. 1958):

... [t]he Commission repeatedly looks through the corporate form of affiliated corporations jointed in a single system to recognize economic realities.

The Company should have recorded in Account 107 only the amounts that the seller had recorded in its construction work in progress account related to the assets transferred. Therefore, the difference between the AFUDC amount in Account 107 allocated to the Company and the carrying charge billed to the Company was not properly classified as the original cost of the generating unit and not an appropriate charge to Account 107.

At the time of the transaction, the Company should have recorded the excess of the amount paid over the original cost in Account 114, Electric Plant Acquisition Adjustments. 2/

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2/ On January 25, 1990, the Company informed the Division of Audits that the seller reduced the transfer price for the transaction to reflect an adjustment of the plant costs and the deferred income taxes previously recorded on the property. As a result of the reduced transfer price, the Company would not have any amount established in Account 114 related to the transaction.
Acquisition Adjustments

Accounting for Transfers of Property Between Affiliated Companies (Continued)

Also, we concluded that the Company should reverse the additional AFUDC accrued on the improper amount recorded in Account 107.

(2) With respect to the accumulated deferred income taxes associated with the transferred property interests, Commission policy requires that the time value benefits associated with deferred income taxes accrue to the ratepayers responsible for the payment of the cost of property. By not recording the deferred income taxes, the associated time value benefits did not accrue to the Company's ratepayers.

We concluded that the Company should record an entry to establish the accumulated deferred income taxes associated with the transferred properties.

As a result of the above accounting deficiencies, the Company overstated its tariff billings to the wholesale customers receiving electricity from the unit under a formula rate.

It was recommended that the Company:

(1) revise procedures to ensure that future transactions of a similar nature are recorded consistent with the requirements of the Uniform System of Accounts.

(2) record a correcting entry to correct the accounting for the acquisition that (a) removes an amount in excess of original cost from utility plant, (b) reverses AFUDC overaccrued on the excess cost, and (c) establishes deferred income taxes that were recorded prior to the transfer of the property.

(3) recompute tariff billings to unit sale customers by eliminating the excess utility plant investment and including the proper amount of accumulated deferred income taxes related to the facility in the billings and make appropriate refunds, with interest computed in accordance with Section 35.19(a) of the Commission's regulations, of any overcollected amounts.
Classification of First Cost Clearing Land

The Company recorded in the accounts for land and land rights the cost incurred in connection with first clearing and grading of land and rights-of-way. Electric Plant Instruction No. 7A, Uniform System of Accounts, states that costs incurred in connection with first clearing and grading of land and rights-of-way shall be included in the appropriate plant accounts directly benefited.

The Company was required to institute procedures which assure that the above costs are included in the plant accounts directly benefited.

Other Plant in Service Procedures

Electric Plant Instruction No. 14 requires that equipment which converts electricity from transmission to distribution voltage shall be classified as distribution equipment and that facilities used jointly for transmission and distribution purposes shall be classified to the major use thereof.

Review of voltage ratings for equipment currently classified as transmission plant indicates that all or a portion of approximately 59 substations should be reclassified as distribution plant. Presently it is not possible to estimate the amount of electric plant and accrued depreciation to be reclassified.

The Company was required to record and report substations as required by Electric Plant Instruction No. 14.

Capitalization of Maintenance Costs

The Company capitalized minor amounts of maintenance expense at the generating plant to correct design problems and to bring the plant up to design levels.

Operating Expense Instruction No. 2, Item 3, states that work performed specifically for the purpose of preventing failure, restoring serviceability or maintaining life of plant shall be charged to maintenance.

In the future, the Company was required to account for maintenance expense as prescribed in the Uniform System of Accounts. No adjustments to plant accounts was required due to the immateriality of the amounts involved.
Capitalization of Property Taxes

A review disclosed that a full year’s property taxes were capitalized on projects undergoing construction on the property tax assessment date. Property taxes assessed on January 1st were applicable to the taxing authorities' fiscal year which began with that January 1st. Property taxes were recorded when paid.

Electric Plant Instruction 3(16) provides that property taxes are properly includible in construction costs only during the period of construction. No property taxes are capitalizable once the facilities become available for service. Additionally, accrual of the property tax liability over the fiscal year of the taxing authority, rather than when paid, is the preferred and generally accepted accounting practice.

The Company was required to institute procedures for the accrual of property taxes over the fiscal year of the taxing authority, and for the capitalization of only those property taxes applicable to periods of construction.

Capitalization of Maintenance Work

As a result of the Three Mile Island accident, the Company had to test, inspect, and in some cases, replace anchor bolts and piping supports at a nuclear unit.

4,909 anchor bolts were inspected and 485 were replaced. A high percentage (74%) of the work was for labor and contractors' work. The bulk of the work involved testing and inspecting the bolts. The bolts themselves are very inexpensive. 5,107 pipe hangers were analyzed and 892 were replaced. Again, a high percentage (90%) of the work was for labor and contractors' work. The bulk of the work involved computing the stresses on the piping systems.

In staff's opinion, the work performed was maintenance and should not have been capitalized. Operating Expense Instruction No. 2 of the USA specifically provides for the costs of inspecting and testing to determine the need for repairs and replacements to be chargeable to the various operating expense accounts.

The Company was required to record an entry to remove from the utility plant accounts and record in Account 182.2, Unrecovered Plant and Regulatory Study Costs the costs incurred to test and inspect the anchor bolts and to write off the AFUDC capitalized on these costs.

These costs were incurred per the Company's compliance with Nuclear Regulatory Commission (NRC) Inspection and Enforcement Bulletins 79-02, 79-07 and 79-14. The accounting requested by the Company conforms with Order No. 390 issued August 3, 1984. A three year amortization period of the amount recorded in Account 182.2 was requested and was determined to be reasonable.
Utility Plant Accounting

Other

Accounting for Computer Software

To meet the accounting and reporting requirements of the Commission, the Company developed computer software programs, which cost approximately $386,000. This cost was capitalized in the tangible gas plant accounts.

The staff is of the opinion that Account 303, Miscellaneous Intangible Plant, is the most appropriate plant account for the recording of such computer software costs.

The Company was required to transfer the computer software costs recorded in the tangible gas plant to Account 303.

Accounting for Computer Software Cost

The Company had recorded in Account 391, Office Furniture and Equipment, company labor expended to develop computer software along with payments to outside consultants for services in developing computer software.

The staff has taken the position that the cost of Company developed computer software and purchased computer software which is separately stated from the hardware cost should be recorded in Account 303, Miscellaneous Intangible Plant, and amortized by charges to Account 404, Amortization of Limited Term Electric Plant, and credited to Account 111, Accumulated Provision for Amortization of Electric Utility Plant, over a period not to exceed five years.

In the future the Company was required to follow the above accounting guidelines for costs incurred to develop computer software programs and record a correcting entry to properly classify the developmental software costs to Account 303, Miscellaneous Intangible Plant.
Accounting for Geophysical Survey Work Orders

At times, the Company will incur costs in connection with geological surveys. The costs are incurred in determining the feasibility of drilling economically productive wells in the various areas of study. The work orders for geophysical surveys are included in Account 107, Construction Work in Progress - Gas. If drilling does not occur, the amounts are written off to Account 798, Other Exploration. Minor amounts of allowance for funds used during construction (AFUDC) are included on the work order before construction is determined feasible.

The text of Account 183.2, Other Preliminary Survey and Investigation Charges, states that this account shall be charged with all expenditures for preliminary surveys, plans, investigations, etc. made for the purpose of determining the feasibility of utility projects under contemplation.

The Company was required to institute procedures which assure that costs incurred in connection with determining the feasibility of utility projects under contemplation are included in Account 183.2, Other Preliminary Survey and Investigation Charges, until the final determination is made. In addition, AFUDC should not be capitalized until construction begins on a planned progressive basis. The Company should also take into consideration the provisions of Account 338, Unsuccessful Exploration and Development Costs when accounting for such costs in the future.

Accounting for Conversion Costs

Staff's review disclosed that the Company had abandoned a Nuclear Project. However, in accordance with the State Commission's Order, a balance of $18.6 million remained in Account 107, Construction Work in Progress - Electric, after abandonment. The $18.6 million was found by the state to be applicable to a possible future conversion of the project to a coal-fired facility. Company officials stated that construction activities to convert the project were not contemplated in the immediate future.

The Uniform System of Accounts provides Account 105, Electric Plant Held for Future Use, for the recording of future use projects such as the conversion costs of the nuclear project. The accrual of AFUDC on Account 105 balances is not provided for by the Uniform System of Accounts. However, carrying costs have been permitted to be recorded in Account 421, Miscellaneous Nonoperating Income, and deferred in Account 186, Miscellaneous Deferred Debits, when recovery of such carrying costs, in future rates, is assured by an appropriate regulatory body.

Staff recommended that the Company make an entry to record the costs of the Nuclear Project applicable to converting it to a coal fired facility in Account 105. However, carrying costs accrued on these conversion costs should be recorded in Account 421 and deferred in Account 186. This recommendation was based upon staff's conclusion, that such costs would be recovered in rates. If recovery of the costs are not granted by the State Commission, the carrying cost balance deferred in Account 186 should be charged immediately to Account 426.5, Other Deductions.
Property Tax Penalties Charged and Interest Expense to Construction

The Company believed it was overassessed on its property related to a Construction project. As a result, the Company placed in various escrow accounts its property tax payments, rather than remit the payments to the appropriate taxing authority. Because the taxes were not paid to the taxing authority when due, the Company incurred an additional liability for interest charges and penalties. The Company paid $113,725,104 in delinquent property taxes along with $9,663,634 of penalties and $7,265,695 of interest charges.

The Company charged the Construction work order with $9,663,634 of penalty charges, and $7,271,695 of interest charges. The Company credited the Construction work order with $7,265,888 of interest income that was earned while the money was held in escrow. The Company also accrued approximately $500,000 of AFUDC on the above interest and penalty charges.

The Uniform System of Accounts requires penalties to be charged to Account 426.3, Penalties; interest expense to be charged to Account 431, Other Interest Expense; and income to be credited to Account 419, Interest and Dividend Income. Accordingly, the inclusion of these amounts in Account 107, Construction Work in Progress, was contrary to the requirements of the Uniform System of Accounts. In addition, the Company's decision to temporarily withhold the payment of property taxes did not reduce its property tax assessments but rather resulted in costing approximately $9,000,000 more than it would have if the taxes were paid when due. The Company also did not establish that the withholding of the tax payments was necessary to try to reduce its property tax assessment. Therefore, if the penalty is not includable in Account 426.3, it must be charged to Account 426.5, Other Deductions, because it is not a just and reasonable expenditure. (Refer to General Instruction 2E of the Commission's Uniform System of Accounts.)

The Company was required to record an entry to charge Account 426.3, Penalties, with the penalty and to reverse the AFUDC accrued on the penalty.

Improper Accounting for Relocation of Plant Not Retired

During the course of certain construction projects it became necessary for the Company to relocate various components of the electric plant in service without retiring such items. The costs of such relocations were capitalized as a component of the construction work.

Operating expense instruction 2C(4) states that the cost of rearranging and changing the location of plant not retired shall be charged to maintenance.

The Company was required to record an entry to remove from electric plant and charge to expense the costs of relocating in service plant, which was performed in conjunction with related construction work.
Utility Plant Accounting

Other

Accounting for Easement Proceeds

The Company recorded in Account 421, Miscellaneous Nonoperating Income, proceeds of $251,347 received from certain oil and gas pipeline companies in consideration for permanent easements across land recorded in Account 101, Electric Plant in Service.

The granting of the easements represents a transfer to another party of previously owned land rights and, therefore, should be accounted for as a retirement. In the opinion of the staff, the retirement should have been accounted for by crediting Account 101 with the fair market value of the easement rights determined at the time of their original purchase. Any difference between the value so determined and the net proceeds received from the granting of the permanent easements should be recorded as a gain or loss in accordance with the requirements of Electric Plant Instruction No. 7(E).

The Company was required to (1) revise its procedures to account for the granting of easements across utility property in accordance with Plant Instruction No. 7 and (2) record the necessary correcting entry to eliminate the original cost of the easement granted the pipeline companies from Account 101 and to properly reflect a profit or loss on the transaction as required by Electric Plant Instruction No. 7(E).

Accounting for Software Development Costs

The Company incorrectly classified the cost of software in Account 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment and Fabrication.

The Company paid to develop an Inventory Management System computer model for use in evaluating nuclear fuel management decisions. The Company recorded the cost of the computer model in Account 120.1.

We concluded that the costs were not properly classified in Account 120.1. The instructions to Account 120.1 state in part:

This account shall include the original cost of the utility of nuclear fuel materials while in process of refinement, conversion, enrichment, and fabrication into nuclear fuel assemblies and components, including processing, fabrication and necessary shipping costs.

Since the computer model will benefit future periods, we concluded that the more appropriate classification of the costs of the software was Account 303, Miscellaneous Intangible Plant. The Company should amortize the software cost over the expected benefit period.

The Company was required to (1) revise its procedures to ensure that the incremental costs of developed software that is expected to benefit future periods is classified in Account 303 and (2) record a correcting entry to reclassify the costs of the computer model to the proper account.
Conversion Project

The Company began an 18-24 month project to convert Unit No. 4 from a gas and oil fired unit to a coal fired unit. At the start of the project the Company removed Unit No. 4 and related facilities from service until the project is completed. The project involved modifying the existing boiler to burn coal, installation of coal and ash handling facilities, addition of pollution control facilities, upgrading the control room and related equipment, and a major turbine generator overhaul.

Although Unit No. 4 was removed from service, the Company did not remove the original cost of the facilities from Account 101, Electric Plant in Service.

The cost of Unit No. 4 did not meet the criteria for inclusion in Account 101 because the unit was not currently used in electric utility operations. Furthermore, the Company did not prepare estimates of maintenance costs expected to be incurred even though it appears that some maintenance work will be done in connection with the conversion.

The Division of Audits concluded that the Unit No. 4 facilities that were removed from service were either no longer useful in utility operations or were being held for future utility use, after completion of the conversion project. When Unit No. 4 was removed from service, the Company should have first identified the retired assets and made the necessary accounting entries to remove the cost of the assets from the plant accounts. The Company should have then transferred the original cost of the remaining assets from Account 101 to Account 105, Electric Plant Held for Future Use.

The Company was required to (1) review the Unit No. 4 conversion project and retire the cost of those assets removed from service that were not used or useful in future utility service, (2) transfer the original cost of Unit No. 4 assets removed from service that are held for future utility service from Account 101 to Account 105, and (3) develop estimates of the cost of maintenance work expected to be incurred in connection with the conversion.

Charges Subsequent to Work Order Closing Date

Many construction work orders were receiving additional charges for a considerable period of time after the facilities were placed in service and the work orders closed. These additional charges consisted mainly of engineering and supervision, labor and related expenses. Major projects reviewed indicated charges being recorded for up to 2 years after the original costs were closed to plant in service.

The Uniform System of Accounts, Account 107, Construction Work in Progress - Electric, Paragraph 5, states, in part, that work orders shall be cleared from this account as soon as practicable after completion of the job.

The Company was required to revise its accounting procedures so as to comply with the above instruction of the Uniform System of Accounts. No correcting entry was required as the amounts involved were insignificant.
Accounting for NRC Mandated Study Costs

The Company improperly recorded the costs of NRC mandated studies in its utility plant accounts.

The Company initially recorded costs incurred to perform NRC mandated studies in Account 107, Construction Work in Progress - Electric. As of December 31, 1986, approximately $26 million had been reclassified to Account 101, Electric Plant in Service, when the work had been completed. The charges consisted of engineering studies to determine if the Nuclear Unit met the current NRC criteria. The Company did not perform an analysis to determine what portion, if any, of the study costs resulted in new construction. For ratemaking purposes the Public Utilities Commission in its Order, permitted these costs to be included in rate base and to be amortized in rates over the 22-year remaining life of the Unit.

NRC mandated study costs incurred prior to the date actual construction begins are properly includable in Account 183, Preliminary Survey and Investigation Charges. The text of Account 183 requires that if construction ultimately results only that portion of the study costs attributable to new construction may be transferred to Account 107 and the remaining costs should be transferred to Account 182.2, Unrecovered Plant and Regulatory Study Costs, or expensed.

The Company requested a waiver from the Chief Accountant to use Account 101, Electric Plant in Service, instead of Account 182.2 for costs incurred to comply with the NRC bulletins. The Chief Accountant denied the Company’s request. The Company agreed to perform an analysis to determine the portion of NRC study costs that did not result in new construction, and to record these costs in Account 182.2.
Procedures for Developing Continuing Plant Inventory Records

The Company did not develop continuing plant inventory records for all components of production, transmission, distribution, and general plant property.

At December 31, 1988, the Company had the following unitized continuing plant inventory records:

<table>
<thead>
<tr>
<th>Plant Function</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nuclear Production</td>
<td>The plant was unitized at the project level.</td>
</tr>
<tr>
<td>Fossil Fuel Production</td>
<td>The Company was in the process of establishing definitions for retirement units.</td>
</tr>
<tr>
<td>Transmission Line</td>
<td>All of the 69 kv lines were unitized since 1972 and some of the higher transmission lines were unitized.</td>
</tr>
<tr>
<td>Property</td>
<td>All substations additions since 1989 were unitized. Some of the substations completed prior to 1988 were unitized.</td>
</tr>
<tr>
<td>Transmission Substation</td>
<td>All distribution lines were unitized since 1972. All substations additions were unitized since 1989.</td>
</tr>
<tr>
<td>Property</td>
<td>All vehicles and land were unitized. All other additions since 1989 were not unitized.</td>
</tr>
</tbody>
</table>

The Staff concluded that the Company had not complied with the requirement of the Uniform Systems of Accounts for maintaining continuing property records in production, transmission, distribution and general property.

It was recommended that the Company:

1. revise procedures for maintaining continuing property records for any future plant additions consistent with the requirements of the Uniform System of Accounts; and

2. develop a formal plan and timetable to unitize all production (other than nuclear), substations (transmission and distribution), transmission and general plants.
CHAPTER 2

DEPRECIATION ACCOUNTING

DEPRECIATION EXPENSE

Depletion on Coal Property Lands and Land Rights

The Company has been crediting Account 111, Accumulated Provision for Amortization of Electric Utility Plant, with the depletion of coal property land and land rights.

The text of Account 108, Accumulated Provision for Depreciation of Electric Utility Plant, contemplates that depletion be credited to that account.

The Company was required to reclassify from Account 111 to Account 108 accumulated depletion of coal property land and land rights and in the future credit Account 108 for depletion of coal property land and land rights.

Reclassification Between Depreciation Provision Sub-Accounts

A review of depreciation disclosed the following:

1. Substations plant costs were transferred from transmission to distribution classification.

2. The accumulated depreciation provisions for these substations were not transferred to the distribution depreciation reserve.

Electric Plant Instruction No. 12 states that "When property is transferred ... from one operating division or area to another, ... any related amounts carried in the accounts for accumulated provision for depreciation or amortization shall be transferred in accordance with the segregation of such accounts."

The Company was required to transfer the accumulated depreciation related to the above substations from the transmission function sub-account to the distribution function sub-account of Account 108, Accumulated Provision for Depreciation of Electric Utility Plant.
Depreciation Expense

Timely Depreciation Studies

Staff review disclosed that the Company had not made a depreciation study since 1971.

Depreciation rates should be reviewed periodically and modified if necessary to reflect a company's experience with the dispersion of retirements, salvage value and removal costs. Failure to recognize changes in depreciation rates on a timely basis can result in substantial deficiencies in accumulated provision for depreciation.

A current depreciation study should be performed and that a review program be established to update depreciation studies at stated intervals not to exceed 5 years.

Availability of Information Supporting Depreciation Expenses

During the course of the audit, the Division of Audits requested information supporting the Company's depreciation rates and recorded provisions for depreciation expense. The information was not readily available for review, although it was available at the offices of the Service Company.

General Instruction No. 2 states:

Each utility shall keep its books of account, and all other books, records, and memoranda which support the entries in such books of account so as to be able to furnish readily full information as to any item included in any account. Each entry shall be supported by such detailed information as will permit ready identification, analysis, and verification of all facts relevant thereto.

The Company was required to revise procedures so as to ensure that depreciation information is readily available at the Company's offices to support its entries for depreciation expense.
Depreciation Expense

Accounting for Accumulated Depreciation Related to Future Use Property

The Company transferred twelve generating units from Account 101, Electric Plant in Service to Account 105, Electric Plant Held for Future Use. The Company performed a study and determined it was feasible to refurbish the units and return them to service in the future. The Company transferred $135,052,961 of accumulated depreciation applicable to the generating units from Account 108, Accumulated Provision for Depreciation of Electric Utility Plant, to Account 111, Accumulated Provision for Amortization of Electric Utility Plant, when the units were transferred from Account 101 to Account 105.

The instructions to Account 108 state, in part,

...Include, also, the balance of accumulated provision for depreciation on property when transferred to Account 105, Electric Plant Held for Future Use, from other property accounts...

Under the above requirements, the Company should not have reclassified the accumulated depreciation to Account 111.

The Company was required to record an entry to reclassify accumulated depreciation on future use fossil generating units to Account 108.

Accounting for Transfer of Accumulated Provision for Depreciation Between Functional Plant Accounts

The Company did not consistently transfer the related accumulated provision for depreciation when transfers of utility property were made between functional plant accounts.

Gas Plant Instruction 12 of the Uniform System of Accounts states, in part, "When property is transferred from one gas plant account to another,...any related amounts carried in the accounts for Accumulated Provision for Depreciation shall be transferred in accordance with the segregation of such accounts."

The Company was required to strengthen its procedures to ensure that the related accumulated provision for depreciation is transferred at the time the utility property is transferred. No correcting entry was required due to the minor amounts involved.
DEPRECIATION ACCOUNTING

Depreciation Expense

Additional Depreciation

The Company retired a Station Steam Plant. The plant was inoperative and fully depreciated. The Company had ceased depreciation accruals when the net value of the plant reached zero. The recording of the costs of removal and salvage to Account 108, Accumulated provision for Depreciation of Utility Plant, resulted in a net debit balance related to the physical retirement. The Company decided to amortize this amount to Account 403, Depreciation Expense, over a five-year period.

The additional write-off was not consistent with theory supporting the use of a composite depreciation rate. The latest depreciation study supporting the composite rates currently in use included the effect of the debit balance for the Station. In addition, the text of Account 108 requires that at the time of retirement of depreciable electric utility plant, Account 108 shall be charged with the cost of removal and credited with the salvage value of the property retired. Further, the write-off of any portion of Account 108 requires Commission authorization as the utility is restricted in its use of the accumulated provision for depreciation. Authorization for the write-off was not requested or received from FERC or the state commission.

The Company was required to cease the accrual of the supplemental charge to depreciation expense and make a corrected depreciation study to determine the adequacy of the depreciation reserve.

Accounting for Plant Retirement Costs

The Company replaced old PCB transformers. The original cost of the retired PCB transformers was recorded in Account 108, Accumulated Provision for Depreciation of Electric Utility Plant. However, cost of removing the contaminated transformers was not maintained by work orders and recorded in Account 108 as a normal cost of removal but was recorded to various distribution and transmission expense accounts. The Company did not retrofit any of the transformers in use.

The instructions to Account 108 state in part:

B. At the time of retirement of depreciable electric utility plant, this account shall be charged with the book cost of the property retired and the cost of removal...

The Company's procedure of recording the cost of removal for the retired transformers to expense was incorrect. When electric plant is retired, the cost of removing the property should be recorded to Account 108.

The Company was required to revise procedures to ensure that removal costs are charged to Account 108 in accordance with the Uniform System of Accounts.
Depreciation Expense

Procedures For Determining Depreciation Rates

The Company had the following deficiencies in its procedures for determining depreciation rates:

A. The Company used depreciation rates for production, distribution and transmission functions based on a study of depreciable plant as of June 23, 1981.

In view of continuing technological advances in the electric industry, and other significant factors affecting economic obsolescence of electric plant, including changes in generation mix, there is a need for depreciation studies to be made at periodic intervals to ensure the adequacy of depreciation rates and provisions. Because seven years elapsed since the Company's last depreciation review was completed, the Company should have made an updated study.

B. The Company included estimated future additions in developing its depreciation rates for fossil steam production plant.

In Opinion No. 165, Commonwealth Edison Company, Docket No. ER79-182, issued on May 12, 1983, the Commission ruled against including future additions in calculating depreciation rates. The Commission reasoned that to assure recovery of its investment, the utility was not only free but obligated to make future adjustments to its depreciation rates to assure as near as possible the full recovery of the service value of its electric plant during its useful life.

C. The Company used the equal life group (ELG) methodology to develop its rates for its general accounts.

For the ELG methodology to be effective there must be adequate historical data that will produce reliable service life and mortality information. Also, a company must keep accrued depreciation and salvage by vintage to measure when each vintage is fully accrued. If these records are not kept, ELG is no better than average life group depreciation and the advantage of using ELG is lost.

This Commission in Opinion No. 234, Middle South Energy, ER82-616, issued June 13, 1985, rejected the Company's use of the ELG method for developing depreciation rates for the above stated reasons.

The Staff concluded that the Company did not maintain the necessary historical data and supporting records to support use of the ELG method.

The Company was required to:

(1) adopt procedures to perform depreciation studies on a regular basis at an interval not to exceed five years.

(2) when preparing depreciation studies, eliminate the factor of future additions in developing depreciation rates.

(3) develop the necessary depreciation records and historical data to support the ELG rates in effect or, in the alternative change to a remaining life method of determining depreciation rates.
Depreciation Expense

Factors Used in Determining Annual Depreciation Expense for Nuclear and Fossil Production Plant

Certain of the Company's depreciation practices did not conform to the Commission's prescribed method for computing depreciation expense related to nuclear and fossil production plant.

The Company used harmonic weighting and an interim retirement factor in determining its depreciation rates and annual expense for the nuclear generating unit and for fossil production plant.

In Opinion No. 234, the Commission specifically disallowed the use of Equal Life Group (ELG) method of calculating depreciation expense for the Grand Gulf nuclear unit. The Commission specifically said (31 FERC Par. 61,305 at p. 61, 658):

While the ELG depreciation method may be technically possible to implement, we are concerned that it will inhibit our ability to effectively monitor MSE's depreciation expense, particularly because the method involves many different depreciation rates and different groups of equipment being retired at different times. We have not previously accepted this depreciation method in a litigated electric rate case, and decline to do so here. Accordingly, MSE is directed to begin using the conventional straight-line depreciation method at the end of the initial 12-month period during which it is allowed to use the UOP depreciation method.

The use of harmonic weighting factor has the same mathematical effect on the depreciation rate as using the ELG factor.

Also, the Company included an interim retirement factor of about 1.0 percent in developing the accrual for its nuclear plant. Most nuclear plants of this vintage use a factor of between 0.1 percent and 0.2 percent. Since the Company has only operated the nuclear unit since 1982, it has little actual experience upon which to base an estimate. Also, we concluded that the interim retirement rate for fossil steam production plant appears excessive and was unsupported.

The Company was required to (1) revise the factors used to develop its annual expense for production plant that uses a direct weighting factor and a supportable interim retirement rate. (2) prepare a new depreciation study reflecting the revised procedures discussed in No. 1 and reflect the revised depreciation rates at the time of its next wholesale and retail rate filings.
Depreciation Accounting

Depreciation Expense

Factors Used in Determining Depreciation Rates

The Company's developed depreciation rates for production and other plant were deficient in the following respects:

A. The Company included estimated future additions in determining the depreciation rate for production plant.

In Opinion 165, Commonwealth Edison, issued on May 12, 1983 (23 FERC Par. 61,219), the Commission disallowed the inclusion of future additions in developing the depreciation rate. Excluding future additions will reduce the Company's depreciation rate for production plant by approximately 0.5 percent.

B. The Company lacked historical records to support its estimates of service lives and salvage for production, transmission and general accounts.

The Company was required to (1) adopt depreciation rates for production facilities that exclude allowances for estimated future additions, and (2) establish and maintain records that will permit the determination of service lives and salvage ratios.

Licensed Project Depreciation Reserve

The Company did not maintain separate depreciation reserve accounts, by function for certain licensed projects.

The Uniform System of Accounts, General Instruction No. 16, separate accounts or records for each Licensed Project, states the accounts or records of each licensee shall be so kept as to show for each project under license the credits and debits to the depreciation and amortization accounts, and the balances in such accounts.

The Company was required to compute the applicable depreciation reserve balances, by function and project for these licensed projects through December 31, 1983, and submit such information with its initial response to the audit findings. In the future, the Company should maintain functionalized depreciation reserve balances for each licensed project as required by General Instruction No. 16.
Depreciation Expense

Accounting For Depreciation Expense

The Company did not record the appropriate amount of depreciation accruals in Account 403, Depreciation Expense, for the period January 1, 1986 to March 31, 1987.

The Company's depreciation rates were previously approved by the Commission in Docket No. 20. The Company recorded depreciation expense based upon the rates approved by the Commission in this docket until May 1986.

In May 1986, the Company revised the useful life for its gathering, underground storage, transmission and general plants and applied the change in depreciation rates retroactive to January 1, 1986.

On September 30, 1986, the Company made a rate change filing that proposed, among other items, a decrease in depreciation rates from those previously approved in the Commission proceeding. The Commission authorized the Company to place the jurisdictional rate change, including the revised depreciation rates, into effect subject to refund, on April 1, 1987.

The Commission approved the Company's depreciation rates. Therefore, we concluded that the Company was precluded under Section 9(a) of the Natural Gas Act from retroactively applying the revised depreciation rates in its depreciation accruals prior to April 1, 1987, the effective date of the rates the Commission accepted.

As a result of retroactively applying the revised depreciation rates, the Company understated depreciation expense and the accumulated provision for depreciation by $23,045,844 for the period January 1, 1986 through March 31, 1987.

The Company was required to

(1) adopt procedures to ensure that depreciation expense is accrued based upon rates approved by the Commission.

(2) record a Correcting Entry to record additional depreciation expense for the period January 1, 1986 to April 1, 1987.
Depreciation Expense

Accounting for Depreciation Expense

The Company was forced to stop deliveries of LNG in April 1980 due to contractual problems with the Algerian government on supplying the LNG. The Company applied the minimum bill provisions of its tariff beginning June 1, 1980. Effective with the June 1, 1980 minimum bill, the Company revised its calculation of depreciation expense and began accruing depreciation in Account 403, Depreciation Expense, at a rate equal to the amount collected through the minimum bill, rather than the greater amount calculated at the 4.5 percent rate. From June 1, 1980, through December 31, 1985, the Company didn't record $23,859,614 of depreciation calculated at the 4.5 percent that was not recoverable through the minimum bill. Since the Company has continued under the minimum bill provisions and is recording depreciation only to the extent billed, the unrecorded depreciation is much greater than $23,859,614.

The Uniform System of Accounts requires a company to record depreciation expense for gas plant in service by charging Account 403, Depreciation Expense, and crediting Account 108, Accumulated Depreciation for Gas Utility Plant. The Company's tariff requires a depreciation rate of 4.5 percent on its entire investment. The Company did not receive any specific Commission authorization to reduce the amount of depreciation expense recorded at the time the minimum bill took effect in June 1980. Absent such approval, the Company should have continued recording depreciation expense at the 4.5 percent annual rate set forth in the initial tariff approved by the Commission. The Company did not have an appropriate basis for reducing the charges to Accounts 403 and 108 effective with the June 1980 adoption of the minimum bill.

The Commission issued an order on January 28, 1988, approving a proposed settlement of the abandonment proceeding for the LNG facilities. Under the provisions of the settlement, the Company would collect its entire investment in the event it reactivates the LNG facilities.

The Commission has approved special accounting to accommodate ratemaking actions of regulatory commissions that created assets in which a company would recover in future rates. The Commission's action approving the Stipulation and Agreement resulted in a regulatory created asset equal to the equity depreciation that the Company did not recover in rates.

Therefore, the Company should have recorded depreciation using the 4.5 percent depreciation rate approved by the Commission on the entire cost of the LNG facilities by charges to Accounts 403 and 108. The Company should have recognized the effect of the Commission approved regulatory created asset for the equity depreciation not recovered in the minimum bill by debiting Account 186, Miscellaneous Deferred Debits, and crediting Account 406, Amortization of Gas Plant Acquisition Adjustments.

The Company was required to revise its procedures to accrue depreciation at the 4.5 percent rate approved in its tariff.
Depreciation Expense

Factors for Determining Service Lives for Depreciating Production Plant

The Company used a 3.495 percent composite rate for calculating depreciation on its Nuclear plant based on a composite average life of approximately 28.6 years, which included estimated interim retirements.

The instructions to Account 403, Depreciation Expense, state in part:

B. The utility shall keep such records of property retirements as will reflect the service life of property which has been retired and aid in estimating probable service life by mortality, turnover, or other appropriate methods; and also such records as will reflect the percentage of salvage and cost of removal for property retired from each account, or subdivision thereof, for depreciable electric plant.

The staff concluded that the Company's estimates of service life related to the Nuclear plant were deficient in the following respects:

1. The Company did not consider the remaining license life in estimating the service life. The Commission has previously approved service life estimates for computing depreciation expense on nuclear generating facilities that are based on the remaining term of the license approved by the Nuclear Regulatory Commission (NRC).

2. The Company lacked historical records to support its adjustments to service life estimates for the Nuclear plant for interim retirements.

The company was required to incorporate the following suggestion at the time it makes another depreciation study: Use a remaining life depreciation method for its nuclear production facilities based on the term of its approved license.

The Company was required to file a copy of the depreciation study with the Office of the Chief Accountant.
Depreciation Accounting

Depreciation Expense

Procedures for Developing Depreciation Rates

The Company had the following deficiencies in its procedures for determining
depreciation rates:

A. The Company's depreciation rates for all production accounts
except nuclear included a factor for future plant additions.

In Opinion No. 165, issued to Commonwealth Edison Company, on May 12, 1983,
(23 FERC ¶ 61,219), the FERC ruled against including future additions in
calculating depreciation rates. The Commission based its reasoning on the
following:

While it is true our traditional practice, as reflected in the
Uniform System of Accounts for Public Utilities and Licensees, has
been, and remains, to disallow costs related to facilities not in
service, there are instances where recovery for such facilities is
allowed . . . These costs, and other removal costs such as
decommissioning, are allowed on an adequate record because they
pertain to current service and because the underlying facility to
which they relate is fully depreciated when costs related to the
additions are incurred with the result that there is no remaining
life existing at such time over which they can be depreciated.

By failing to extend our treatment for removal costs to future
service life additions as Commonwealth proposes, we reject its
claim that this will leave some costs unrecovered after the plant
is retired. Such a result might occur if Commonwealth would fail
to adjust its depreciation rates from time to time, taking into
account up-to-date information on changes in plant balances,
estimated remaining life, salvage and removal cost experience, and
accumulated provision for depreciation to date.

Under the above stated policy, the Company should not have included a factor
for future plant additions in developing its depreciation rates for all
production accounts.

B. The Company's depreciation rates for its nuclear production
accounts were based on a thirty-five year service life.

In Docket No. ER89-265, the Company agreed to use the forty year license life
approved by the Nuclear Regulatory Commission (NRC) to recover decommissioning
costs for nuclear production units. Staff concluded that the Company should
use the forty-year license life in developing its depreciation rates for
nuclear production units.

Staff recommended that the Company:

1. revise procedures to eliminate the factor of future additions in developing
any future depreciation studies to support depreciation rates; and

2. revise procedures to use the estimated life based on the NRC's license
life of forty years in developing any future depreciation studies to
support depreciation rates.
DEPRECIATION ACCOUNTING

Depreciation Expense

Accounting for Depreciation Expense

It was the Company's policy to begin accruing depreciation on completed construction projects by recording one half month's depreciation on projects in the month that they are transferred from Account 107, Construction Work in Progress-Electric, to Account 106, Completed Construction Not Classified Electric.

On several projects with costs greater than $5,000,000, the transfer to Account 106 was delayed one or two months due to clerical errors. The Company failed to record depreciation expense during the period of delay.

General Instruction No. 4 of the Uniform System of Accounts states:

Each utility shall keep its books on a monthly basis so that for each month all transactions applicable thereto, as nearly as may be ascertained, shall be entered in the books of the utility.

Staff recommended that the Company:

(1) strengthen procedures to begin depreciation on major projects in the month of in-service; and

(2) record correcting entry to record additional depreciation on major projects.

Accounting for Depreciation Expense

The Company did not record the proper amount of depreciation expense on the Station from September 1987 through December 31, 1989.

The Company transferred the plant investment related to the Station, except the switchyard, to Account 105, Electric Plant Held for Future Use. It ceased recording depreciation expense on its investment in the Station effective September 1, 1987.

Under the requirements of the Uniform System of Accounts, after the transfer to Account 105 the Company should have continued recording depreciation expense on the Station by charges to Account 421, Miscellaneous Nonoperating Income, and credits to Account 108, Accumulated Provision for Depreciation of Electric Utility Plant.

Staff recommended that the Company:

(1) revise procedures for recording depreciation on the cost of property included in Account 105; and

(2) record correcting entry to record depreciation expense for the period September 1987 through December 31, 1989.
Depreciation Expense

Procedures for Developing Depreciation Rates

The Company's electric depreciation rates for all of its properties were based on a depreciation study conducted in 1976 using depreciable plant existing at December 31, 1975.

In view of continuing technological advances in the electric industry, and other significant factors affecting economic obsolescence of electric plant, there is a need for depreciation studies to be made at periodic intervals to ensure the adequacy of depreciation rates and provisions.

Staff recommended that the Company adopt procedures to perform electric depreciation studies on a more timely basis.

The Company shall submit a copy of the new electric depreciation study to the Office of Chief Accountant no later than December 31, 1991.

Support for Depreciation Rates

The Company based its depreciation rates on a study of depreciable plant as of December 1978.

In view of continuing technological advances in the electric industry, and other significant factors affecting economic obsolescence of electric plant, there is a need for depreciation studies to be made at periodic intervals to ensure the adequacy of depreciation rates and provisions.

Staff recommended that the Company:

(1) adopt procedures to perform depreciation studies on a regular basis at periodic intervals; and

(2) submit a copy of the current depreciation study to the Office of Chief Accountant when completed.
Depreciation Accounting

Reaccounting for Depreciation Expense Related to Nuclear Unit No. 1

The State #1 Commission issued a rate order that directly disallowed in rates of plant costs of the Unit, due to the Company's imprudent actions. Also, the State Commission indirectly disallowed from rate base common facility costs assigned to the previously abandoned Units. However, the State #1 Commission permitted the Company to recover the State #1 jurisdictional portion of the $180 million in the cost of service over 10 years, with no return on the unamortized amount.

In 1987 the Company obtained permission from the State #2 PSC to defer the jurisdictional portion of post operational expenses, including depreciation expense, related to the Unit. On August 26, 1987, the PSC permitted the Company to include 50 percent of the Unit's cost in rate base along with 50 percent of the related depreciation expense. The PSC permitted the Company to defer the remaining depreciation expense pending completion of the next rate case.

The PSC issued an Order concerning the prudence of the Unit's cost. The PSC removed $440 million from the Unit's cost and permitted the Company to recover the amount over the remaining license life of the plant without a return on the unamortized amount.

The FERC settlement agreement did not disallow or exclude any portion of the cost of the Unit from rate base or cost of services. The agreement did not make specific mention of the depreciation rate for the Unit.

The settlement contained the following provision to address the costs of the Unit.

The parties agree that the settlement reached in this proceeding is a dollar-level settlement and that there is no claim or admission by any party regarding any imprudence with regard to the Unit.

The parties also agree that, in the interest of interclass equity, the rate treatment in subsequent proceedings at FERC of the Company's investment in the Unit will track the accounting treatment adopted for ratemaking purposes by the State #1 PSC, subject to change as a result of any changes thereto directed as a result of the appeal(s) of such order.

The settlement contained the following provisions with respect to depreciation rates:

(c) The proposed settlement rates reflect, inter alia, the depreciation rates filed by the Company in this proceeding except with regard to nuclear plant accounts which are hereby modified so as to be depreciated using a nuclear production property depreciation rate of 2.8530% percent that reflects depreciation based on a 40-year license life.
Reaccounting for Depreciation Expense Related to Nuclear Unit No. 1
(Continued)

The Company began recording all operating expenses (including depreciation) related to the Unit beginning on the in-service date of the Unit. It recorded depreciation expense by debiting Account 403, Depreciation Expense, and crediting Account 108, Accumulated Depreciation of Electric Utility Plant.

The Company accounted for the economic effects of the rate actions by the State #1, State #2 and the FERC as follows:

(1) Beginning in May 1987 it established an asset to reflect the rate actions of the retail jurisdictions in permitting the deferral of post operational costs (including depreciation) on the 50 percent of the Unit's costs by debiting Account 186, Miscellaneous Deferred Debits, and crediting Account 406, Amortization of Electric Plant Acquisition Adjustments.

(2) In 1988 it expensed the State #1 and wholesale jurisdictional portion of the cost disallowance on the Unit by debiting Account 426.5, Other Deductions, and crediting Account 101, Electric Plant in Service.

(3) It transferred from Account 101 to Account 182.2, Unrecovered Plant and Regulatory Study Costs, the State #1 and FERC portions of the indirect plant cost disallowance and the State #2 portion of the indirect disallowance.

(4) It removed the State #1 and State #2 jurisdictional portions of deferred depreciation by debiting Account 406 and crediting Account 186, Miscellaneous Deferred Debits.

(5) It reversed the State #1 and State #2 jurisdictional portions of depreciation recorded during the period May 1987 through August 1988, on the direct and indirect plant cost disallowances, by debiting Account 108 and crediting Account 403, Depreciation Expense.

(6) It reversed depreciation expense accrued on the wholesale jurisdictional portion of the direct and indirect disallowed plant costs by debiting Account 108 and crediting Account 403.

(7) It reversed depreciation expense by debiting Account 108 and crediting Account 403. This amount represented the estimate of the difference in depreciation expense that would have been accrued during the period May 1987 through August 1988 had it used a 2.85301 depreciation rate instead of a 4.0144 rate on that portion of the investment in the Unit that it allocated to one wholesale customer. It did not reverse depreciation expense related to any other wholesale customer.

The Company's reaccounting for depreciation expense on the FERC jurisdictional portion of its investment in the Unit was not consistent with the Uniform System of Accounts in the following respects:
Reaccounting for Depreciation Expense Related to Nuclear Unit No. 1
(Continued)

(1) It was appropriate for the Company to begin recording depreciation expense on its investment on the Unit on the in-service date of the unit. Therefore, the Company incorrectly reversed depreciation expense previously accrued during the period May through September 1988 on the Unit's direct and indirect disallowed plant costs.

The Company correctly followed Commission policy by not deferring depreciation expense related to the wholesale jurisdictional portion of a facility between the time it is placed in-service and included in rate base. The Company should have obtained Commission approval before it reversed the depreciation expense previously recorded in Account 108.

The Commission has approved special accounting to accommodate the economic effects of ratemaking in instances when there was sufficient assurance that such rate actions created assets that the Company would recover in future rates.

In the FERC settlement agreement, the parties agreed to adopt consistent rate treatment in subsequent proceedings at FERC with the results of the State No. 1 PSC rate decisions. The Company informed the Division of Audits that it planned to seek recovery of the amounts equal to the previously recorded depreciation in its next wholesale rate filing. Under the circumstances, the Company should have recorded a regulatory created asset by debiting Account 186 and crediting Account 406, pending a final determination in a future proceeding before the FERC. Furthermore, the Company should amortize the amount recorded in Account 186 by charging Account 406 over the period that the Commission provides for rate recovery. In the event that the Company does not receive future rate recovery for amounts recorded in Account 186, it should expense the unrecovered amounts by charging Account 426.5, Other Deductions.

(2) The Company incorrectly reversed depreciation expense previously accrued after a change was made in the depreciation rate for the Unit.

The Company properly began recording depreciation expense using a 4.0144 depreciation rate when it placed the Unit in-service.

The FERC settlement agreement authorized the change in the rates on a prospective basis only. Therefore, the Company should not have reversed any previously recorded depreciation expense amounts in Accounts 403 and 108.

(1) revise procedures to ensure that Commission approval is obtained before it removes any amounts from Account 108 in the future;

(2) record correcting entry by debiting Account 403, Depreciation Expense and crediting Account 108, Accumulated Provision for Depreciation of Electric Utility Plant.
Reaccounting for Depreciation Expense Related to Nuclear Unit No. 1
(Continued)

(a) reverse the Company's improper adjustment to depreciation expense and the accumulated provision for depreciation made in 1988; and

Debiting Accounting 186, Miscellaneous Deferred Debits, and crediting Account 406, Amortization of Electric Plant Acquisition Adjustments.

(b) establishes a regulatory asset for the amount deemed recoverable in rates.

If any portion of the regulatory asset is not permitted in future rates, the Company shall expense the disallowed amount by charging Account 426, Other Deductions; and

(3) record correcting entry by debiting Account 403, Depreciation Expense and crediting Accounting 108, Accumulated Provision for Depreciation of Electric Utility Plant, to reverse the Company's improper adjustment to depreciation expense and the accumulated provision for depreciation made in August, 1988 related to a change in the depreciation rate used for the Unit.

Reaccounting for Depreciation Expense and the Accumulated Provision for Depreciation

The Company recorded monthly entries crediting Account 403, Depreciation Expense, and debiting Account 108, Accumulated Provision for Depreciation of Gas Utility Plant, to reduce the accumulated depreciation over a five-year period.

The Company made the adjusting entries as a result of a ratemaking study it conducted in 1984 during a rate case before the Public Service Commission (PSC). As part of a stipulation to the Settlement Agreement, the parties agreed that the overstatement would be reduced over a five-year period beginning January 1, 1985. The PSC approved the entries to bring the accumulated provision for depreciation recorded in the accounts for accounting purposes in line with the balance of accumulated depreciation established for retail ratemaking.

The Company did not obtain the approval of the Federal Energy Regulatory Commission to record the adjustments to Accounts 403 and 108 over the period 1985 to 1989.

The Commission's general policies with respect to depreciation are as follows:

(1) Section 9(a) of the Natural Gas Act provides the Commission with the following responsibilities:
Reaccounting for Depreciation Expense and the Accumulated Provision for Depreciation (Continued)

The Commission may from time-to-time, ascertain and determine, and by order, fix the proper and adequate rates of depreciation and amortization of the several classes of property of each natural gas company used or useful in the production, transportation, or sale of natural gas. Each natural gas company shall conform its depreciation and amortization accounts to the rates so ascertained, determined, and fixed. No natural gas company subject to the jurisdiction of the Commission shall charge to operating expenses any depreciation or amortization charges on classes of property other than those prescribed by the Commission, or charge with respect to any class of property a percentage of depreciation or amortization other than that prescribed therefor by the Commission. No such natural gas company shall in any case include in any form under its operating or other expenses any depreciation, amortization, or other charge or expenditure included elsewhere as a depreciation or amortization charge or otherwise under its operating or other expenses. Nothing in this section shall limit the power of a State commission to determine in the exercise of its jurisdiction, with respect to any natural gas company, the percentage rates of depreciation or amortization rate, for the purpose of determining rates or charges.

(2) Definition No. 11D of the Uniform System of Accounts defines depreciation as the loss in service value not restored by current maintenance, incurred in connection with the consumption or prospective retirement of gas plant in the course of service from causes that are known to be in current operation and against which the utility is not protected by insurance.

(3) Gas Plant Instruction No. 1 of the Uniform System of Accounts provides in part:

B. Adjustments shall not be made to record in utility plant accounts amounts previously charged to operating expenses or to income deductions in accordance with the uniform system of accounts in effect at the time or in accordance with the discretion of management as exercised under a uniform system of accounts, or under accounting practices previously followed.

(4) The instructions to Account 108, Accumulated Provision for Depreciation of Gas Utility Plant, state in part:

E. The utility is restricted in its use of the provision for depreciation to the purposes set forth above. It shall not transfer any portion of this account to retained earnings or make any other use thereof without authorization by the Commission.
Reaccounting for Depreciation Expense and the Accumulated Provision for Depreciation (Continued)

(5) Annual rates for calculating depreciation expense provisions and the related accumulated provisions for depreciation are determined based upon depreciation studies. A depreciation study takes into consideration a company's latest available information of actual property retirement experience, and includes estimates of remaining plant lives, plant removal cost, and salvage values.

(6) In a letter issued on May 29, 1989, the FERC's Chief Accountant informed the Company that it would have to establish the following circumstances in order to justify adjusting the balance of accumulated provisions for depreciation other than through a prospective change in depreciation rates:

(1) that the balance was over- or underaccrued;

(2) the over- or under accrual resulted from an accounting error rather than the use of estimates in setting depreciation rates; and

(3) that any amounts of overaccrued depreciation resulting from an accounting error was not in fact recovered in utility rates.

Based upon Staff review of the available information, Staff concluded that the facts and circumstances present in the Company's situation would not justify, under the Commission's accounting requirements, recording adjustments to the accumulated provisions for depreciation for the period 1985-1989.

The Commission has approved special accounting to accommodate the ratemaking orders of public utility regulatory commissions in instances when there was sufficient assurance that such actions created assets that the Company would recover in future rates. Based upon the stipulation between the Company and PUC, there is good probability that future retail rates will be determined using the balance in Account 108 as adjusted by the Company. Therefore, a portion of the adjustment represents an amount that the Company may collect in retail rates.

Under the circumstances, the Company should not have adjusted the amounts recorded in Accounts 403 and 108. Instead, the Company should have established an amount equal to that portion of the rates regulated by the PUC as a regulatory created asset, by charges to Account 186, Miscellaneous Deferred Debits, and credits to Account 406, Amortization of Gas Plant Acquisition Adjustments. The amount would then be subject to amortization from Account 186 to Account 406, over the period that rate recovery is provided by the PUC. In the event that the Company does not receive future rate recovery for the amounts recorded in Account 186, it should expense the unrecovered amounts by charges to Account 426.5, Other Deductions.

Staff recommended that the Company:

(1) adopt procedures to ensure that Commission approval is received before any amounts are transferred from the reserve;
Reaccounting for Depreciation Expense and the Accumulated Provision for Depreciation (Continued)

(2) record (a) the correcting entry to restate depreciation expense and the accumulated provision for depreciation to the proper amounts as of December 31, 1988; and (b) a further entry to correct such accounts for additional incorrect entries recorded from January 1, 1989, to date of this letter directive; and

(3) record an entry to establish a regulatory created asset for the amount that the Company anticipates collecting in retail rates as a result of the PUC's action.

Accounting for a Depreciation Provision Adjustment

The Company improperly recorded an adjustment to the depreciation provision by debiting Account 108, Accumulated Provision for Depreciation of Electric Utility Plant, and crediting Account 421, Miscellaneous Nonoperating Income, without obtaining the required Commission approval.

The Company based the adjustment on a Public Utility Commission (PUC) stipulation agreement. The purpose of the correcting entry was to reduce the amount accumulated in the accounts to the theoretical reserve used for ratemaking purposes. Subsequent to the date the Company recorded the correcting entry, the PUC used the accumulated provision on the books to determine rate base for return purposes and to determine depreciation rates.

The Commission has approved special accounting to accommodate the ratemaking orders of public utility regulatory.

The Company should not have removed the amount from Account 108 but rather establish the amount as a regulatory created asset in Account 186, Miscellaneous Deferred Debits. The amount would then be subject to amortization to Account 406, Amortization of Electric Plant Acquisition Adjustments, over the period of recovery provided for in rates set by the PUC.

Staff recommended that the Company:

(1) adopt procedures to ensure that Commission approval is received before any amounts are transferred from Account 108; and

(2) the Company should amortize the balance recorded in Account 186 to Account 406, Amortization of Electric Plant Acquisition Adjustments, over the same period the amount is collected in rates. If for any reason a determination is made that some or all of the amount recorded in Account 186 will not be collected in rates, the Company should charge the portion not to be collected to Account 426.5, Other Deductions, in the same year as the determination is made.
Depreciation Reaccounting

Reaccounting for the Accumulated Provisions for Depreciation

The Company recorded an adjustment to the accumulated provisions for depreciation by debiting Account 108 and crediting Account 421, Miscellaneous Nonoperating Income. The Company should not have reaccounted for any amounts previously charged to the depreciation provision without the prior approval of the Commission.

The Commission has approved special accounting to accommodate the ratemaking orders of public utility regulatory commissions in instances when there is sufficient assurance that such actions created assets that the Company would recover in future rates. Based upon the PUC's order and its subsequent use of the adjusted reserve for establishing rate base, Staff concluded it was probable that future retail rates will be determined using the balance in Account 108 as adjusted by the Company. Therefore, the adjustment represents an amount that the Company may collect in retail rates.

The Company should have established the depreciation provisions as a regulatory created asset by debiting Account 186, Miscellaneous Deferred Debits, and crediting Account 406, Amortization of Electric Plant Acquisition Adjustments, instead of removing that amount from Account 108. It should have amortized the amounts included in Account 186 by charges to Account 406, over the period that the PUC approved for rate recovery.

Staff recommended that the Company:

(1) revise procedures to ensure that Commission approval is received before any amounts are transferred from Account 108; and

(2) to record correcting entry to restore the portion of the depreciation reserve that was removed from Account 108. Also, to establish a regulatory created asset for an amount the Company may collect in future rates.

The Company should amortize the balance recorded in Account 186 by charges to Account 406 over the same period the amount is collected in rates.

If for any reason a determination is made that some or all of the amount recorded in Account 186 will not be collected in rates, the Company should charge the uncollected amount to Account 426.5, Other Deductions, in the year disallowed.
DEPRECIATION ACCOUNTING

Cost of Removal

Accounting for Cost of Removal

During 1987 the Company began a project to replace two L.O. rows of blades on the low pressure rotor serving the No. 2 Turbine. It contracted with General Electric Company to perform the removal of the existing blades and the installation of the new blades.

The Company accounted for the retirement of the old blades by crediting Account 101, Electric Plant in Service, and charging Account 108, Accumulated Provision for Depreciation of Electric Utility Plant. Also, it recorded $18,602 related to the cost of removing the old blades in Account 107, Construction Work in Progress—Electric.

Electric Plant Instruction No. 10(B) (2) states in part:

When a retirement unit is retired from electric plant, with or without replacement, the book cost thereof shall be credited to the electric plant account in which it is included . . . charged to the accumulated provision for depreciation applicable to such property. The cost of removal and the salvage shall be charged or credited, as appropriate, to such depreciation account.

Under the above requirements, the Company should have charged the cost of removal to Account 108 instead of Account 107.

It was recommended that the Company:

(1) strengthen its procedures to ensure that all costs of removal are charged to Account 108 consistent with the requirements of the Uniform System of Accounts; and

(2) record an entry to classify the cost of removal to the proper account.

Improper Accounting for the Cost of Removal

The Company had charged to Account 101, Electric Plant in Service, the cost of removing and replacing old condenser tubes.

The instructions of Account 108, Accumulated Provision for Depreciation of Electric Plant, require that the cost of removal associated with the retirement of depreciable plant be charged to Account 108.

The Company was required to record an entry to properly state Account 101 and Account 108 and reverse APUDC.
Cost of Removal

Accounting for Removal Costs

Removal costs associated with certain retirements were recorded in construction work orders. The removal costs were later transferred to retirement work orders. This procedure led to the overcapitalization of AFUDC in some work orders since the removal costs were part of the AFUDC base.

Electric Plant Instruction No. 11A states that all items relating to the retirements shall be kept separate from those relating to construction.

The Company was required to revise its procedures to ensure project costs are segregated between construction and retirement. No adjustment was required due to the immateriality of the amounts involved.

Accounting for PCB and Hazardous Material Removal Costs

The Company began a program for the removal of PCB contaminated oil from its system. The Company undertook this work because of EPA requirements to check all transformers greater than a 50 KVA rating and replace any oil containing PCBs. Quantities of such oil were minor items of property rather than retirement units. It established procedures to charge the cost of removing, handling, packing and disposing of the PCB contaminated oil to Account 108, Accumulated Provision for Depreciation of Electric Utility Plant.

Electric Plant Instruction No. 10C(3) states, in part, "When a minor item of depreciable property is replaced independently of the retirement unit of which it is a part, the cost of replacement shall be charged to the maintenance account appropriate for the item...."

The Company was required to (1) revise its procedures and charge the cost of removing PCB contaminated oil to the appropriate maintenance accounts and (2) record an entry to eliminate from Account 108 and charge to expense, the cost incurred for the removal of oil containing PCBs.
CHAPTER 3

NUCLEAR FUEL

SPENT FUEL/DISPOSAL COSTS

Accounting for Nuclear Fuel Disposal Cost

The Company began recording monthly provisions to Account 518, Nuclear Fuel Expense, for nuclear fuel disposal cost. The provisions were based on one-twelfth the annual cost filed in the retail rate proceedings before the State Public Utilities Commission.

The Company's only operating nuclear plant was connected to load for 597.5 hours in 1980 and was shut down during most of the year for refueling and engineering modifications. During the period of outage, accruals for disposal cost continued because they were based on the elapse of time rather than the output of the assemblies. The other components of nuclear fuel expense are accrued based on level of output and it is Staff's opinion that disposal cost should likewise be based on thermal output of the assemblies.

The Company was required to revise its accounting procedures so as to accrue for nuclear fuel disposal cost based on the thermal output of the nuclear fuels.

Accounting for Estimated Nuclear Fuel Disposal Cost Applicable to Prior Period Fuel Burned

Account 518, Nuclear Fuel Expense, was charged for the estimated cost of nuclear fuel disposal expenses related to fuel burned in past and current periods. Disposal costs for fuel currently being burned are recovered through retail fuel adjustment clause. Nuclear fuel disposal costs related to prior periods are recovered through base rates. The Company has no wholesale rates.

Commission policy requires disposal costs applicable to fuel burned in prior periods to be charged to Account 524, Miscellaneous Nuclear Power Expenses. Disposal costs related to currently burned nuclear fuel are properly chargeable to Account 518.

Staff recommended that nuclear fuel disposal costs applicable to past periods be charged to Account 524 in the future.
Spent Fuel/Disposal Costs

Accounting for Spent Nuclear Fuel Disposal Costs

The Public Service Commission authorized the amortization of additional provisions for disposal of spent nuclear fuel (SNF) over a ten year period. The costs were the result of revisions in nuclear fuel salvage assumptions.

The Company amortized the additional amounts by charges to Account 518, Nuclear Fuel Expense. The Company also included the amortized SNF costs in the retail and wholesale fuel adjustment clauses (FAC). The wholesale FAC provided only for the recovery of costs of fuel burned in the current period. The Company did not obtain specific Commission approval to collect the above noted costs through the wholesale FAC. Therefore, the additional SNF costs should not have been recovered through the wholesale FAC.

The Company was required to: (1) revise its procedures to include future SNF accruals for fuel burned in prior periods in Account 524, Miscellaneous Nuclear Power Expense, (2) exclude SNF accruals related to fuel burned in prior periods from future FAC billings and (3) recompute prior FAC billings eliminating any SNF accruals and refund, with interest, any overcollected amounts.

Nuclear Fuel Disposal Costs

During the audit period, the Company accrued for the estimated disposal costs of nuclear fuel by debiting Account 518, Nuclear Fuel Expense, and crediting Account 120.5, Accumulated Provision for Amortization of Nuclear Fuel Assemblies. The Staff's examination disclosed that the accrual included a component for disposal costs applicable to nuclear fuel burned in past periods (prior to April 7, 1983). The Company had no wholesale fuel clause in effect. All past disposal costs were collected through base rates and were approved by the Public Service Commission.

In Opinion No. 118, Virginia Electric Power Company, issued April 10, 1981, the FERC found it acceptable to accrue for both present and past disposal costs but stated that Account 524, Miscellaneous Nuclear Power Expenses, was the appropriate account for recording disposal costs related to past spent nuclear fuel.

In the future, the Company was required to charge disposal costs related to past spent nuclear fuel to Account 524.
NUCLEAR FUEL

Spent Fuel/Disposal Costs

Accounting for Interest Expense Related to SNFDC

As a result of the Nuclear Waste Policy Act of 1982, the Department of Energy (DOE) assumed responsibility for the disposal of nuclear waste. DOE subsequently assessed a charge on each owner of a nuclear reactor for the cost of the disposal of spent nuclear fuel. DOE assessed a one-time charge for fuel burned prior to April 7, 1983 and a charge (currently at 1 mill) for all fuel burned after April 7, 1983. DOE established several options for the payment of the one-time charge.

In 1983 the Company entered into a contract with the DOE for the disposal of spent nuclear fuel. DOE assessed the Company a charge for fuel burned prior to April 7, 1983 for Unit 1 and Unit 2 in the amounts of $39,192,320 and $27,360,876, respectively. In June 1985, the Company elected DOE's lump-sum payment option for the SNFDC liability. Therefore, the Company is required to make payment to DOE for the SNFDC liability and related interest prior to the first scheduled delivery date (January 31, 1998) of spent fuel. The interest is based on U.S. Treasury bill rates for the period April 7, 1983, through the payment date.

Starting in the late 1970's the Company recorded estimated SNFDC related to fuel burned at the plant in prior periods as part of the accruals of nuclear fuel expense. When the Company received DOE's assessment of the one-time charge for fuel burned prior to April 7, 1983, it established an additional liability for the uncollected amounts by debiting Account 186, Miscellaneous Deferred Debits, and crediting Account 224, Other Long-Term Debt. After the Company decided in June 1985 to select the lump-sum method of payment, it recorded an additional liability for the interest expense incurred for the period April 7, 1983 to June 1985 by debiting Account 186 and crediting Account 224. The Company also accrued monthly interest expense on the SNFDC liability by debiting Account 186 and crediting Account 224. In the same month the Company made another entry crediting Account 186 and debiting Account 224 in the same amount. The amount amortized each period is equal to the cost level included in the Company's retail and wholesale rates.

Under the requirements of the Uniform System of Accounts, a company must accrue interest expense as a cost of each particular accounting period. At the date the Company made a decision to select the deferred payment option, it should have recorded a liability for the actual interest on the SNFDC liability covering the period April 7, 1983 to the date of the decision. It should have recorded the interest liability by debiting Account 427, Interest on Long-Term Debt, and crediting Account 224. Also, the Company should record the actual interest accruing on the SNFDC liability each month by debiting Account 427 and crediting 224.
Spent Fuel/Disposal Costs

Accounting for Interest Expense Related to SNFDC (Continued)

The Commission has approved special accounting to accommodate the rate actions of regulatory commissions where there is evidence that such actions have resulted in the creation of regulatory assets for future recovery from customers. The Company provided the Division of Audits with evidence that both the FERC and the Public Service Commission had approved rates that included provisions for the collection of both the principal amount and the interest related to the SNFDC liability. The Company should have established a regulatory created asset to recognize the rate recovery of the SNFDC amounts over a different period by debiting Account 186 and crediting Account 421, Nonoperating Income.

The Company was required to revise procedures to ensure that SNFDC related interest is accrued monthly by charging Account 427 and crediting Account 224 and the ratemaking asset related to the collection of the SNFDC related interest is recorded by crediting Account 421 and charging Account 186; and charges for both principal and interest deferred in Account 186 are amortized by charging Account 524 and crediting Account 186.

Interest Charge Accrued on Spent Nuclear Fuel Disposal Costs (SNFDC)

In June 1983, the Company entered into a spent fuel disposal contract with the Department of Energy (DOE). The liability established for the fuel burned prior to April 7, 1983, was recorded as a credit to Account 224, Other Long-Term Debt, with a contra entry to Account 186, Miscellaneous Deferred Debits.

The Company began accrued interest on the SNFDC liability by charges to Account 518, Nuclear Fuel Expenses, and credits to Account 224.

On June 30, 1985, the Company made payment of its entire liability to DOE. The Company credited the interest accrued through that date in the amount of $2,955,963 to Account 518 with a contra entry to Account 224.

Under the requirements of the Uniform System of Accounts, the accruals for interest on the DOE liability should have been recorded in Account 431, Other Interest Expense.

The Company was required to revise its procedures to record future interest charges in the appropriate interest expense accounts. Since the interest accruals collected from the customers related to the SNFDC liability were deducted from rate base for billing purposes, the customers received carrying charges for the use of their payments. Therefore, no further staff action was recommended.
Spent Fuel/Disposal Costs

Accounting for Disposal Costs of Spent Nuclear Fuel (SNF)

The Company used the wrong expense account to record the one-time fee paid to the Department of Energy (DOE) for the disposal of spent nuclear fuel (SNF). Also, it recorded the interest related to the one-time fee in the wrong account.

The Company recorded the one-time fee for previously burned SNF in Account 186, Miscellaneous Deferred Debits. Also, the Company selected the delayed payment option provided by DOE for the one-time fee. Under the option, the Company is subject to interest on the unpaid amounts until it pays the one-time fee. The Company classified the interest it had accrued on the one-time fee in Account 186. It began amortizing the deferred principal and interest amounts to Account 518, Nuclear Fuel Expense, over a ten-year period approved for rate recovery.

The Company did not include any of the deferred amounts in computing fuel costs for wholesale fuel adjustment clause billings.

The Commission addressed the appropriate accounting for previously burned SNF in Opinion No. 118 issued to Virginia Electric Power Company (VEPCO) (15 FERC 61,052 (1981)). In Opinion No. 118, the Commission established the policy that a utility should record the disposal cost for previously burned SNF in Account 524, Miscellaneous Nuclear Power Expense.

Under the requirements of the Uniform System of Accounts, interest expense related to debt included in Accounts 221, Bonds, or 224, Other Long-Term Debt, is properly classified in Account 427, Interest on Long-Term Debt.

It was recommended that the Company revise procedures to record the amortization of previously burned SNFDC in Account 524. and the related interest in Account 427, Interest on Long-Term Debt.
Contract Settlements/Termination

Accounting for Proceeds of Nuclear Fuel Contract Settlement

The Company improperly recorded the proceeds of a contract settlement with Westinghouse in Account 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment and Fabrication. Also, the Company improperly recorded the net interest on a Federal income tax deficiency related to the Westinghouse settlement in Account 120.1.

The Company had entered into a contract with Westinghouse to supply nuclear fuel. Westinghouse subsequently informed the Company that is wouldn't supply the required nuclear fuel. In 1979, the Company settled a suit it had pending with Westinghouse over the fuel supply contract. Under the terms of the settlement, the Company would receive over an eight-year period payments about $39 million. The Company's share of the contract settlement amounted to $7,422,350.

The Company credited Account 120.1 when it received the settlement payments from Westinghouse. The Company also credited Account 120.1 with a negative allowance for funds used during construction (AFUDC), beginning with the date that the Westinghouse payments were received.

For Federal income tax purposes the Company initially included the settlement proceeds as taxable income in the years that such amounts were received. The Company recorded deferred income taxes for all book/tax timing differences related to the Westinghouse settlement. On January 3, 1983, the Internal Revenue Service (IRS) advised the Company that the entire amount of the settlement proceeds were includible in taxable income in 1979, the year the Company reached settlement with Westinghouse. The Company accrued interest from 1983 to 1986 on a possible tax deficiency by charging Account 120.1 and crediting Account 236, Taxes Payable. The accrued interest wasn't included in the base for computing AFUDC.

The settlement proceeds didn't constitute a component of the direct cost of nuclear fuel in process, in the reactor, or the fuel held for future use. Rather, these amounts are more appropriately viewed for accounting purposes as a liability to the Company's ratepayers to be disposed of as directed by the appropriate regulatory commissions. Until the regulatory commissions made such determinations, the Company should have classified the proceeds from the Westinghouse settlement in Account 253.

The Company's accounting for interest on the tax deficiency in Account 120.1 wasn't consistent with the requirements of the Uniform System of Accounts. The Special Instructions to Account 409.1, 409.2, and 409.3 state in part:

Note 2: Interest on tax refunds or deficiencies shall not be included in these accounts but in account 419, Interest and Dividend Income, or account 431, Other Interest Expense, as appropriate.

The Company should have recorded the interest accrued on the tax deficiency in Account 431 and credited the interest income to Account 419.
Contract Settlements/Termination

Accounting for Proceeds of Nuclear Fuel Contract Settlement (Continued)

The Company's improper inclusion of the Westinghouse payments and the net interest expense related to the tax deficiency and its procedure of accruing a negative AFUDC had the effect of lowering the cost of nuclear fuel included in Account 120.1 and subsequently amortized to Account 518. Since the Company used the lower cost included in Account 518 in calculating fuel adjustment clause billings, the Company's incorrect accounting did not result in an overbilling of fuel costs to customers.

The Company was required to revise procedures to ensure:

1. the proceeds of future settlements of nuclear fuel contracts are recorded in Account 253 pending final approval by each regulatory commission; and

2. interest expense and interest income related to future tax deficiencies are recorded in Accounts 431 or 419, as appropriate.

Accounting for Nuclear Fuel Settlement Proceeds

The Company entered into a settlement for the supply of nuclear fuel. One of the terms of the agreement was that a cash payment of approximately $31 million was paid to the Fuel Company.

The PSC ordered the Company to reduce the cost of the nuclear fuel to be used at stations with the benefits of the settlement. In December the Company transferred the proceeds from Account 253, Miscellaneous Deferred Credits, to Account 120.1, Nuclear fuel in Process of Refinement, Conversion, Enrichment and Fabrication.

The staff concluded that interest expense was overcapitalized since the proceeds were not used until December 31, 1981, to reduce the Trust borrowings. The staff computed the amount of interest expense overcapitalized during the period May through December to be approximately $2.3 million.

The Company was required to (1) revise its procedures to ensure that the Trust give appropriate recognition to the time value of refunds not immediately credited to Account 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment and Fabrication, and (2) record the appropriate journal entry to reverse the interest expense overcapitalized by the Trust during the period May through December 1981.
Contract Settlements/Termination

Accounting for Losses Resulting From the Sales of Enrichment Services and From the Termination of a Nuclear Fuel Supply Contract

The Company recorded nuclear fuel contract termination payments in Account 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment, and Fabrication, and accrued an allowance for funds used during construction (AFUDC) on this amount.

In addition, the Company sold to other electric utilities at a discount, certain enrichment services that were to be performed by the Department of Energy (DOE). The Company accounted for the sales by crediting Account 120.1 with the proceeds received from the sales and charged Account 120.1 with all brokerage fees it incurred. The result of this accounting procedure was to record the net losses on the sales of enrichment services in Account 120.1 and accrue AFUDC thereon.

Contract termination charges and net losses on the sales of DOE enrichment services are not properly recordable in Account 120.1. The text of Account 120.1 provides for the costs incurred to obtain and process nuclear fuel material into completed assemblies.

The net losses on the DOE enrichment sales and the payments made for contract termination were not for the procurement or processing of nuclear fuel materials but rather to terminate existing contracts for nuclear fuel and enrichment services. The joint owners received no goods or services in exchange for the payment. The payments represent expenditures to avoid taking future goods and services. The appropriate expense account to charge these types of costs is Account 524, Miscellaneous Nuclear Fuel Expenses. Additionally, only amounts properly includible in Account 107 and 120.1 are eligible for the accrual of AFUDC. The payments incurred as a result of terminating the contract and the net losses on the sales of DOE enrichment services were not properly includible in Accounts 107 or 120.1. Therefore, it would be improper for the Company to accrue AFUDC on these payments and record this AFUDC in Account 120.1.

The Company was required to (1) adopt procedures to ensure that contract termination payments and net losses incurred on the sales of DOE enrichment services are charged to the appropriate expense account, (2) record a correcting entry to properly record these expenses, and reverse all AFUDC that was accrued on the contract termination payments and the net losses incurred on the sales of DOE enrichment services.
Accounting for Nuclear Fuel Contract Cancellation Charges

The joint owners agreed to pay $14.2 million, plus $.27 million of interest to cancel a contract for the supply of uranium concentrate. The Company's share of the contract cancellation charge and interest was approximately $6 million.

The Company charged Account 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment and Fabrication, with the portion of the contract cancellation charge related to Unit Nos. 1 and 2, and accrued AFUDC on the amount.

The contract cancellation charge should not have been charged to Account 120.1. The text of Account 120.1 provides for the costs incurred to obtain and process nuclear fuel materials into complete assemblies.

The payment made was not to procure or process nuclear fuel materials, but rather, to terminate an existing uranium supply contract. The Company did not enter into a new contract to replace the cancelled contract. The cancellation charge was a period cost since it provided no future economic benefit to the Company.

The appropriate expense account to charge the cancellation charge was Account 524, Miscellaneous Nuclear Power Expenses, and the appropriate account to charge the interest paid was Account 431, Other Interest Expense.

The Company was required to record an entry to expense nuclear fuel contract cancellation charges that were improperly capitalized. In addition, the Company should reverse the AFUDC that was accrued on the cancellation charge.
Accounting for Nuclear Fuel Termination Payments

The Company initially secured the anticipated near-term uranium ore requirements through a fuel supply agreement. The agreement contractually obligated the participants to purchase not less than 800,000 nor more than 1,200,000 pounds of uranium per year.

In 1981, the market price for uranium ore declined. The Company believed that further purchases of uranium ore would not be necessary until 1985. Under the circumstances, the Company considered that it was in the best interest of their customers to abrogate the uranium supply contract in exchange for contract termination payments plus interest. The Company charged its share of the termination payments ($860,954) and interest ($184,300) to Account 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment and Fabrication.

The text of Account 120.1 does not allow contract termination payments to be recorded therein. The staff concluded the contract termination costs were period costs that the Company should have recorded in Account 524, Miscellaneous Nuclear Power Expenses, and the interest payment in Account 431, Other Interest Expense.

The Company was required to (1) record an entry to expense the termination costs consistent with the requirements of the Uniform System of Accounts, and (2) reverse any allowance for funds used during construction which may have been capitalized on the termination costs during the period such amounts were included in Account 120.1
Contract Settlements/Termination

Accounting for Contract Termination Fees

The Company improperly included a portion of purchased power costs related to payments for contract terminations fees as a component of fuel cost for wholesale FAC billings. Also, the Company improperly included contract termination fees paid to Getty Oil Company in Account 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment and Fabrication.

A. Termination Fees Included in Purchase Power

As part owner, the Company is entitled to purchase a similar percentage of the output in each of the plants. Formula rate tariffs are used to bill each owner company for power sold.

During the period of 1981 through 1985 certain contracts for the purchase of fuel or for enrichment services were cancelled. In all cases, the termination fees were charged to the cost of other fuel in Account 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment and Fabrication, and included such amounts in billings to the sponsor companies as part of the amortization of the nuclear fuel recorded in Account 518, Nuclear Fuel Expense.

The Company recorded its share of the costs billed, including the termination fees in Account 555, Purchased Power. The Company also included the portion of the billed costs that related to the termination fees in its calculation of fuel cost for FAC billings to wholesale customers.

The Commission's regulations limit the nuclear fuel cost that are allowed recovery through FAC billings to those costs properly included in Account 518.

The instructions to Accounts 120.1, 102.2, Nuclear Fuel Materials and Assemblies--Stock Account, and 120.3, Nuclear Fuel Assemblies in Reactor, do not permit termination costs to be included as a component of the cost of fuel.

The termination payments were made so as to allow them to cancel contracts for either nuclear fuel materials, conversion or enrichment service that required payments at a price that, in their judgment, they could acquire from other vendors at less expense. Since there is no provision in the Uniform System of Accounts to associate these payments with the cost of subsequent materials or services, these amounts should have been expensed by charges to Account 524, Miscellaneous Nuclear Power Expenses.

We recommend the Company adopt procedures to exclude nuclear fuel termination payments from the computation of fuel costs for future wholesale FAC billings; and recompute wholesale FAC billings by eliminating previously incurred termination payments from such billings and make appropriate refunds, with interest computed in accordance with Section 35.19(a) of the Commission's regulations, to wholesale customers for any overbillings.
Contract Settlements/Termination

Accounting for Contract Termination Fees (Continued)

B. Termination Fees Paid for the Nuclear Project

The Company has a 4.05985 percent undivided interest in the Nuclear Project, including related fuel requirements. The project owners initially secured the project's anticipated near-term uranium ore requirements through a fuel supply agreement with Getty Oil Company (Getty). The agreement contractually obligated the project owners to purchase not less than 800,000 nor more than 1,200,000 pounds of uranium per year for each of the years 1978 through 1982. Under the terms of the contract, Getty was to receive the higher of the current market price at time of delivery or the escalated contract price, which in 1980 ranged from $45.53 to $49.62 per pound.

In March 1981 the market price for uranium ore was $25.27 per pound and calculations indicated that the project owners would incur costs of $25-30 million in excess of market prices if they adhered to the contract with Getty for 1981 and 1982. Moreover, the project owners believed that further purchases of uranium ore would not be necessary until 1985. Therefore, the project owners decided to cancel the uranium supply contract. The project owners negotiated a settlement with Getty whereby they were relieved of the obligation to accept and pay for 400,000 to 600,000 pounds of uranium ore in 1981 and 1982 in exchange for contract termination payments of $14,250,000, plus interest, paid in eight quarterly installments.

The Company initially charged its 4.05985 percent share of the termination payments ($578,529) and related interest ($123,843) to Account 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment and Fabrication.

During 1985 the Company announced the cancellation of Unit 2. The Company subsequently transferred its investment in Unit 2, including $322,848 of the Getty termination payments, to Account 186, Miscellaneous Deferred Debits.

As a result of a retail rate case approved by the public service commission (PSC) in 1986, the Company transferred 97.61 percent of its investment in Unit 2 to Account 182.2, Unrecovered Plant and Regulatory Study Costs. The Company amortized the amount included in Account 182.2 over a ten-year period by charges to Account 407, Amortization of Property Losses, Unrecovered Plant and Regulatory Study Costs.

During the audit period the Company didn't request the PSC to grant rate recovery of the balance of the termination payments assigned to Unit 1. Furthermore, the Company didn't request the approval of the Federal Energy Regulatory Commission for rate recovery of the wholesale portion of the termination payments assigned both to Unit No. 1 (included in Account 120.1) and the remaining $7,716 assigned to Unit No. 2 (included in Account 186).
NUCLEAR FUEL

Contract Settlements/Termination

Accounting for Contract Termination Fees (Continued)

The Division of Audits concluded that the contract termination payments and related interest were expenses of the current accounting period. The project owners, including the Company, should have recorded the payments in utility operating expense and interest expense accounts when incurred, unless a company had sufficient regulatory assurance that its regulatory commission(s) will permit recovery of such amounts in future rates.

The Company's timely request and subsequent approval by the PSC was sufficient assurance of a ratemaking asset to permit the deferral of the retail portion of the termination payment assigned to Unit 2 in Account 182.2. The Company didn't receive similar PSC approval to collect the portion of the termination payments assigned to Unit 1 or approval from the FERC to collect the wholesale portion of the termination payments assigned both to Unit 1 and Unit 2. Therefore, the Division of Audits concluded that it was appropriate for the Company to charge the remaining amounts to operating expense Account 524, Miscellaneous Nuclear Power Expenses.

The Company was required to revise procedures to record future contract termination payments in the appropriate expense accounts.

Nuclear Fuel Supply Contract Terminations

The Company terminated two nuclear fuel supply contract.

1. The Company recorded the proceeds from the settlement of a nuclear fuel supply contract by reducing the balances in Account 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment, and Fabrication. The Company added a negative carrying charge to the settlement balance by debiting Account 419.1, Allowance for Other Funds Used During Construction, and Account 432, Allowance for Borrowed Funds Used During Construction.

The Company amortized the settlement amounts from Account 120.1 to Account 518, Nuclear Fuel Expense, over the periods that the amounts were included in rate levels.

2. The Company recorded uranium supply contract termination payments in Account 120.1 and began accruing an allowance for funds used during construction (AFUDC). As of December 31, 1989, the Company had accrued AFUDC in Account 120.1 by crediting Account 419.1 and Account 432.

The Company planned to assign the termination payments to future purchases of fuel, by transferring the payments and carrying costs to Account 120.3, Nuclear Fuel Assemblies in Reactor, or Account 120.6, Nuclear Fuel Under Capital Leases. When it burns the related nuclear fuel, the Company planned to amortize the termination payments, with carrying costs, to Account 518, Nuclear Fuel Expense, and seek recovery of the amortized amounts from each regulatory commission having rate jurisdiction.

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Contract Settlements/Termination

Nuclear Fuel Supply Contract Terminations (Continued)

The Company did not include any portion of the refunds or the termination payments in its fuel adjustment clause billings during the period under audit.

The Company's accounting procedures for recording the settlement proceeds and the termination payments made were not consistent with the requirements of the Uniform System of Accounts:

(1) The Company should not have classified the settlement proceeds credit initially in Account 120.1 because such amounts did not currently relate to nuclear fuel in process of refinement, conversion, enrichment or fabrication.

The instructions to Account 120.1 of the Uniform System of Accounts state in part:

A. This account shall include the original cost to the utility of nuclear fuel materials while in process of refinement, conversion, enrichment, and fabrication into nuclear fuel assemblies and components, including processing, fabrication, and necessary shipping costs . . .

There are no specific provisions in Account 120.1 that permit a utility to include in that account credits from a contractor related to a contract termination to take delivery of nuclear fuel fabrication services in accordance with contract terms.

Also, the Company should not have recorded an amount equivalent to the termination credits and related financing cost in Account 120.1, since such amounts were not a part of the acquisition cost of nuclear fuel under construction.

(2) With respect to the termination payments, the Company provided information showing that it could achieve savings by terminating the Western contract and entering into the new contracts. Furthermore, it informed the Division of Audits that it planned to seek recovery of the termination payments from its customers.

The Commission has approved special accounting to accommodate the ratemaking orders of public utility regulatory commissions in instances when there was sufficient assurance that such actions created regulatory assets that the company would recover in future rates. Under the special accounting, once a company received such assurances it would be permitted to give effect of the rate actions of a public utility commission by entries to separate income and balance sheet accounts so that net income for the particular periods would reflect the economics of the regulators' actions.
Nuclear Fuel Supply Contract Terminations (Continued)

The Company should have used Account 186, Miscellaneous Deferred Debits, to record the termination payments made to terminate the fuel contract, pending subsequent rate decisions. The instructions to Account 186 state in part:

A. . . . this account shall include all debits not elsewhere provided for, such as miscellaneous work in progress, and unusual or extraordinary expenses, not included in other accounts, which are in process of amortization and items the proper final disposition of which is uncertain.

(3) The Uniform System of Accounts provides miscellaneous balance sheet accounts to record transactions for which the ultimate disposition is uncertain.

The Company should have used Account 253, Other Deferred Credits, to record the receipt of the proceeds from the settlement, pending subsequent rate decisions. The instructions to Account 253 state:

This account shall include advance billings and receipts and other deferred credit items, not provided for elsewhere, including amounts which cannot be entirely cleared or disposed of until additional information has been received.

(4) It was inappropriate for the Company to record AFUDC on its share of the credits or termination payments. Under the Commission’s regulations, a utility can capitalize AFUDC as a cost of nuclear fuel only on costs properly classified in Account 120.1.

(5) The Company should amortize the termination payments to Account 518, Nuclear Fuel Expense, over the period allowed for rate recovery.

In the event any of the regulatory commissions disallow future rate treatment of the termination payments, the Company should expense unamortized balance to Account 426.5, Other Deductions, in the year disallowed.

Staff recommended that the Company:

(1) adopt procedures to ensure that any future settlements related to nuclear fuel contract are accounted for consistent with the requirements of the Uniform System of Accounts; and

(2) revise procedures to ensure that AFUDC is only accrued on expenditures properly includible in Accounts 107 and 120.1 of the Uniform System of Accounts.
NUCLEAR FUEL

Contract Settlements/Termination

Accounting for Payments Made to Modify/Cancel a Nuclear Fuel Contract

The Company incorrectly classified certain payments made to Account 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment, and Fabrication, instead of Account 186, Miscellaneous Deferred Debits. Furthermore, it incorrectly amortized the payments to Account 518, Nuclear Fuel Expense, instead of Account 524, Miscellaneous Nuclear Power Expenses.

The parties agreed to defer the scheduled purchase from 1983 until 1986. The Company agreed to pay a non-refundable payment for deferring the delivery.

In another contract change the parties agreed to add another year to the contract. Exercise of the option would result in the Company forfeiting the non refundable payment.

During June 1983 the Company paid the required amounts under the contract changes and recorded the payment in Account 120.1. Also, it began accruing an allowance for funds used during construction (AFUDC) on the payments.

In March, 1985, the Company was notified of the termination of the agreement.

The Company assigned the amount paid in 1983 (that it recorded in Account 120.1) to the nuclear fuel materials purchased for Cycle No. 11. The Company accrued AFUDC on the total amount from the date included in Account 120.1 until the date that it placed Cycle No. 11 in the reactor.

Beginning in early 1989, the Company began amortizing the payments and capitalized AFUDC as part of the cost of fuel for Cycle No. 11 by charges to Account 518, Nuclear Fuel Expense.

Staff concluded that the Company's accounting for the payments made was not consistent with the requirements of the Uniform System of Accounts. Staff based the conclusion on the following accounting requirements.

A utility should classify in Account 120.1 only the original cost of nuclear materials entering the process of refinement, conversion, enrichment and fabrication of completed assemblies for insertion into the reactor.

There are no specific provisions in Account 120.1 that permit a utility to include in that account payments to a contractor related to a utility's failure to take delivery of nuclear fuel materials in accordance with contract terms.

Also, the Uniform System of Accounts provides a specific account for charges that are in the nature of prepayments.

Staff concluded that the Company should have accounted for the payments as follows:
Accounting for Payments Made to Modify/Cancel a Nuclear Fuel Contract
(Continued)

1. It should have initially recorded non refundable payment to defer the 1983 purchase until 1986 either as an operating expense in Account 524 in 1983 or as a deferred charge to Account 186, Miscellaneous Deferred Debits. Accounting as a deferred charge during 1983 would only be appropriate if the Company had a probability of taking delivery of materials in 1986.

2. It should have initially recorded the payment for the "prepayment" of the future purchases (in 1987) under the contract in Account 165.

3. It was inappropriate for the Company to record AFUDC on the 1983 payment. Under the Commission's regulations, a utility can only capitalize AFUDC on charges properly classified in Account 120.1. (Under the terms of the existing tariff, the Company could have included the non refundable payment classified in Account 165 as part of the "net investment" in computing return under its formula rate tariff.)

4. Once the Company acquired nuclear fuel materials elsewhere and canceled the contract, it should have charged the 1983 payment as an expense to Account 524. However, if the Company believed it would be more appropriate for rate purposes to recover the expense over the burn period for Cycle No. 11, it should have filed a request for Commission approval to defer the amount in Account 186 and amortize the amount to Account 524, accordingly.

Staff conclusion on the appropriate accounting for the payments is consistent with the Commission's policy of fuel adjustment clause treatment of utility payments to reduce or eliminate contract purchase commitments to buy coal.

The Commission set forth the following policy guidance with respect to coal buyouts:

1. The purpose of Account 151 is to accumulate the cost of fuel on hand, whereas, buyout costs are for the purpose of terminating a contract to purchase future coal.

2. Buyout costs are payments to vendors in consideration for not purchasing fuel required by contract. As such, buyout costs are the very antithesis of the cost of fuel consumer.

3. Buyout costs should be expensed as incurred or, in the event that rate recognition is given in an appropriate proceeding, amortized to expense from a deferred charge account consistent with the rate recognition.

On the matter of current payments for coal not purchased that a utility can recover by reducing the cost of future coal deliveries, the Commission determined in Opinion No. 327 that the utility should include such payments in Account 165, Prepayments, and later recognize the payments as part of the cost of coal delivered in the appropriate future periods.
Contract Settlements/Termination

Accounting for Payments Made to Modify/Cancel a Nuclear Fuel Contract
(Continued)

The Company provided additional information supporting the deferral of the payments and the amortization of such amounts to expense over the burn period of Cycle No. 11. The materials that replaced the materials not purchased under the contract were used as fuel for Cycle No. 11. Furthermore, it demonstrated that it achieved significant savings in the cost of fuel for Cycle No. 11 by obtaining the materials from other sources, thereby providing future economic benefits to its customers.

Therefore, we concluded that it was appropriate under the circumstances for the Company to defer the payments in Account 186, Miscellaneous Deferred Debits, and to amortize them to Account 524 over the burn period of Cycle No. 11.

Staff recommended that the Company:

(1) adopt procedures to ensure that any future nuclear fuel contract buyout costs are either charged directly to Account 524 or Commission approval for deferral, in Account 186, and amortization of the period expense setting forth all details of the accounting be requested;

(2) record correcting entries to: (a) reclassify the payments to Account 186, (b) reverse the related AFUDC; and (c) reclassify any previous amortization from Account 518 to Account 524; and

(3) furnish revised tariff billings to its sponsors to reflect the appropriate accounting for the payments and the reversal of AFUDC.

Accounting for a Buy-Out of a Nuclear Fuel Contract

The Company transferred the retail jurisdictional portion of a uranium ore contract buy-out cost from Account 123, Investment in Associated Companies, to Account 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment and Fabrication. The Public Service Commission approved the accounting. The Company subsequently amortized the amount to Account 518, Nuclear Fuel Expense, as approved by the PSC.

The Company transferred the FERC jurisdictional portion of the contract buy-out cost from Account 123 to Account 186, Miscellaneous Deferred Debits, pending further direction from the FERC. On December 30, 1989, the Company filed a request with the FERC to waive its fuel adjustment clause regulations.

On March 21, 1990, the FERC issued an order addressing the Company's request. The Commission stated:
Accounting for a Buy-Out of a Nuclear Fuel Contract (Continued)

In accordance with Kentucky Utilities, the Company may seek recovery of these buyout costs through the fuel clause. However, consistent with Delmarva, since the first applicable fuel cycle commences prior to 1991, the settlement-imposed rate design change moratorium precludes fuel clause recovery of buyout costs for the first part of that cycle, until after the moratorium expires December 31, 1990.

The Company's accounting for the nuclear buy-out was not consistent with the Commission's accounting requirements.

In Kentucky Utilities, the Commission addressed the appropriate accounting for coal buyouts. The Commission stated:

. . . the Commission notes that the purpose of Account 151 is to accumulate the cost of fuel on hand, whereas, buyout costs are for the purpose of terminating a contract to purchase future coal. Buyout costs would therefore be includable in Account 151 only to the extent that we were to interpret our accounting regulations to contemplate that costs of future fuel purchases should include some portion of previously incurred buyout costs. We have not so interpreted our accounting regulation in the past, nor do we believe that it would be wise to do so here. We believe that buyout costs should be expensed as incurred or, in the event that rate recognition is given in an appropriate proceeding, amortized to expense from a deferred charge account consistent with the rate recognition.

Under the above guidelines, it was inappropriate for the Company to include the retail portion of the buy-out cost in Account 120.1. It should have classified the entire cost of the nuclear buyout in Account 186. Furthermore, it should have amortized the buy-out cost over the period allowed in rates by charges to Account 524, Miscellaneous Nuclear Power Expenses, instead of Account 518, Nuclear Fuel Expenses. Finally, it should have expensed (and not deferred in Account 186) an amount equal to the wholesale portion of the buy-out cost covering the period to January 1, 1991, that was not permitted recovery as a result of the rate design change moratorium.

Staff recommended that the Company:

(1) record a correcting entry to reclassify the retail portion of the asset related to the nuclear buyout to Account 186 and to expense the wholesale portion of the buy-out costs not permitted recovery in rates.
NUCLEAR FUEL

Contract Settlements/Termination

Accounting for Payments Made to Cancel Nuclear Fuel Fabrication Contract

The Company entered into a new contract with Combustion Engineering. The Company incurred a contract termination fee in canceling a nuclear fuel fabrication contract.

The Company recorded in Account 120.1 its share of the termination fee. Also, the Company capitalized an allowance for funds used during construction (AFUDC).

Staff concluded that the Company's accounting for the payments made was not consistent with the requirements of the Uniform System of Accounts. Staff based the conclusion on the following accounting requirements.

The instructions to Account 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment, and Fabrication, state in part:

   A. This account shall include the original cost to the utility of nuclear fuel materials while in the process of refinement, conversion, enrichment and fabrication into nuclear fuel assemblies and components, including processing, fabrication and necessary shipping costs . . .

Under the above instructions, a utility should classify in Account 120.1 only the original cost of nuclear materials entering the process of refinement, conversion, enrichment and fabrication of completed assemblies for insertion into the reactor.

There are no specific provisions in Account 120.1 that permit a utility to include in that account payments to terminate a contract that did not provide certain services that a Company deemed necessary. Additionally, only amounts properly includable in Accounts 107, Construction Work in Progress-Electric, and 120.1 are eligible for the accrual of AFUDC.

The Uniform System of Accounts provides a miscellaneous account to record nuclear expenditures not specifically provided for in other accounts. The instructions to Account 524, Miscellaneous Nuclear Power Expenses, state:

   This account shall include the cost of labor, materials used and expenses incurred which are not specifically provided for or are not readily assignable to other nuclear generation operation accounts.
Accounting for Payments Made to Cancel Nuclear Fuel Fabrication Contract
(Continued)

Staff concluded that the Company should have accounted for the termination payments as follows:

1. It should have recorded the termination fee as an operating expense in Account 524 when it canceled the contract. However, if the Company believed it would be more appropriate for rate purposes to recover the expense over future burn periods, it should have filed a request for Commission approval to defer the amount in Account 186 and amortize the amount to Account 524, accordingly.

2. It was improper for the Company to record AFUDC on its share of the termination payment. Under the Commission's regulations, a utility can only capitalize AFUDC on charges properly classified in Account 120.1.

Section 35.14 of the Commission's Regulations under the Federal Power Act addresses fuel adjustment clauses.

Subsection 35.14(a)(2)(i) states:

Fuel and Purchased economic power costs (f) shall be the costs of:

(i) Fossil and nuclear fuel consumed in the utility's own plants, and the utility's share of fossil and nuclear fuel consumed in jointly owned or lease plants.

Also, Subsection 35.14(a)(6) states:

... The cost of nuclear fuel shall be that as shown in Account 518 ...

The Company would not be permitted to include the termination payments in billings under its wholesale fuel adjustment clause since the payments were properly chargeable to Account 524 and not to Account 518, Nuclear Fuel Expense.

Staff conclusion on the appropriate accounting for the payments is consistent with the Commission's policy of fuel adjustment clause treatment of utility payments to reduce or eliminate fuel contract purchase commitments.

The Commission set forth the policy guidance with respect to termination costs on coal contracts in decisions to Kentucky Utilities Company (Docket No. EL88-20-000), Nevada Power Company (Docket No. EL88-32-000), Northern States Power Company (Wisconsin) (Docket No. EL 88-39-000), and Northern States Power Company (Minnesota) (Docket No. EL89-9-000). In Wisconsin Public Service Corporation, Docket No. EL89-22-000, 50 FERC ¶ 61,337, issued March 21, 1990, the Commission set forth the following policy guidance with respect to uranium ore milling contract buyout costs:
Contract Settlements/Termination

Accounting for Payments Made to Cancel Nuclear Fuel Fabrication Contract (Continued)

We view the EFN uranium ore milling contract buyout as analogous to a coal contract buyout. Milling costs are a component of the cost of nuclear fuel; as such, they may be reflected in the fuel clause. (Footnote omitted) Partnership had a minimum contractual obligation to EFN; Partnership discharged its obligation via the buyout, thus allowing it to obtain less costly uranium elsewhere. In accordance with Kentucky Utilities, Wisconsin may seek recovery of these buyout costs through the fuel clause. We note that Wisconsin has correctly defined the amortization period as the nuclear fuel cycles during which the replacement fuel will be expensed.

The Company did not include any portion of the payments in its wholesale or retail fuel adjustment clause billings during the period under audit.

Under the circumstances, the Company should reclassify the payments to Account 186, Miscellaneous Deferred Debits, pending further action on the rate recovery for such amounts. Any amount disallowed for rate recovery should be currently expensed to Account 426.5, Other Deductions.

Staff recommended that the Company:

(1) adopt procedures to ensure that any future nuclear fuel contract buyout costs are recorded consistent with the requirements of the Uniform System of Accounts; and

(2) to reclassify the payments to Account 186, pending rate actions on the recovery of such amounts.

Contract Termination Payment

The owners incurred a contract termination fee in the termination of a nuclear fuel fabrication contract.

The Company paid its share of a contract termination fee, which it recorded in Account 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment and Fabrication. Also, the Company accrued allowance for funds used during construction (AFUDC) on the termination fee.

The Trust financed the Company's expenditures for the cost of nuclear fuel, the termination fee paid and the related AFUDC. Upon transfer to the Trust, the Company removed the nuclear fuel amounts recorded in Account 120.1, including the payments from its accounts.

Under the terms of the fuel burn contract, the Trust was to assign a portion of the termination fee and related carrying charges to the cost of fabricated nuclear fuel over the life of the Combustion Engineering contract. The Trust was to begin billing the Company for all amounts financed, including the assigned portion of the termination payment, as the fuel fabricated under the Combustion Engineering contract and loaded in the reactor is burned.
Contract Settlements/Termination

Contract Termination Payment

As discussed in Item No. 1, the Company determined that the Trust's investment in nuclear fuel "loaded" in the reactor qualified as a capital lease for recording in Accounts 120.6 and 227. The Company planned to record the entire lease payments to the Trust, including the portion related to repayment of the mining venture losses, in Account 518, Nuclear Fuel Expense. Also, it planned to include the entire payment as a component of fuel cost in fuel adjustment clause (FAC) billings to wholesale customers.

Staff concluded that the Company's accounting for the termination payments was not consistent with the requirements of the Uniform System of Accounts in the following respects.

(1) The Company should not have classified the payments initially in Account 120.1 because such amounts did not relate to the nuclear fuel in process of refinement, conversion, enrichment or fabrication.

The instructions to Account 120.1 of the Uniform System of Accounts state in part:

A. This account shall include the original cost to the utility of nuclear fuel materials while in process of refinement, conversion, enrichment and fabrication into nuclear fuel assemblies and components, including processing, fabrication, and necessary shipping costs.

There are no specific provisions in Account 120.1 that permit a utility to include in that account payments to a contractor related to a utility's failure to take delivery of nuclear fuel fabrication services in accordance with contract terms.

Also, the Company should not have recorded an amount equivalent to the termination payment and related financing cost in Account 120.6, since such amounts were not a part of the acquisition cost of nuclear fuel placed under lease.

(2) It was inappropriate for the Company to record AFUDC on its share of the termination fee. Under the Commission's regulations, a utility can capitalize AFUDC as a cost of nuclear fuel only on costs properly classified in Account 120.1.

(3) The Company should have charged the termination fees when incurred to Account 518 or in the event rate recognition is given in an appropriate proceeding, amortized to expense from a deferred charge account consistent with the rate recognition.

Under the circumstances, the Company should reclassify the payments to Account 186, Miscellaneous Deferred Debits, pending further action on the rate recovery for such amounts. Any amounts subsequently disallowed for recovery in rates should be written off by charges to Account 426.5, Other Deductions.
Contract Settlements/Termination

Contract Termination Payment (Continued)

In summary, the Company should have adopted the following accounting for the termination fees:

(1) establish an asset in Account 186 for the amounts it expected to recover from its wholesale and retail customers;

(2) establish a liability in Account 227 in an amount equal to the termination fees and related carrying charges for which it is obligated under the terms of the Trust;

(3) charge to Account 518 each month the portion of the lease payment related to the termination fees and related carrying charges as they are recovered in billings from customers; and

(4) in the event rate recovery of the termination fees and carrying charges is disallowed, write off the unrecoverable amounts by charges to Account 426.5 in the period when nonrecovery becomes known.

As stated in Exception No. 1, the Commission set forth the policy guidance with respect to termination costs on coal contracts in decisions to Kentucky Utilities Company (Docket No. EL88-20-000), Nevada Power Company (Docket No. EL88-32-000), Northern States Power Company (Wisconsin) (Docket No. EL88-39-000), and Northern States Power Company (Minnesota) (Docket No. EL89-9-000). In Wisconsin Public Service Corporation, Docket No. EL89-22-000, 50 FERC ¶ 61,337, issued March 21, 1990, the Commission set forth the following policy guidance with respect to uranium ore milling contract buyout costs:

We view the EFN uranium ore milling contract buyout as analogous to a coal contract buyout. Milling costs are a component of the cost of nuclear fuel; as such, they may be reflected in the fuel clause. (Footnote omitted) Partnership had a minimum contractual obligation to EFN; Partnership discharged its obligation via the buyout, thus allowing it to obtain less costly uranium elsewhere. In accordance with Kentucky Utilities, Wisconsin may seek recovery of these buyout costs through the fuel clause. We note that Wisconsin has correctly defined the amortization period as the nuclear fuel cycles during which the replacement fuel will be expensed.

Staff recommended that the Company:

(1) revise its procedures to account for termination payments in accordance with the requirements of the Uniform System of Accounts;

(2) revise procedures for recording the lease payments consistent with the previous discussion of the requirements of the Uniform System of Accounts; and

(3) record a correcting entry to establish an asset for the termination fees and related APUDC in Account 186 pending rate recovery approval by its regulatory jurisdiction.
Interim Storage

Accounting for the Cost of the Interim Storage of Spent Nuclear Fuel

The Company entered into agreements with the Department of Energy (DOE) and the Electric Power Research Institute (EPRI) for the development of facilities to store spent nuclear fuel on an interim basis at the reactor site.

It recorded the construction cost of the three concrete silos along with cost of the metal canisters, less any proceeds from the DOE and EPRI, in Account 186, Miscellaneous Deferred Debts. In November 1990, the Company transferred the cost of the experimental project from Account 186 to Account 101, Electric Plant in Service.

In 1987, the Company began constructing five additional modules to store spent nuclear fuel assemblies at the site. It recorded the cost of constructing the concrete silos and the cost of the five metal canisters in Account 107, Construction Work in Progress-Electric, and accrued an allowance for funds used during construction on these costs. In July 1989, the Company completed construction of the storage facility and transferred the facilities cost, including $730,000 related to the cost of the metal canisters, from Account 107 to Account 101, Electric Plant in Service. The Company began recording depreciation expense as soon as it transferred the amounts to Account 101 by charging Account 403, Depreciation Expense, and crediting Account 108, Accumulated Provision for Depreciation of Electric Utility Plant.

The Company incorrectly recorded the construction cost of the concrete silos used to store spent nuclear fuel in Account 186, Miscellaneous Deferred Debts. Under the previously mentioned requirements, the Company should have recorded the cost of constructing the concrete silos in Account 107 until July 1989.

In July 1989, the Company should have transferred the cost of the concrete silos to Account 103, Experimental Electric Plant Unclassified, instead of waiting to transfer the amount to Account 101 in November 1990.

Therefore, the Company should have considered the concrete silos as experimental plant. It should have transferred the cost to Account 103, Experimental Electric Plant Unclassified, upon completion of construction in July 1989.

Also, the Company should have begun depreciating the cost of the three experimental silos upon transfer to Account 103 during July 1989.

The Company completed construction of the concrete silos in July 1989. Therefore, the Company should have begun recording depreciation on the completed plant during July 1989, instead of delaying recording depreciation until November 1990.

The Company's accounting for the cost of the metal canisters was not consistent with the requirements of the Uniform System of Accounts.
Interim Storage

Accounting for the Cost of the Interim Storage of Spent Nuclear Fuel
(Continued)

The Company's classification of the costs of the concrete bunkers in Account 101 was consistent with the requirements of the Uniform System of Accounts. However, the Company's use of Account 101 to record the cost of the metal canisters used to store spent nuclear fuel on an interim basis was contrary to the Commission's decision in Opinion No. 118 and Docket No. FA87-63-000.

The Commission policy regarding interim storage costs was summarized in an order issued to Virginia Electric Power Company on April 20, 1988, in Docket No. FA87-63-000. The Commission stated:

In Opinion No. 118, we concluded that interim storage costs should be charged, to the extent practicable, to the periods benefitting from the related nuclear generation and that it would be inappropriate to delay rate recognition of that cost where the facts and circumstances indicate that a liability exists and the costs are reasonably ascertainable (15 FERC ¶61,052, at p.61,104). We directed that: (1) the amounts related to previously burned fuel should be charged to Account No. 524 with credits to Account No. 120.5, and must be excluded from wholesale fuel adjustment clause calculations; and (2) the amounts related to fuel in the reactor should be charged to Account No. 518, but that changes in such amounts were not subject to automatic adjustment through fuel adjustment clause calculations.

... (B) Virginia Electric is hereby ordered to exclude interim storage costs from the fuel adjustment clause calculations and adopt accounting procedures which will recognize interim storage costs on an accrual basis rather than on a cost expenditure basis.

Under the requirements of the Uniform System of Accounts, the cost of the nonreusable metal canisters were interim storage costs properly includible on an accrual basis by charges to Account 524. The Company should not have waited until it purchased the canisters to recognize the related cost in its accounts.

At the time it could reasonably estimate the costs of metal canisters for the interim storage of spent nuclear fuel, the Company should have made appropriate provisions in its accounts to recognize the cost of the canisters for fuel already burned by charging Account 524 and those necessary in the future to storage fuel currently in the reactor by charging Account 518.1. The Company should credit Account 120.5, Accumulated Provision for Amortization of Nuclear Fuel Assemblies, with interim storage costs charged to Accounts 518 or 524, and charge Account 120.5 for the incurred cost of purchasing metal canisters.
Accounting for the Cost of the Interim Storage of Spent Nuclear Fuel
(Continued)

The Commission's policy is to preclude a utility from including any estimate for interim storage costs recorded in Account 518 as a component of fuel costs in determining fuel adjustment clause billings to wholesale customers, unless such amounts have been reviewed and approved by the Commission.

The Commission has approved special accounting to accommodate the economic effects of ratemaking in instances when there was sufficient assurance that such rate actions created assets that the Company would recover in future rates.

If the Company has rate recovery plans that provide for the collection of interim storage costs over different periods than that determined from an accrual accounting standpoint, it may record a regulatory created asset or liability by entries to Account 406 and Account 186 (regulatory asset) or Account 253 (regulatory liability). The amount would then be subject to amortization from Account 186 to Account 406 over the period that the regulatory authorities provides for rate recovery. In the event that the Company does not receive future rate recovery for amounts recorded in Account 186, the Company would expense the unrecovered amounts by debiting Account 426.5 with concurrent credits to Account 186.

It was recommended that the Company:

(1) revise accounting procedures to ensure that:

   (a) the cost of constructing experimental facilities are recorded consistent with the previously mentioned requirements of the Uniform System of Accounts;

   (b) the costs of metal canisters for the interim storage costs are recognized on an accrual basis rather than on a cost expenditure basis, and recorded by charging Account 518 (for fuel currently in the reactor) or Account 524 for previously burned fuel and crediting Account 120.5

(2) record a correcting entry to reflect the accrual of the costs of metal canisters for the interim storage of current and future spent nuclear fuel, beginning with the date that it could reasonably estimate the costs of metal canisters, by charging Accounts 518 and 524 and crediting Account 120.5;

(3) record a correcting entry to remove the costs of previously purchased canisters by charging Account 120.5 and crediting Account 101; and
Interim Storage

Accounting for the Cost of the Interim Storage of Spent Nuclear Fuel
(Continued)

(4) if appropriate, record a correcting entry to establish a regulatory created asset or liability by entries to Account 406 and Account 186 (regulatory asset) or Account 253 (regulatory liability) for the difference between the accruals for interim storage costs and the actual amounts collected in rate levels.

Accounting and Tariff Billings of Costs Related to the Interim Storage of Spent Nuclear Fuel

The Company charged Account 518, Nuclear Fuel Expense, with approximately $5 million of costs related to the interim storage of spent nuclear fuel. Approximately fourteen percent or $700,000 was improperly collected from the wholesale customers through the wholesale fuel adjustment clause (FAC) as of December 31, 1985.

In 1984, the Company embarked on a program to store spent nuclear fuel above ground in metal storage casks, pending its permanent disposal at a DOE facility.

The Company charged the cost of the storage casks to Account 518 during 1984 and Account 188, Research, Development and Demonstration Expenditures, during 1985. Amounts recorded in Account 188 were expensed to Account 518 monthly. Additionally, the costs incurred to (a) prepare the site for the casks (i.e., construction of a concrete pad), and (b) purchase and install equipment to handle the dry casks were capitalized.

In Opinion No. 118 dated April 10, 1981, the Commission recognized the need for companies to collect interim storage costs from their customers and directed VEPCO to provide a provision for interim storage costs by charged to Account 524, Miscellaneous Nuclear Fuel Expenses. The Commission also reaffirmed its position that interim storage costs were not properly includable in the wholesale FAC.

The Company's use of Account 518 to record the cost of the casks was contrary to the Commission's decision in Opinion No. 118 that interim storage costs should be recorded in Account 524 and not recovered through FAC billings.

The Company was required to (1) revise procedures to record the costs of the dry casks incurred for interim storage of spent nuclear fuel in Account 524, (2) recalculate the applicable wholesale FAC billings excluding interim storage costs from the date such costs were first billed to the current date, and (3) refund any overcollected amounts with interest computed in accordance with Section 35.19(a) of the Commission's Regulations, to the wholesale customers which were charged.

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AFUDC on Completed Assemblies

The cost of the completed assemblies was recorded in Account 120.1, Nuclear Fuel in Process. The Company had continued to accrue Allowance for Funds Used During Construction (AFUDC) on the cost of the completed assemblies subsequent to the dates that the assemblies were placed in storage. Storage charges were charged to Account 120.1 as an additional cost of constructing these assemblies.

Commission Accounting Release No. 5 provides that AFUDC may be capitalized starting from the date the construction costs are continuously incurred on a planned progressive basis and stopped when the facilities are placed in or ready for service.

The correcting entry transfers the cost of the completed assemblies to Account 120.2, records in Account 186 the AFUDC accrued and storage costs incurred with an offsetting credit to Account 120.1.

Accounting for Professional Fees

The Company had improperly charged Account 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment and Fabrication, with $2,552,810 of legal and professional fees and capitalized approximately $1.6 million of interest expense thereon.

The Company provided information that the payments made to the various law firms included services for drafting financial agreements, negotiations with Occidental, and evaluating Resources Corporation financial situation for possible takeover.

The Uniform System of Accounts prescribes the use of Account 923, Outside Services Employed, for expenses associated with professional consultants.

The Company was required to make an entry to expense legal and professional fees improperly capitalized along with expensing interest expense improperly capitalized.
Accounting for the Cost of Thimble Plugs

In 1982, the Company purchased 91 thimble plugs at a cost of $85,946. (Thimble plugs are placed over certain fuel assemblies to control water flow in the reactor). The cost of the thimble plugs was charged to Account 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment, and Fabrication, and AFUDC was accrued thereon. As of December 31, 1986, the costs were transferred to Account 120.3, Nuclear Fuel Assemblies in Reactor, and had been partially expensed by debits to Account 518, Nuclear Fuel Expense, and credits to Account 120.5, Accumulated Provision for Amortization of Nuclear Fuel Assemblies.

The Uniform System of Accounts limits Account 120.1 for recording the cost of nuclear fuel materials, such as uranium, thorium, etc., which are processed into fuel assemblies. It is inappropriate to charge the cost of thimble plugs to Account 120.1 since thimble plugs contain no nuclear fuel materials and are not removed from the reactor when the fuel assemblies are removed. Thimble plugs have an estimated useful life of forty years and can be reused in subsequent reloads. The Company should have recorded the cost of thimble plugs to Account 107, Construction Work in Progress—Electric, and then reclassified them to Account 101, Electric Plant in Service, when construction on the thimble plugs was completed. The Company should depreciate such costs by charges to Account 403, Depreciation Expense, over its estimated useful life.

Also, the Company did not retire the original cost of four thimble plugs recorded in Account 101, Electric Plant in Service, that were removed when the new thimble plugs were installed.

The Uniform System of Accounts requires that the original cost of utility plant that is withdrawn from service be charged to Account 108, Accumulated Provision for Depreciation of Electric Utility Plant.

The Company was required to (1) revise procedures to ensure that (a) the cost of thimble plugs are recorded in Account 322, and (b) the cost of thimble plugs withdrawn from service are retired on a timely basis.
Nuclear Fuel Advance Payments

In 1976 and 1978, the Company advanced $15 million and $5 million, respectively, for a future supply of uranium concentrates to meet the anticipated fuel requirements of its nuclear generating units which were under construction at the time. In accordance with a rate order of the Public Service Commission, the Company recorded the advances in Account 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment and Fabrication and began capitalizing carrying charges on the amounts. The advances remained in Account 120.1 at December 31, 1984 and the Company continued to accrue carrying charges on such amounts through the current date.

The staff was of the opinion that the foregoing accounting practices were improper in the following respects:

The advances should have been initially charged to Account 165, Prepayments, rather than Account 120.1. The advance payments, by definition, represent payments to a vendor prior to the delivery of the goods or services necessary to commence or continue the process. Accordingly, the advances did not qualify for inclusion in Account 120.1 because they did not constitute a cost of nuclear materials in process.

The advances together with the related carrying charges should have been transferred to Account 186 in June 1981 when the circumstances surrounding the transaction changed so dramatically that performance by the vendor under the terms of the contract and recovery of the advances became doubtful.

The funds advanced no longer constituted a valid prepayment which qualified for inclusion in Account 165, Prepayments. Rather, the advances and related carrying charges represented costs the final disposition of which were uncertain. Under the requirements of the Uniform System of Accounts items of this nature should be recorded in Account 186, Miscellaneous Deferred Debits.

The Commission, by regulation or as a matter of general policy, permits the capitalization of AFUDC only on expenditures properly includible in Account 107, Construction Work in Progress, or Account 120.1. As the advances were not properly includible in either of these accounts, the capitalization of AFUDC thereon was inappropriate. The staff does not object however to the capitalization of carrying charges, in lieu of AFUDC, prior to June 1981 because the PSC's May, 1976 rate order provides some reasonable assurance of recovery of such amounts through the ratemaking process. The order cannot be relied upon for that purpose after that date because the circumstances so dramatically changed in the interim that the May 1976 order cannot reasonably be expected to apply to the carrying costs improperly capitalized on the advances after that date. Accordingly, all carrying charges capitalized on the advances after June 1981 should be reversed.
Other

Nuclear Fuel Advance Payments (Continued)

The Company was required to (1) discontinue capitalization of all carrying charges on the advances immediately, (2) record an entry to (a) transfer the advances and related carrying charges capitalized through June 1981 from Account 120.1 to Account 186, and (b) reverse the carrying charges improperly capitalized on the advances between July 1981 and December 1984, and (3) reverse all carrying charges capitalized on the advances after December 31, 1984.

Accounting for Nuclear Fuel Advance Payments

The Company has made advance payments to the Department of Energy (DOE) for nuclear fuel enrichment services. Beginning on October 1, 1978, the DOE started accruing interest on such advance payments, until they are credited against amounts due DOE for enrichment services performed.

In July 1980, the Company recorded a retroactive entry debiting Account 120.2, Nuclear Fuel Materials and Assemblies - Stock Account, and crediting Account 419, Interest and Dividend Income, to accrue interest for the period October 1, 1978 through July 31, 1980, as prior to this date no amounts had been reflected on the Company's books. However, it was noted that the Company had computed allowance for funds used during construction (AFUDC) on these advances for the period October 1, 1978 through October 31, 1979.

As a result of the above accounting, a double recovery of costs from customers will occur in future years as the fuel is utilized.

The Company was required to record an entry to remove the AFUDC recorded on these advance payments during the period October 1, 1978 through October 31, 1979.

Nuclear Fuel

The Company recorded several transactions for the sale of Nuclear Fuel. All of the transactions resulted in book gains. The gains were recorded in Account 253, Other Deferred Credits and Account 120.1, Nuclear Fuel in Process. The Company deferred the gains to offset future uranium purchases. An adjustment was required to transfer the gain recorded in Account 120.1 to Account 253.
NUCLEAR FUEL

Other

Accounting for Amortization of Damaged Assemblies

During a reload of the reactor, eleven nuclear fuel assemblies were removed for examination. The Company accounted for this removal by debiting Account 120.2, Nuclear Fuel Materials and Assemblies - Stock Account, and crediting Account 120.3, Nuclear Fuel Assemblies in Reactor. In January 1982, ten of the eleven assemblies were found to be damaged. The nature of the damage to the assemblies was limited to some breaking of the grid separation devices. The ten damaged assemblies will not be reused.

The original cost of the ten assemblies amounting to $199,459 was transferred to Account 120.4, Spent Nuclear Fuel from Account 120.2. Of the $199,459 approximately $89,759 had been amortized during the time the assemblies were in the reactor. The balance of $109,700 representing the unamortized amount, was written off over a 12-month period commencing February 1982 by charges to Account 518, Nuclear Fuel Expense, and credits to Account 120.5, Accumulated Provision for Amortization of Nuclear Fuel.

The staff was of the opinion that it was inappropriate to amortize the unrecovered cost of the damaged assemblies to Account 518.

Paragraph A of the instructions to Account 518 states in part:

"This account shall be debited and Account 120.5, Accumulated Provision for Amortization of Nuclear Fuel Assemblies, credited for the amortization of the net cost of nuclear fuel assemblies used in the production of energy." (emphasis added)

Since the damaged assemblies were not re-entered into the reactor, the fuel could not be used in the production of energy and therefore the related costs do not qualify for inclusion in Account 518.

Abandoned Nuclear Power Project

The Company has been ordered by the Public Utility Commission to write off its investment in the abandoned Nuclear Power Project. The related nuclear fuel was recorded in Account 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment and Fabrication, while the Company is attempting to dispose of the fuel.

The text of Account 121, Nonutility Property, states, "this account shall include the book cost of land, structures, equipment or other tangible or intangible property owned by the utility, but not used in utility service and not properly includible in Account 105, Electric Plant Held for Future Use."

The Company was required to record an entry to transfer the remaining investment in the Nuclear Power Project nuclear fuel from Account 120.1 to Account 121.
Items Included in Account 518, Nuclear Fuel Expense

The following costs were charged to Account 518:

- Fuel buying activities - Nuclear
- Quality assurance activities - Nuclear fuel
- Nuclear fuel management services
- Spent fuel storage
- Provisions for net disposal costs of spent nuclear fuel

Fuel disposal cost related to previously consumed fuel is chargeable to Account 524, Miscellaneous Nuclear Power Expenses, and fuel buying activities, quality assurance activities and nuclear management services are chargeable to the appropriate operation and maintenance supervision and engineering accounts.

The Company was required to properly classify these costs in the operating expense accounts. The Company agreed to the Staff’s recommendations, except as related to provisions for net disposal costs of spent nuclear fuel, which it is required to include in Account 518 by the State Commission. For the latter item, the Company agreed to utilize Account 524 in future FERC Forms No. 1, and to exclude such amounts from wholesale fuel adjustment clause calculations.

Accounting for Fuel Enrichment Costs Related to the Cancelled Nuclear Project

Prior to cancellation of the nuclear plant, the Company had contracted with the Department of Energy (D.O.E.) for enrichment services on the nuclear fuel which would be needed in the future. The Company advanced funds to D.O.E. under the terms of this contract. When the project was cancelled, the Company found itself in a position where the enrichment services for the plant were no longer needed. The Company sold or assigned its enrichment rights under the D.O.E. contract to other utilities. The advance payments were recorded in Account 107, Construction Work in Progress-Electric, and were reduced by any proceeds from the sales or assignments.

Since the project was cancelled, the net amount remaining in Account 107 applicable to nuclear fuel should have been transferred to Account 182.2, Unrecovered Plant and Regulatory Study Costs.

The Staff recommended that the Company: (1) record similar costs related to the cancellation in Account 182.2 in the future, and (2) record an entry to reclassify the balance of nuclear fuel costs remaining as of December 31, 1983 from Account 107 to 182.2

The amount included in Account 182.2 shall be amortized to Account 407, over the period of recovery permitted for ratemaking purposes. If any portion of the above amount is disallowed in rate proceedings, such amounts shall be charged to Account 426.5, Other Deductions, in the year of such disallowance.
Accounting for Uranium Production Payments

The Company and another company entered into an uranium production contract. The agreement required the two companies to split the uranium production and costs evenly. The companies were required to pay a monthly minimum production payment regardless of whether or not uranium was produced. Payments under the contract began in 1980. The accounting procedure followed by the Company was to charge the minimum production payment to Account 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment and Fabrication, during periods when actual uranium was produced and purchased and to expense payment during periods when no uranium was produced or purchased.

During 1982 and 1983, when no uranium was produced due to extended shut down of the plant, the Company charged the minimum payments as a period cost to Account 524, Miscellaneous Nuclear Power Expense. The total charged to Account 524 for 1982 and 1983 was $1,466,020.

It was the staff's opinion that the minimum production payments should be considered a part of the cost of producing uranium and as such, should be recorded in Account 120.1.

Accounting Classification of Analyses and Feasibility Study Cost for Nuclear Fuel

The Company improperly recorded the following expenses related to analyses and feasibility studies in Account 120.2, Nuclear Fuel Materials and Assemblies - Stock Account:

(1) A study conducted by the fuel fabricator to make fuel useable in a different core configuration at higher plant power levels.

(2) Analyses conducted to establish that fuel was safe to use under different plant thermal - hydraulic conditions.

(3) Fuel safety analyses that had to be redone in response to plant operating and safety system changes.

The total expended for these studies during the audit period was $1,909,543.

Operating Expense Instruction No. 2, Maintenance, provides a description of work operations applicable to utility plant that should be recorded in operating expense. The description provided under Item No. 2 states,

Inspecting, testing and reporting on conditions at plant specifically to determine the need for repairs, replacements, rearrangements and changes and inspecting and testing the adequacy of repairs which have been made.

The Company was required to (1) revise procedures to reclassify costs incurred for items of a similar nature to an appropriate expense account and (2) record an entry to transfer the costs of studies from Account 120.2 to Account 524, Miscellaneous Nuclear Power Expenses.
Accounting for the Cost of Secondary Sources

In 1982, the Company purchased two secondary sources at a cost of $17,060. (Secondary sources are used to provide neutrons to neutron detectors when the reactor is shut down and to start the chain reaction after each refueling). The Company charged the cost of the secondary sources to Account 120.1 and accrued allowance for funds used during construction (AFUDC) on such amounts. As of December 31, 1986, the costs were transferred to Account 120.3, Nuclear Fuel Assemblies in Reactor, and had been partially expensed by debits to Account 518, Nuclear Fuel Expense, and credits to Account 120.5, Accumulated Provision for Amortization of Nuclear Fuel Assemblies.

The instructions to Account 120.1 limit the costs to nuclear fuel materials such as uranium, thorium, etc., which are processed into fuel assemblies. Although secondary sources do contain nuclear material, they are not a fuel source and are not removed from the reactor when the fuel assemblies are removed. Secondary sources have an estimated useful life of ten years and are used during many fuel cycles.

The cost of the secondary sources should therefore be charged to Account 107, Construction Work in Progress-Electric, and reclassified to Account 101, Electric Plant in Service, when construction on the secondary sources is completed. The Company should depreciate such costs by charges to Account 403, Depreciation Expense, over its estimated useful life.

The Company did not retire the original cost of two secondary sources recorded in Account 101, Electric Plant in Service, that were removed when the new secondary sources were installed.

The Uniform System of Accounts requires that the original cost of utility plant that is withdrawn from service be charged to Account 108, Accumulated Provision for Depreciation of Electric Utility Plant.

The Company was required to (1) revise procedures to ensure that (a) the cost of secondary sources are recorded in Account 322, and (b) the cost of secondary sources withdrawn from service are retired on a timely basis, and (2) record a correcting entry to reclassify the original cost of two secondary sources at December 31, 1986, and to retire the original cost of the secondary sources which were withdrawn from service.
Accounting for Storage Charges on Converted Nuclear Fuel

During 1983, the Company renegotiated several fuel conversion contracts to reduce its near-term fuel conversion obligations. After conversion, the vendors stored the UF₆ at their sites since the Company did not have immediate need to further process the converted fuel. The Company paid the vendor storage charges, which amounted to $381,045. The Company recorded all amounts paid to the vendors in Account 120.2, Nuclear Fuel Materials and Assemblies - Stock Account.

The staff concluded that the Company should have expensed the storage charges as period costs in Account 525, Rents. The storage charges did not result from the normal processing cycle for the nuclear fuel and therefore, capitalization in Account 120.2 was not appropriate. The Company should have considered the storage charge as a hold cost that should have been expensed.

The Company was required to (1) revise procedures to ensure that storage costs of fuel that is not being processed is recorded in Account 525, and (2) record an entry to expense the storage charges incurred.

Procedures for Determining the Costs of Nuclear Fuel for Fuel Adjustment Billing

During 1987, the Company purchased the nuclear fuel it had under lease and terminated the lease. It reclassified the cost of the nuclear fuel to Accounts 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment and Fabrication; 120.2, Nuclear Fuel Materials and Assemblies—Stock Account; 120.3, Nuclear Fuel Assemblies in Reactor; 120.4, Spent Nuclear Fuel, 120.5, Accumulated Provision for Amortization of Nuclear Fuel Assemblies.

The Company recorded the amortization of the original cost of the nuclear fuel in Account 518. The Company financed the acquisition of the nuclear fuel with a combination of intermediate term notes and commercial paper. It recorded the interest expense related to the unamortized nuclear fuel in the reactor in Accounts 427, Interest on Long-Term Debt, and 431, Other Interest Expense.

Beginning March 1988, the Company assigned a portion of the interest expense related to the financing of the nuclear fuel in the reactor that it recorded in Accounts 427, Interest on Long-Term Debt, and 431, Other Interest Expense, as a component of nuclear fuel expense in its wholesale FAC billings.

Section 9, Fuel Cost Adjustment, of the Company's wholesale rate tariff, states in part:

b. Fuel costs (F) shall be the cost of:

(1) Fossil and nuclear fuel consumed in the Company's own plants, and the Company's share of fossil and nuclear fuel consumed in jointly owned or leased plants . . .
Procedures for Determining the Costs of Nuclear Fuel for Fuel Adjustment Billing (Continued)

(2) Nuclear fuel consists only of amounts properly recordable in Account 518, Nuclear Fuel Expense.

The Company properly recorded the interest expense on nuclear fuel in the reactor in Accounts 427 and 431. Because charges to such accounts are not fuel cost, they should not have included any interest amount as a component of fuel cost for fuel adjustment clause billings to wholesale customers.

From June 1984 through May 1987, the Company was allowed to include a portion of construction work in progress and nuclear fuel in process of refinement, conversion, enrichment and fabrication (CWIP) in its wholesale rate base through May 1988.

Prior to March 1986, the Company's accrual of AFUDC properly reflected a reduction to take into account the amounts of Account 107 and 120.1 included in rate base.

Beginning in March 1986, the Company reduced its wholesale FAC billings by an amount intended to reflect the effects of the AFUDC offset on the amount of Account 120.1 included in rate base and subsequently transferred to Account 120.3. Due to a number of errors in the Company's calculation, the amount it deducted did not represent the proper amount of AFUDC offset related to nuclear fuel in rate base.

It was recommended that the Company:

(1) revise its procedures to ensure that interest expense recorded in Accounts 427 and 431 is not included in FAC billings to wholesale customers without specific Commission approval;

(2) strengthen procedures to ensure that the proper amount of AFUDC is assigned to nuclear fuel and included in FAC billings to wholesale customers; and

(3) recalculate the wholesale FAC billings for the period covered by the above errors and make refunds, with interest computed in accordance with Section 35.19(a) of the Commission's Regulations, to the wholesale customers for any overbilled amounts.
Accounting and Fuel Adjustment Clause Billing of Payments Made to the Trust

The Company established the Trust for the purpose of financing all costs (direct and indirect) related to the Company's nuclear fuel needs.

The Company asked for reimbursement from the Trust for the losses incurred on the mining venture. The Trust financed the mining venture loss, assigning the amount financed and related carrying charges to the cost of the first 70 batches of nuclear fuel used for the nuclear units.

The Trust's investment in nuclear fuel is divided between (1) fuel in process (uranium mining, milling, conversion, enrichment and/or fabrication), referred to as "unloaded fuel" and (2) fuel in the reactor, referred as "loaded fuel".

On August 3, 1984, the Commission issued Order No. 390 amending the requirements of the Uniform System of Accounts for capital leases. The Commission established Accounts 120.6, Nuclear Fuel Under Capital Leases, and 227, Obligations Under Capital Leases - Noncurrent, to record the assets and liabilities for nuclear fuel leased from others.

After issuance of Order No. 390, the Company determined that the Trust's investment in nuclear fuel "loaded" in the reactor qualified as a capital lease for recording in Accounts 120.6 and 227.

The Company recovered a portion of the mining venture costs from customers as a fuel cost through the retail fuel clause. The Company sought recovery of the portion of the venture costs assigned to its customers as fuel costs in its last fuel reconciliation case, however such costs were disallowed and written off.

The Company did not include the portion of the Trust payments recorded in Account 518 related to the mining venture as a component of fuel cost in computing fuel adjustment clause billings to wholesale customers. During 1987 the Company reached a rate settlement with wholesale customers that did not provide for the deferral and recovery of the FERC jurisdictional portion of the uranium venture losses over future periods.

The Company's accounting for the losses from the mining venture were deficient as follows:

(1) The Company should not have included the losses from the mining venture in Account 120.6 since such losses were not related to the acquisition of the leased nuclear fuel.

The instructions to Account 120.6 of the Uniform System of Accounts state in part:

A. This account shall include the amount recorded under capital leases for nuclear fuel leased from others for use by the utility in its utility operations.
Accounting and Fuel Adjustment Clause Billing of Payments Made to the Trust
(Continued)

General Instruction No. 20, Accounting for Leases, states in part:

C. Rental payments on all leases shall be charged to rent expense, fuel expense, construction work in progress, or other appropriate accounts as they become payable. [emphasis added]

The instructions to Account 186 state in part:

A. For Major utilities, this account shall include all debits not elsewhere provided for, such as miscellaneous work in progress, and unusual or extraordinary expenses, not included in other accounts, which are in process of amortization and items the proper final disposition of which is uncertain.

The Company should have charged the FERC portion of the loss from the mining venture to an appropriate operating expense account when incurred.

The Company should have classified the portion of the unamortized loss assigned to retail customers to Account 186 pending final disposition.

(2) The Company should not have treated the portion of the payments to the Trust under the lease related to the financing of the loss as a cost of fuel in Account 518, Nuclear Fuel Expense.

In an order issued on March 21, 1990, to Wisconsin Public Service Corporation (50 FERC ¶ 61,337), the Commission addressed the issue of whether a company should classify an abandoned mining venture as a fuel cost. The Commission stated:

Here, Wisconsin asks that the Commission expand this policy to allow losses from failed investments to be flowed through the fuel clause. We will deny Wisconsin's request for fuel clause recovery. Direct payments to fuel suppliers are simply not the same as uneconomic investments. While Wisconsin attempts to analogize the two, the fact is that Wisconsin is requesting to recover not a fuel cost, but rather a property loss . . . [emphasis added]

The lease arrangement in effect was used as a means of borrowing funds equivalent to the mining venture losses. Therefore, the lease payment was composed of the following items:

(1) cost of nuclear fuel, and carrying charges thereon, and

(2) borrowed funds equivalent to the loss on the mining venture, and related carrying charges (interest) on the borrowed funds.
Accounting and Fuel Adjustment Clause Billing of Payments Made to the Trust
(Continued)

The Company was recovering the retail portion of the mining loss and related carrying charges from its retail customers over future periods but not from its FERC customers. Under the circumstances, the Company should have adopted the following accounting procedures:

1. record in Account 524, Miscellaneous Nuclear Power Expenses, in 1987 an amount equivalent to the FERC portion of the loss, which it could not defer and collect from wholesale customers over future periods;

2. record in Account 518 each month the portion of the lease payment applicable to the costs of constructed nuclear fuel, excluding the loss and the related carrying charges;

3. charge to Account 406, Amortization of Electric Plant Acquisition Adjustments, each month the portion of the lease payment related to the mining loss and related carrying charges that it is recovering in billings from retail customers; and

4. in the event the Company is disallowed recovery of the mining loss from its retail customers, the Company should expense the balance of the unrecovered loss by charges to Account 426.5, Other Deductions, in the period disallowed.

Accounting for Legal Fees

The Company charged Account 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment and Fabrication, with legal fees incurred to negotiate the termination of a uranium supply contract.

Fees and expenses of attorneys are specifically listed as items properly chargeable to Account 923. Therefore, legal expenses should be recorded in Account 923 if they are for general legal services only incidentally related to the termination and buyout activities; otherwise, the amounts should be recorded in the specific function or account properly charged for costs related to contract termination and buyout activities.

The Company was required to (1) revise procedures to ensure that legal fees are charged to the appropriate account consistent with the requirements of the Uniform System of Accounts and (2) record a correcting entry to expense the legal fees and other expenses to Account 524 and reverse all APUDC improperly accrued thereon.
CHAPTER 4

INTERCOMPANY TRANSACTIONS AND OTHER INVESTMENTS

Earnings in Subsidiaries Recorded in Error

The Company has investments in subsidiary companies and the earnings and dividends of these companies should be accounted for by the equity method of accounting.

However, the Company assumed that the earnings and dividends would be the same.

This assumption caused the investment in subsidiaries and subsidiary earnings to be misstated. The Company made the necessary correcting entries to properly state the balances.

In the future the Company was required to debit the investment in subsidiaries with subsidiary earnings and credit the investment with dividends received.

Classification of Investment in Fuels Subsidiary

The Company owns 35% of Fuels Subsidiary (Fuels), which operates on a non-profit basis to procure fuel supplies for the Company and the affiliated companies who own the remaining interest in Fuels. The investment of $7,000 in common stock and $31,145,250 in long term notes was recorded in Account 123, Investment in associated companies.

The investment should be classified in Account 123.1, Investment in Subsidiary Companies. Definition No. 35 of the Uniform System of Accounts states, "A corporate joint venture in which a corporation is owned by a small group of businesses as a separate and specific business or project for the mutual benefit of the members of the group is a subsidiary company for the purposes of this system of accounts." The instructions to Account 123.1 state, "This account shall include the cost of investments in securities issued or assumed by subsidiary companies and investment advances to such companies . . . ."

The Company was required to reclassify the investment in Fuels recorded in Account 123 to Account 123.1.
Accounting for Investment in Fuels Subsidiary

The Company recorded its 13% interest in Fuels Subsidiary (Fuels) in Account 123, Investment in Associated Companies. Fuels is a non-profit fuel subsidiary of the Company. The Company's investment in Fuels consisted of $2,600 in common stock and $11,294,250 in long term notes.

The Uniform System of Accounts provides for the recording of the costs of securities issued by subsidiary companies, and investment advances to such companies, in Account 123.1, Investment in Subsidiary Companies.

The Company was required to conform its accounting to the Uniform System of Accounts in the future, and record an entry to record the investment in Fuels in Account 123.1.

Accounting for Payments Made to Subsidiary Company

The Company's wholly-owned subsidiary, served as purchasing agent for virtually all of the Company's supplies and equipment. The Public Utilities Commission permits the Company to earn a profit for certain services that is based on the overall rate of return the PUC allows the Company to earn on rate base.

The Company computed the subsidiaries profit on its service using the return on common equity allowed the Company. The Company's return on common equity was greater than its overall return on net investment allowed by the PUC. This resulted in the subsidiary recognizing an excess profit on its services.

General Instruction No. 2 of the Uniform System of Accounts states, in part:

All amounts included in the accounts prescribed herein for electric plant and operating expenses shall be just and reasonable and any payments or accruals by the utility in excess of just and reasonable charges shall be included in Account 426.5, Other Deductions.

The Company was required to record any payments made to the subsidiary that were in excess of approved profit levels in Account 426.5
Accounting for Preferred Stock Dividend

The staff's examination disclosed that the Company received a preferred stock dividend. The entry recording this dividend was a debit to Account 146, Accounts Receivable from Associated Companies, and a credit to Accounts 419, Interest and Dividend Income. Account 123.1, Investment in Subsidiary Companies, and Account 216.1, Unappropriated Undistributed Subsidiary Earnings, were adjusted by reflecting the dividend paid to the Company in current subsidiary earnings.

The instructions of the Uniform System of Accounts require that, when dividends are declared, Account 123.1 should be credited with the amount of the dividend. When dividends are received Account 216.1 is to be debited and Account 216, Unappropriated Retained Earnings, is to be credited. Dividends should not be reflected in current earnings of the subsidiary.

Accounting for Investment in Associated Company

The Company acquired a 10% interest in a Gas Company along with five other pipeline companies who own the remaining interest in the gas company. The Company has recorded its investment in Account 123, Investment in Associated Companies.

The staff was of the opinion that the investment should be classified in Account 123.1, Investment in Subsidiary Companies. Definition No. 35 states, "A corporate joint venture in which a corporation is owned by a small group of businesses as a separate and specific business or project for the mutual benefit of the members of the group is a subsidiary company for the purposes of this system of accounts."

Accounting for Investment in Subsidiary Company

The Company accounted for its investment in subsidiary companies on the cost basis. The Uniform System of Accounts and the text of Account 123.1, Investment in Subsidiary Companies, requires that investments in subsidiaries be accounted for using the equity method of accounting.

The Company was required to revise its accounting procedures for investment in subsidiaries to: (1) show in Account 123.1, Investment in Subsidiary, the cost of subsidiaries at acquisition, plus investment advances and the equity in undistributed earnings or losses since acquisition, and (2) use Account 418.1, Equity in Earnings of Subsidiary Companies, to show the earnings or losses of subsidiary companies for the year, and Account 216.1, Unappropriated Undistributed Subsidiary Earnings, to include the balances of undistributed retained earnings of subsidiary companies since their acquisition.
Accounting for Service Corporation Billing

The Service Corporation billings to operating company included the following:

(1) Monthly, the service corporation determined that a portion of service corporation administrative and general expenses (A&G) related to construction activities. These expenses were applied to service corporation construction labor as an overhead. The portions of A&G expenses capitalized were unsupported by time studies as required by Plant Instruction No. 4B.

(2) Numerous service corporation labor, operating expenses, employee reimbursements, etc. billed directly to operating company were improperly classified on operating company's books.

(3) Many of the A&G expenses allocated monthly by service corporation were not classified in the proper accounts.

(4) Percentages used in allocated A&G expenses between the system companies were unsupported. In some instances, percentages used appeared arbitrary.

Commission policy with respect to affiliated service company bills is that amounts billed should be charged to the same accounts as would have been charged had operating company performed the work. Charges from the service company should be invoiced in sufficient detail in order to determine the proper classification of such amounts. In addition, charges should be billed directly to the extent possible and any remaining costs should be allocated in a reasonable and fair manner supported by appropriate studies. The service corporation should conduct periodic time studies of its administrative personnel in order to support the portion of administrative and general expenses applied to construction labor.

Accounting for Service Corporation Costs

Service Corporation rendered services to the Company in connection with matters relating to operations, management, financial planning, regulatory, employee benefits, accounting, etc. Each month Service Corporation issues a bill to the Company for its share of such services. The bill was broken down into numerous categories, such as salaries, general office and other rents, insurance, dues and memberships, contributions and donations, taxes, interest, etc. The Company charged the total expenses to Account 923, Outside Services Employed.

This accounting is in violation of General Instruction No. 14 of the Uniform System of Accounts which states:

"Transactions with associated companies shall be recorded in the appropriate accounts for transactions of the same nature."
Failure to Allocate Operating Expenses to Subsidiary

The Company made no allocation of salaries or operating expenses to its wholly-owned subsidiary for work performed on behalf of the subsidiary.

General Instruction No. 9 states that the charges to operating expense and other accounts for services and expenses of employees engaged in activities chargeable to various accounts shall be based upon the actual time engaged in the respective classes of work, or if impractical, upon the basis of a study of the time actually engaged during a representative period.

The Company was required to establish procedures to properly allocate salaries and expenses incurred on behalf of its subsidiary.

Investments in Pipeline Partnerships

The Company recorded its 25% equity investment in Gas Transmission System in Account 124, Other Investments, and its 33 1/3% and 20% investments in Pipeline Company and Other Pipeline Company in Account 183.2, Other Preliminary Survey and Investigation Charges.

The recording of these investments in Accounts 124 and 183.2 is not in accordance with Definitions 5B, Control, and 36, Subsidiary Company of the Uniform System of Accounts.

In the future, the Company was required to record investments which meet the requirements of Definitions 5B and 36 of the Uniform System of Accounts in Account 123.1, Investment in Subsidiary Companies and record an entry to properly classify the Company investments in Gas Transmission System, and Pipeline Companies.
INTERCOMPANY TRANSACTIONS AND OTHER INVESTMENTS

Classification of Billings from Parent

Staff's review of administrative and general expenses billed by Parent Company disclosed that such expenses were classified by the Company in Account 921, Office Supplies and Expenses. The billing from Parent included elements of labor, supplies, expenses, and labor related taxes and benefits.

The Uniform System of Accounts General Instruction No. 14 provides that "transactions with associated companies shall be recorded in the appropriate accounts for transactions of the same nature."

The Company was required to revise its procedures for classification of billings from associated companies in order to comply with the requirements of General Instruction No. 14.

Allocation of Administrative and General Expenses and Other Corporate Overhead Costs

The Company is a wholly-owned subsidiary of Parent Company. Parent was allocating total executive compensation (salary, expenses, bonuses, retirement benefits, etc.), audit fees, stock issue costs, Board of Director's fees and other miscellaneous expenses on an inequitable basis. Several of Parent's subsidiaries, including the Company, were not included in the allocation formula or billed any of Parent's corporate overhead costs.

Parent's administrative and general costs benefit all members of the corporate family, rather than only specific subsidiaries. Therefore, each subsidiary should bear its equitable share of the parent company's properly allocable administrative and general costs.

The Company was required to absorb allocated Parent's administrative and general expense based upon the Massachusetts Formula. The Massachusetts Formula gives equal weight to each of three factors -- investment in property, operating revenues, and direct labor. The use of a different allocation method may be necessary in the future in the event the Commission adopts another allocation method in establishing rates for the Company.

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Accounting for Finance Subsidiary Company Transactions

The Company established Finance N.V. as an international finance subsidiary in 1982 for the purpose of obtaining funds for the Company's general use.

The Company recorded its initial investment in Finance N.V. in Account 123.1, Investment in Subsidiary Companies. Subsequent transactions recorded by the Company related to the Finance N.V. operation did not result in the appropriate account classifications as required by the Uniform System of Accounts. The following is a listing of examples indicating the nature of the transaction, classification by the Company and account classification recommended.

<table>
<thead>
<tr>
<th>Description</th>
<th>Account Used</th>
<th>Account Recommended</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company liability for note payable of $20,000,000 to Credit Lyonnais.</td>
<td>123.1</td>
<td>224</td>
</tr>
<tr>
<td>Retained earnings of Finance N.V.</td>
<td>216</td>
<td>216.1</td>
</tr>
<tr>
<td>Company payable of $60,000,000 to Finance N.V. for advance of funds</td>
<td>224</td>
<td>223</td>
</tr>
<tr>
<td>from the proceeds of 16 1/2% Guaranteed Notes.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Earnings of Finance N.V.</td>
<td>237</td>
<td>123.1</td>
</tr>
<tr>
<td>Interest receivable by Finance N.V. on $20,000,000 commercial time deposit</td>
<td>427</td>
<td>418.1</td>
</tr>
<tr>
<td>with Credit Lyonnais.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Recommendations: The Company adopt procedures to account for future items of a similar nature in accordance with the Uniform System of Accounts for subsidiary companies.

Investment in Subsidiary Company

The Company formed Finance Company as a wholly owned financing subsidiary. All amounts expended for the subsidiary have been classified in Account 186, Miscellaneous Deferred Debits.

Account 123.1, Investment in Subsidiary Companies, states that this account shall include the cost of investment in securities issued by subsidiary companies and investment advances to such companies.

The Company was required to reclassify the investment in securities of advances to Finance Company to Account 123.1.
Capitalization of Service Company Services Charges

The Company included the following charges from Service Company in utility plant accounts:

(1) System planning - research and development.
(2) System planning - transmission facilities - joint reliability.
(3) Transmission system - electrical equipment evaluation.

Under the provisions of Operating Expense Instruction Nos. 1 and 2 of the Uniform System of Accounts, the Company should record charges of the nature listed above in operation or maintenance expense accounts.

The Company was required to (1) revise procedures to charge expenses of this nature to the appropriate operating or maintenance expense account and (2) record a correcting entry to properly state the plant accounts.

Accounting Classification of Intercompany Loans

The Company and certain of its affiliates signed an umbrella loan agreement dated April 4, 1983. The agreement was to provide for loans from the Company to any of the affiliates from time to time and for borrowings by the Company from any of the affiliates from time to time. The principal amounts were not to exceed an aggregate of $200,000,000 outstanding at any time payable upon demand of the Lender and not to be outstanding for more than one year.

The Company recorded the notes resulting from the loan agreements with its affiliates in Account 146, Accounts Receivable from Associated Companies, and Account 234, Accounts Payable to Associated Companies.

Under the requirements of the Uniform System of Accounts notes and drafts upon which associated companies are liable, and which mature no later than one year from the date of issue are properly classified in Account 145, Notes Receivable from Associated Companies. In addition, amounts owing to associated companies on notes, drafts, acceptances, or other similar evidences of indebtedness subject to current settlement are properly classified in Account 233, Notes Payable to Associated Companies.

The Company was required to revise procedures to ensure that Intercompany Notes Receivable, including interest, are recorded in Account 145 and Intercompany Notes Payable are recorded in Account 233.
CHAPTER 5

CURRENT ASSETS

ACCOUNTS RECEIVABLE FINANCING

Accounting for the Sales of Accounts Receivable

The Company and the Credit Co. entered into an agreement for the sale of all rights, title and interest in all accounts receivable.

The Company recorded the difference between the amount of the accounts receivable sold and the proceeds received in Account 930.2, Miscellaneous General Expenses. It included the amounts recorded in Account 930.2 in billings under the Intercompany Sales Agreement.

There are no provisions under the Commission's Uniform System of Accounts for a company to record any gains or losses resulting from the sale of utility assets, including accounts receivable, in operating expense accounts. Except for the sale of future use property, the Uniform System of Accounts requires a company to record any gains or losses from the disposition of assets in nonoperating expense accounts. With respect to property recorded in Account 105, Electric Plant Held for Future Use, the Commission requires a company to include a gain in Account 411.6, Gains from Disposition of Utility Plant, and a loss in Account 411.7, Losses from Disposition of Utility Plant.

Under the requirements of the Uniform System of Accounts, the Company should have recognized a loss for the difference between the proceeds received and the carrying amount of the customer accounts receivable sold by charges to Account 426.5, Other Deductions.

Staff recommended that the Company:

1. revise procedures to ensure it records any future expenses related to the sale of accounts receivable according to the requirements of the Uniform System of Accounts;

2. record a correcting entry to classify the loss for the difference between the proceeds received and the carrying amount of the customer accounts receivable sold by charges to Account 426.5; and

3. recalculate billings by correcting the accounting for the loss on the sale of receivables to and make refunds, with interest, for any overbilled amounts.
CURRENT ASSETS

Accounts Receivable Financing

Accounting for the Sale of Accounts Receivables

In 1987 the Company entered into an agreement with Credit Co. to sell its billed accounts receivables. The Company recorded the discounts on the initial and subsequent monthly sales of receivables in Account 903, Customer Records and Collections Expense. The Company repurchased all outstanding receivables sold in 1988.

There are no provisions under the Commission's Uniform System of Accounts for a company to record any gains or losses resulting from the sale of utility assets, including accounts receivables, in operating expense accounts. Except for the sale of future use property, the Uniform System of Accounts requires a company to record any gains or losses from the disposition of assets in nonoperating expense accounts.

Under the requirements of the Uniform System of Accounts, the Company should have recognized a loss for the difference between the proceeds received and the carrying amount of the customers accounts receivable sold by charges to Account 426.5, Other Deductions. The instructions to Account 426.5 state in part:

This account shall include other miscellaneous expenses which are nonoperating in nature, but which are properly deductible before determining total income before interest charges.

Staff recommended that the Company:

(1) revise procedures to ensure that it records any future expenses related to the sale of account receivables according to the requirements of the Uniform System of Accounts; and

(2) record a memorandum correcting entry to reclassify the fees paid from Account 903 to the proper nonoperating expense accounts.

The Company did not agree to adopt the above recommendations at this time.
Accounts Receivable Financing

Accounting Classification for Expenses Related to the Sale of Customer Accounts Receivable

The Company entered into agreements with CREDIT Co. for the sale of certain of its customer accounts receivables without recourse. The Company recorded the difference between the amount of the accounts receivable and the net cash received from CREDIT Co. in Account 903, Customer Records and Collection Expenses.

Under the requirements of the Uniform System of Accounts, the Company should have recognized a loss for the difference between the proceeds received and the carrying amount of the customer accounts receivable by charges to nonoperating expense.

Staff recommended that the Company:

(1) revise procedures to ensure it records any future expenses related to the sale of accounts receivable according to the requirements of the Uniform System of Accounts; and

(2) record memorandum entries to correct the accounting for the expenses related to the sale of accounts receivables.
Improper Use of Account 165, Prepayments

Insurance accruals for estimated premiums applicable to renewed policies were recorded as a credit in Account 165 prior to the actual receipt of the insurance bill. In some cases Account 165 had a credit balance at year end.

The Company was required to record the year end credit balances applicable to estimated insurance premiums in Account 242, Miscellaneous Current and Accrued Liabilities.

Failure to Record Dividends Receivable on a Timely Basis

The Company's policy was to record dividends from subsidiaries at the time they were received.

The text of Account 171, Interest and Dividends Receivable, states, "This account shall include the amount of dividends declared or guaranteed on stocks owned." Note A to the text of Account 171 states, "interest and dividends receivable from associated companies shall be included in Account 146, Accounts Receivable from Associated Companies."

In the future, the Company was required to record in Account 146, as of the declaration date, dividends receivable from subsidiary companies with an offsetting credit to Account 123.1, Investment in Subsidiary Companies, so that at year end, investments in subsidiary companies will be properly stated on the equity basis.

Accounting for Advances Made to Employees

The Company recorded amounts advanced to employees and officers for travel and miscellaneous purposes in Account 143, Other Accounts Receivable.

The Uniform System of Accounts provides that Account 135, Working Funds, shall include cash advances to officers, agents, employees, and others as petty cash or working funds.

In the future, advances made to employees and officers related to travel and other miscellaneous purposes should be recorded in Account 135.
Other

Write-Off of Advances for Gas

The Company recorded advances for gas paid to producers for exploration and development in Account 124, Other Investments, Account 166, Advances for Gas Exploration, Development, and Production, and Account 167, Other Advances for Gas. The Company established a reserve for the write-off of the gas advances in the amount of $9,677,000 by charging Account 426.5, Other Deductions, and crediting Account 253, Other Deferred Credits. In December 1984, all advances for gas were transferred from Accounts 124 and 166 to Account 167 to reflect the Commission's exclusion of the advances from rate base. This exclusion was a part of the Stipulation and Agreement. The end result of the Company's accounting was to retain an asset (in Account 167) and related liability (in Account 253) on its accounts and financial statements for the unrecovered gas advances.

The Company informed the staff of its intentions to seek recovery of the advances from the gas producers. Accordingly, the staff will defer proposing elimination of the gas advances from Account 167 and 253 until the Company completes negotiations with the gas producers and a decision is reached on the future collectibility of the unrecovered amounts. In the event the Company is unsuccessful in its efforts to collect the unrecovered amounts from the gas producers, the Company should remove the unrecovered amounts from Accounts 167 and 253.

Advance Payments Excluded From Rate Recovery

The filing for Purchased Gas Cost Adjustment (PGA) 82-2a included an advance payment adjustment to reflect the change in the adjusted advance payment balance of Account 166, Advances for Gas Exploration, Development and Production, from the adjusted advance payment balance included in PGA filing 82-1a. In computing the advance payment balance subject to PGA recovery in PGA 82-2a, the balance of Account 166 gas was reduced to reflect repayments of advance payments by an affiliated company, at a rate of 20% annually pursuant to the Company's Stipulation and Agreement in FERC Docket.

Settlement rates in the FERC Docket provided for recovery of return and income taxes attributable to a specified advance payment level. The Company was to include in the net remaining balance of advance payments, an amount that reflects a payback of monies advanced under such agreements over the life of the specified recovery period at a rate of 20% annually.

In staff's opinion, only advance payment balances which are provided rate recovery through general rate proceedings or advance payment adjustments should be recorded in Account 166. Accordingly, advance payment balances specifically excluded for rate recovery purposes should be recorded in Account 167, Other Advances for Gas.

The Company expressed the view that it was complying with the requirements of the Uniform System of Accounts. Based on discussions of this point, the staff recommended that the Company's accounting continue unchanged, but that the Company provide adequate footnotes on the appropriate pages of FERC Form No. 2 to fully disclose the amount of advances not receiving rate base treatment.
CURRENT ASSETS

Other

Accounting for Discount on Commercial Paper

The Company recorded in Account 165, Prepayments, discounts on commercial paper issued.

It is the staff's opinion that the discount from face value of commercial paper should be treated as a valuation reserve and not an asset.

The staff recommended that the Company revise its procedures to record discounts on commercial paper issued in Account 242, Miscellaneous Current and Accrued Liabilities. The Company agreed to recalculate billings to sponsor companies to the extent Account 165 was included in rate base and to make any appropriate refunds.

Accounting For Work Performed For Others

The Company was requested by the Power & Light Company to modify the transfer control scheme at one of its substations. The Power & Light Company agreed to reimburse the Company for all costs incurred on this modification. The Company did not request reimbursement from P&L and capitalized the cost of this job in Account 101, Electric Plant in Service.

The text of Account 143, Other Accounts Receivable, states, "this account shall include amounts due the utility upon open accounts, other than amounts due from associated companies and from customers for utility services and merchandising, jobbing and contract work."

The Company was required to record an entry to eliminate from electric plant in service, the costs capitalized for work performed for and to request reimbursement from P&L and in the future, implement procedures to insure proper billing of costs for work performed for others.

Accounting for Unbilled Purchases of Energy

Although the Company recorded unbilled revenues in Account 173, Accrued Utility Revenue, at the end of each month, it did not record associated unbilled purchased power.

Instructions for Account 173, require, in part, that: "In case accruals are made for unbilled revenues, they shall be made likewise for unbilled expenses, such as for the purchase of energy." The identified practice also did not provide for the proper matching of revenues with expenses.

In the future, the Company was required to record unbilled purchases of energy in accordance with the instructions for Account 173.
CURRENT ASSETS

Other

Accounting for Advance Payments

The Company included in Account 166, Advances for Gas Exploration, Development and Production, $750,000 for an advance payment in April 1983. This advance was not included in rate base in the Company's currently effective rates.

Commission Order No. 441, provided that all advance payments disqualified by option or regulation from rate base treatment be recorded in Account 167, Other Advances for Gas.

The Company was required to: (1) transfer advance payments disallowed rate treatment to Account 167 pursuant to Order No. 441 and, (2) record a correcting entry to reclassify the disallowed advanced payments to Account 167, Other Advances for Gas.

Accounting for Withdrawals of Noncurrent Gas Inventory

From February through May, the Company withdrew noncurrent gas from its storage field which gas was recorded in Account 117, Gas Stored Underground-Non-Current. The Company used the weighted average cost of its gas recorded in Account 164.1, Gas Stored Underground-Current, to estimate the price of gas withdrawn from its noncurrent account. The estimated cost of this withdrawn noncurrent gas was charged to Account 808.1, Gas Withdrawn from Storage - Debit, and to Account 823, Gas Losses, and credited to Account 164.1. In June 1984, the Company replaced the previously withdrawn noncurrent gas by crediting Account 808.2, Gas Delivered to Storage - Credit, and charging Account 164.1. The injection was priced at June's 1984 actual weighted average cost of purchased gas which was $0.39/Mcf less than the estimated price recorded at the time of storage withdrawal.

The Company's accounting for gas withdrawn from noncurrent inventory was not proper because its accounting did not conform to the instructions for Account 117. Under the instruction of Paragraph D of Account 117, when gas is withdrawn from noncurrent storage and is to be replaced within 12 months, the Company is permitted to price the gas at the estimated cost of replacement. Account 808.1 is to be charged and Account 253, Other Deferred Credits, credited with the estimated replacement cost. When gas is purchased and used to replace the previously withdrawn noncurrent storage gas within 12 months, the cost of such gas should be charged to the appropriate purchased gas cost account and the balance in Account 253 should be cleared. The purpose of the above accounting requirements is to charge the appropriate purchased gas cost accounts which are billable to customers with the actual average cost of the replacement gas and thereby maintain the balance recorded in Account 117 at the same cost as was recorded therein prior to the withdrawal and replacement cycle.

The Company was required to revise its accounting procedures to conform its accounting for gas withdrawn from noncurrent storage to the requirements of Account 117 in the future.
CURRENT ASSETS

Other

Accounting for Unbilled Revenue


The text of Account 173, Accrued Utility Revenues, states, in part, "...the estimated amount accrued for service rendered, but not billed at the end of any accounting period, may be included herein."

The Company was required to record an entry to reclassify the estimated unbilled revenues.

Accounting for Nonrecoverable Gas Advances

The Company did not remove $9,325,000 of nonrecoverable advances for gas from Account 167, Other Advances for Gas. Instead, the Company recorded a "loss valuation reserve" for nonrecoverable advances in Account 228.4, Accumulated Miscellaneous Operating Provisions.

The special instructions to Account 228.1 through Account 228.4 state, in part,

No amounts shall be credited to these accounts unless authorized by a regulatory authority or authorities to be collected in a utility's rate levels.

The "loss valuation reserve" was not a provision subject to rate authorization and therefore did not meet the requirements of Account 228.4. The Uniform System of Accounts contemplates that advances determined to be nonrecoverable be charged to expense and credited to Account 167.

The Company was required to (1) revise procedures to remove nonrecoverable advances for gas from Account 167 and (2) record an entry to correct the balances of Account 167 and 228.4.
CHAPTER 6

DEFERRED ASSETS

CARRYING CHARGES IN LIEU OF AFUDC

Accounting for Common Facilities

The Company improperly classified a portion of its investment in common facilities in two generating plants in Account 107 after the in-service date of the first unit at each station. In addition, the Company improperly classified accruals of carrying charges permitted by the State Commission in the accounts established for Allowance for Funds Used During Construction.

At the time Nuclear Unit No. 1 was placed in service, the Company transferred only one-half of the cost of common facilities to Account 101, Electric Plant in Service. The balance of the investment in the common facilities remained recorded in Account 107, Construction Work in Progress-Electric. The Company planned to transfer the remaining amount to Account 101 concurrent with the in-service date of Unit No. 2. The investment in common facilities which was retained in Account 107 continued to accrue Allowance for Funds Used During Construction (AFUDC).

The Company's accounting for the common facilities is based upon State Commission rate orders, involving generating stations where two units were being constructed. In these cases, the PUC allowed only one-half of the cost of common facilities to be included in rate base concurrent with the in-service of the first unit.

The Company's accounting for the common facilities is not in accordance with the instructions to Account 107 of the Uniform System of Accounts. Instruction B to Account 107 states, in part, "...any expenditures which are common to and which will be used in operation of the project as a whole shall be included in electric plant in service upon the completion and the readiness of service of the first unit. Any expenditures which are identified exclusively with units of property not yet in service shall be included in this account."

In addition, the Company's accounting for the accrual of AFUDC on the balance of the investment in common facilities included in Account 107 after the in-service date of Unit No. 1, is contrary to the requirements of Electric Plant Instruction 3(17) of the Uniform System of Accounts. Therefore, AFUDC on the total investment in common facilities should have been ceased at the in-service dates of the related units.
DEFERRED ASSETS

Carrying Charges in Lieu of AFUDC

Accounting for Common Facilities (Continued)

In Docket No. EL80-4, issued November 19, 1980, to Metropolitan Edison Company the Commission ordered, under similar circumstances, that AFUDC accrued on common facilities after the in-service date of the first unit should be recorded in Account 186, Miscellaneous Deferred Debits and amortized to Account 406, over the remaining depreciable life of the property.

The Company was required to (1) revise its procedures to account for the cost of common facilities in accordance with the instruction to Account 107 in the future, and (2) record correcting entries to properly state the accounts related to common plant and carrying charges.

Accounting for AFUDC on The Generating Station

The Generating Station went into service June 1982. During the period June 1982 to April 1983, the Company accrued $12,306,207 of AFUDC on its investment in the Generating Station. The Company subsequently transferred the AFUDC to Account 101 (Electric plant in service).

Under the requirements of the Commission's Uniform System of Accounts, the capitalization of AFUDC should have ceased when the generating unit was placed in-service. Accounting Release No. AR-5 states: "Capitalization of interest stops when the facilities have been tested and are placed in or ready for service."

The Commission has approved special accounting to accommodate the orders of state commissions where a company could demonstrate there was sufficient assurance that the cost to be deferred would be recovered in rates.

The Company did receive approval from the Public Utilities Commission to compute AFUDC after the in-service date of its major projects. The PUC included such amounts in the Company's rate base. The Company should have recorded a carrying charge on its investment in the Generating Station by debiting Account 186, Miscellaneous Deferred Debits and crediting Account 421, Miscellaneous Nonoperating Income.

The Company was required to (1) revise accounting procedures and (2) record an entry to reclassify the carrying charges computed on the Generating Station to Account 186, Miscellaneous Deferred Debits.

The balance in Account 186 should be amortized to Account 406. In the event that retail ratemaking does not provide for the recovery of the amounts recorded in Account 186, the Company should expense the unrecovered amounts to Account 426.5, Other Deductions.
Carrying Charges in Lieu of AFUDC

Accrual of Allowance for Funds Used During Construction After the In-Service Date

The Company improperly recorded Allowance for Funds Used During Construction (AFUDC) on its investment in a project after the in-service date.

The Public Utilities Commission allowed the Company to accrue carrying charges on its investment after the in-service date until revenues were collected.

The Company transferred the applicable property to Account 101, Electric Plant in Service, and continued to record AFUDC on the portion of its project investment subject to the jurisdiction of the PUC in income statement Accounts 419, Allowance for Funds Used During Construction and 432, Allowance for Borrowed Funds Used During Construction Credit. As of the end of the audit period the carrying charges were classified in Account 101, Electric Plant in Service.

Electric plant instruction 3(17) of the Uniform System of Accounts states, in part, "Allowance for funds used during construction includes the net cost for the period of construction..." In addition, Accounting Release No. AR-5 (revised) issued by the Chief Accountant on January 1, 1968, requires that AFUDC stop when plant facilities have been tested and are placed in, or are ready for service.

The Company was required to revise its procedures to record the authorized post in-service carrying charges in Account 186, Miscellaneous Deferred Debits and credit account 421, Miscellaneous Nonoperating Income, with future accruals of carrying charges.

The amounts recorded in Account 186 are to be amortized to Account 406, Amortization of Electric Plant Acquisition Adjustments, over the period that the amounts are being recovered in the Company's cost of service.
DEFERRED ASSETS

Carrying Charges in Lieu of AFUDC

Accounting for Carrying Charges Related to Common Facilities

The Company accrued Allowance for Funds Used During Construction (AFUDC) on a portion of common facilities which were placed in-service but excluded from rate base treatment by the state commission. No AFUDC was accrued on the wholesale portion of the common facilities subsequent to the in-service date.

The PUC allowed the Company to accrue AFUDC on the common facilities not allowed in rate base until Unit No. 4 was placed in-service. Upon inclusion in plant-in-service, the Company commenced depreciation of the AFUDC accrued on the common facilities by charges to Account 403, Depreciation Expense and credits to Account 108, Accumulated Provision for Depreciation of Electric Utility Plant.

The carrying charges allowed by the PUC to be accrued on the common facilities subsequent to the in-service date represents a deferred regulatory created asset. It is the Commission's policy that deferred regulatory created assets of this nature are properly accounted for as charges to Account 186, Miscellaneous Deferred Debits, and credits to Account 421, Miscellaneous Nonoperating Income.

Consequently, the Company should not have recorded depreciation expense on these amounts. Instead, the Company should have amortized the amount deferred in Account 186 by charges to Account 406 and credits to Account 186.

The Company was required to (1) revise procedures to record the deferred amounts in Account 186 and amortize the approved amounts to Account 406, and (2) record entries to eliminate the AFUDC from the Account 419.1 and 432 and record such carrying charge accruals to Account 421, Miscellaneous Nonoperating Income.
Deferred Assets

Carrying Charges in Lieu of AFUDC

AFUDC on Delayed Project

In December 1981, the Company transferred a project from Account 105 - Electric Future Use Property to Account 107 - CWIP. The transfer was made in accordance with an order of the State Commission which required the Company to make the transfer and to begin capitalizing AFUDC on the amounts transferred. The State Commission ordered the transfer because it found the project more analogous to CWIP than to future use property.

The Company had originally transferred the project to Account 105 from Account 107, when the project was suspended due to revised capacity forecasts.

The project is still suspended and is not expected to resume until 1990. The project basically consists of distribution system equipment.

Per the Uniform System of Accounts, AFUDC should not be capitalized unless there is continuing construction. Accordingly, it is not proper for the Company to recognize AFUDC on this project until construction resumes.

The Company was required to record the "AFUDC" (or carrying charges) ordered by the State Commission by charging Account No. 186 - Miscellaneous Deferred Debits and crediting Account No. 421 - Miscellaneous Nonoperating Income.

The Company was required to record an adjusting entry to transfer the cost of the suspended project and the related AFUDC capitalized from Account 107, Construction Work in Progress to Account 105, Plant Held for Future Use and Account 186, Miscellaneous Deferred Debits. Capitalization of AFUDC on future use projects is not permitted under the USofA. Future carrying charge accruals are to be recorded in Account 186 and credited to Account 421, Miscellaneous Nonoperating Income.
DEFERRED ASSETS

Carrying Charges in Lieu of AFUDC

Accounting for Unit No. 2 Carrying Charges

Recorded in Account 105, Electric Plant Held for Future Use, was the Company's investment in Unit No. 2 common facilities. It was recorded in Account 105 to coincide with the plant in service classification of Unit No. 1 common facilities.

In the final order of the PUC, the Company was allowed to accrue carrying charges on its investment in Unit No. 2 common facilities. Effective June 1982, the Company began recording carrying charges on the investment, consisting of direct charges, AFUDC and cumulative carrying charges. The carrying charge accruals were charged to Account 107, Construction Work in Progress - Electric and cleared to Account 105 in the following month. As of September 30, 1982, total carrying charges accrued were $682,725.

The Uniform System of Accounts does not provide for carrying charges to be added to the cost of property recorded in Account 105. While the PUC rate order allowed the Company to accrue these carrying charges, approval was not sought from the Chief Accountant. Such approval is required to record the carrying charges, in which case the Chief Accountant may direct such amounts to be recorded in Account 186, Miscellaneous Deferred Debits.

In addition, the staff noted that Unit No. 2 common facilities were included in FERC rate base. Rates resulting from this rate case became effective May 31, 1982. Accordingly, there was no basis for accruing carrying charges on the wholesale allocated portion of Unit No. 2 common facilities.

The Company was required to (1) request written permission from the Chief Accountant, to record carrying charges as described above and (2) reclassify the carrying charges recorded through 1982 from Account 105 to Account 186, Miscellaneous Deferred Debits.
Deferred Assets

Carrying Charges in Lieu of AFUDC

Excess Return Recorded in Account 253

The Public Service Commission ordered the Company to calculate its earned rate of return monthly and defer any excess return resulting from the Company's austerity program. The PSC stated, in part:

The conventional revenue requirement, shall be subject to any equity earnings cap. The excess earned equity will be computed monthly and any excess will be deferred. The deferrals will be cumulated and subject disposition for the benefit of ratepayers. In the event the Company earns less that its allowed return in any month, the accumulated deferral will be reduced by the shortfall, but the amount in the deferral account shall at no time be less than zero.

As of December 31, 1984 the Company had recorded $16 million of excess return over that permitted by debits to Account 930.2, Miscellaneous General Expenses, and credits to Account 253, Other Deferred Credits. The Company computed a monthly negative carrying charged on the excess return by debits to Account 419.1, Allowance for Other Funds Used During Construction, and Account 432, Allowance for Borrowed Funds Used During Construction, and by crediting Account 253, Other Deferred Credits.

Since the excess return will be refunded to the customer the staff believes Account 449.1, Provision for Rate Refunds, should be charged and Account 229, Accumulated Provision for Rate Refund, should be credited. The instruction to Account 229 states,

This account shall be credited with amounts charged to Account 449.1, Provision for Rate Refunds, to provide for estimated refunds where the utility is collecting amounts in rates subject to refund.

Further, the use of Account 419.1 and 432 to record the negative carrying charge on the excess return is improper since these accounts are to be used to record an allowance for borrowed and other funds used for construction. The staff believes Account 426.5, Other Deductions, should be debited with the additional expense the Company accrues on the excess revenues it has collected.

The Company was required to record an entry to reclassify the amount of excess return at December 31, 1984 from Account 253 to Account 229.
DEFERRED ASSETS

Carrying Charges in Lieu of AFUDC

Accounting For Carrying Charges on Excess Plant Capacity

The Public Service Commission disallowed certain of the Company's investment in utility plant from rates as excess capacity. However, the PSC's order allowed the Company to accrue carrying charges on the disallowed plant and provided necessary rate assurances that the carrying charges would be collected in future rates.

The Company recorded the carrying charges by debiting Account 186, Miscellaneous Deferred Debits and crediting Account Nos. 419.1, Allowance for Other Funds Used During Construction and 432, Allowance for Borrowed Funds Used During Construction.

Under the requirements of the Uniform System of Accounts, the accrual of allowed for funds used during construction should cease when property is ready or available for service. The text of Account 421, Miscellaneous Nonoperating Income, of the Uniform System of Accounts, states, "This account shall include all revenue and expense items except taxes properly includable in the income account and not provided for elsewhere." The Company should have recorded the carrying charges on the disallowed plant in Account 421.

The Company was required to adopt procedures to ensure that carrying charges accrued based upon specific state actions that provide future rate assurances are included in Account 421.

Accounting for Costs Incurred After the In-Service Date of Certain Transmission Construction Projects

The Company's accounting for certain of its transmission construction projects was deficient as follows:

(1) It incorrectly recorded allowance for funds used during construction (AFUDC) after the in-service date of the projects.

(2) It did not accrue depreciation expense for all periods after the transmission projects were in service.

The Company placed certain transmission projects in service during the period May 1984 to December 1984. The Company transferred the original cost of the transmission projects to Account 101, Electric Plant in Service, discontinued the accrual of AFUDC and began computing depreciation expense on the projects.

In rate order dated April 29, 1985, the State Commission (SC) ordered the Company to accrue additional amounts of AFUDC on these transmission projects. Also, the SC ordered the Company to discontinue the depreciation on the projects.

During the period April 1985 to December 1985 the Company accrued $5,436,243 of additional AFUDC on the transmission. Also, from April 1985 to December 1985 the Company did not record $1,094,526 of depreciation expense on the transmission projects.
Carrying Charges in Lieu of AFUDC

Accounting for Costs Incurred After the In-Service Date of Certain Transmission Construction Projects (Continued)

The Uniform System of Accounts requires that the accrual of AFUDC ceases when a project is placed in-service or is ready for service.

Accounting Release No. AR-5 issued by the Chief Accountant on January 1, 1968, requires that a company cease the accrual of AFUDC when facilities are tested and are placed in or are ready for service.

Also, Commission policy dictates that AFUDC ceases when a unit is placed in service regardless of the effective date of the rates. This policy was summarized by Opinion No. 279, issued July 20, 1987, in which the Commission stated:

Commission policy dictates that the in-service date up to which AFUDC may be accrued should be the date of commencement of commercial operation of the plant, regardless of the effective dates of any related wholesale or retail rate increases; synchronization of the in-service date of a plant and the effective dates of any related rate increases is the responsibility of the filing utility.

The Commission previously enunciated this policy in the Southern California Edison Company decision dated March 30, 1984, and the Metropolitan Edison Company decision dated April 15, 1980. The Commission stated in the Southern California Edison decision, 26 FERC 61,419, the following:

It would be contrary to this Commission's policy to allow Edison to include amounts in rates equivalent to post-operational AFUDC and thereby to effectively inflate the total cost of its unit. AFUDC is, by definition, an allowance for recovery of carrying costs during the period of construction; AFUDC was never intended to make a company whole when it chooses not to place appropriate rates in effect to recover a unit's cost upon its completion.

Also, the Commission, in Metropolitan Edison Company, (11 FERC 61,027), specifically disallowed the accrual of AFUDC after the plant was placed in service.

With respect to depreciation, the Uniform System of Accounts requires that a company begin accruing depreciation expense by charges to Account 403, Depreciation Expense, at the date a project is placed in-service or is ready for service. The Uniform System of Accounts contemplates that a company continue recording depreciation expense on utility property until the property is retired from utility service. The Company did not receive specific Commission approval to cease accruing depreciation expense during the period April 1985 to December 1985.
DEFERRED ASSETS

Carrying Charges in Lieu of AFUDC

Accounting for Costs Incurred After the In-Service Date of Certain Transmission Construction Projects (Continued)

The Commission has approved special accounting to accommodate the ratemaking orders of public utility regulatory commissions in instances when there was sufficient assurance such actions created regulatory assets that the Company would recover in future rates.

We concluded that the SC's rate order provided the Company with the necessary assurance of rate recovery to recognize a regulatory created asset. Also, we concluded that the Company did not have the prerequisite rate recovery assurances to support the capitalization of carrying charges or the deferral of depreciation on the portion of the transmission projects that are subject to the FERC's rate jurisdiction.

The Company should have adopted the following accounting procedures to reflect the rate actions of both commissions:

(1) Compute and record depreciation on the entire investment related to a completed project at the time of in-service date by charges to Account 403 and credits to Account 108, Accumulated Provision for Depreciation of Electric Utility Plant.

(2) Cease accruing AFUDC by credits to Account 419.1 and Account 432 at the in-service of the project.

(3) Recognize the effects of the SC's rate actions by accruing a carrying charge on the portion of its investment subject to SC jurisdiction by debiting Account 186, Miscellaneous Deferred Debits, and crediting Account 421, Miscellaneous Nonoperating Income.

(4) Recognize the effects of the SC's rate actions by deferring an amount equal to the depreciation on the portion of its investment subject to SC jurisdiction by debiting Account 186, Miscellaneous Deferred Debits, and crediting Account 421, Miscellaneous Nonoperating Income.

(5) Amortize the amount deferred in Account 186 to Account 406 over the period the SC provides for rate recovery.

Furthermore, in the event the SC subsequently disallows any of the cost deferrals included in Account 186, the Company should expense the disallowed amounts to Account 426.5, Other Deductions.
Carrying Charges in Lieu of AFUDC

Accounting for the Investment in Nuclear Unit No. 1

The Company's accounting for the investment in Nuclear Unit No. 1 was deficient in that the Company:

(1) Didn't transfer the investment in Nuclear Unit No. 1 to Account 101, Electric Plant in Service, upon the in-service date of the unit;

(2) Improperly deferred operating costs and accrued allowance for funds used during construction (AFUDC) on the FERC jurisdictional portion of its investment in Nuclear Unit No. 1 after the in-service date of the unit;

(3) Improperly classified deferred operating costs and accrued carrying charges computed on its investment in Nuclear Unit No. 1 from the in-service date of the unit to the dates that the plant investment was included in rates.

Under the general requirements of the Commission's Uniform System of Accounts, the Company should have transferred its entire investment related to Nuclear Unit No. 1 from Account 107 to Account 101, ceased capitalizing AFUDC and operating expenses and commenced recording depreciation expense when Nuclear Unit No. 1 was placed in service on December 19, 1984.

The instructions to Account 107 state in part:

A. This account shall include the total of the balances of work orders for electric plant in process of construction. [emphasis added]

With respect to the accounting for AFUDC, Electric Plant Instruction No. 3(17) of the Uniform System of Accounts states in part:

Allowance for funds used during construction includes the net cost for the period of construction.... [emphasis added]

Accounting Release No. AR-5, issued by the Chief Accountant on January 1, 1968, requires that a company should cease the accrual of AFUDC when facilities have been tested and are placed in or ready for service.

The Commission has approved special accounting to accommodate the ratemaking orders of public utility regulatory commissions in instances when there was sufficient assurance that such actions created regulatory assets that the company would recover in future rates.
EXPENSES

Carrying Charges in Lieu of AFUDC

Accounting for the Investment in Nuclear Unit No. 1 (Continued)

The special accounting would require a company to adopt the following procedures:

(1) Transfer the entire investment related to a completed project from Account 107 to Account 101 at the time of the in-service date.
(2) Compute and record depreciation on the entire cost of facility by charges to Account 403, Depreciation Expense and credits to Account 108, Accumulated Provision for Depreciation of Electric Utility Plant.
(3) Record property taxes in Account 408.1, Taxes Other than Income Taxes, Utility Operating Income.
(4) Record operation and maintenance expenses in Accounts 401, Operation Expense and 402, Maintenance Expense.
(5) Recognize the effects of the regulatory created asset by debiting Account 186, Miscellaneous Deferred Debits, and crediting Account 406, Amortization of Electric Plant Acquisition Adjustments, in an amount equal to the depreciation expense, property taxes and operation and maintenance expenses deferred for future collection.
(6) If also permitted by the regulatory commission, accrue a carrying charge (and not AFUDC) by debiting Account 186, Miscellaneous Deferred Debits, and crediting Account 421, Miscellaneous Nonoperating Income, for any regulatory commission approved carrying costs.
(7) Amortize the amount deferred in Account 186 to Account 406 over the period recovered in rate levels. If in the event the cost deferrals are subsequently disallowed, the unamortized cost included in Account 186 should be charged to Account 426.5, Other Deductions.

The Company should have used the special accounting discussed above with respect to the deferred costs and carrying charges computed on Nuclear Unit No. 1 form the December 19, 1984 in-service date until the revised rates were placed in effect by the various public service commissions. The Company was provided sufficient guarantees from each rate jurisdiction, except the FERC, in rate orders issued by the various jurisdictions that the deferred amounts would be collected in future rates.

The Company didn't have the prerequisite rate recovery assurances from the FERC to support the capitalization and amortization of $1,820,341 of deferred costs recorded in its accounts related to FERC jurisdictional costs.

We recommend that the Company revise procedures to ensure that:

(1) Completed construction projects are classified in the proper accounts.
(2) Adequate regulatory assurance of rate recoverability is present for the accrual of carrying charges and the deferral of costs on property placed in operation and/or ready for service.
(3) Carrying charges and deferred costs are recorded in the proper accounts as described above.
Carrying Charges in Lieu of AFUDC

Accounting for Carrying Charges on Coal Generating Unit

The Company declared Coal Unit No. 3 in commercial operation on January 10, 1984. The Company continued to accrue AFUDC on the portion of its investment in Unit No. 3 regulated by the various state commissions until the unit was included in rates. The carrying charges were recorded in Account 186, Miscellaneous Deferred Debits.

The Company subsequently filed for a change in rates with the Public Service Commission proposing to include Coal Unit No. 3 and related common facilities in rate base. In accordance with an accounting order received from the PSC dated May 1, 1984, the Company continued to accrue AFUDC on Coal Unit No. 3 and related common facilities after January 10, 1984, until the issuance of the PSC's final order on the rate change.

On August 20, 1984, the PSC issued an order concluding that Coal Unit No. 3 capacity was not "actually used and useful" and that AFUDC treatment was not appropriate. However, the Company continued to accrue carrying charges until April 21, 1985. In an order issued on April 22, 1985, the PSC allowed Coal Unit No. 3 and 78 percent of the related common facilities in rate base.

The Company ceased accruing deferred carrying charges on April 21, 1985 on all of Coal Unit No. 3 and common plant, except on 22 percent of common plant attributable to Unit 4 not allowed in rate base.

From January 10, 1984 through April 21, 1985 the Company recorded $570,584 of deferred carrying charges related to Coal Unit No. 3 and related common plant in Account 186, Miscellaneous Deferred Debits. An additional 462,014 of deferred carrying charges were accrued from January 10, 1984 through December 31, 1986, on the 22 percent of common plant attributable to Coal Unit No. 4.

The Other Public Service Commission (OPSC) in an order issued March 20, 1984 (Docket No. 9454) granted the Company only 7.40 percent of the 14.81 percent return on common equity requested in the rate filing. In granting a reduced common equity return the PSC determined that the Company's stockholders should bear Coal Unit No. 3 risk and burden to the extent of a lowered rate of return on equity. From January 10, 1984, when Coal Unit No. 3 was placed in service, through April 30, 1985, the Company deferred carrying charges in Account 186 for the loss it attributed to receiving only one-half of its requested common equity return on Coal Unit No. 3 when it was allowed in rate base.

In a subsequent rate proceeding, the PSC issued an order effective May 2, 1985 allowing one-half of Coal Unit No. 3 in rate base. The PSC approved a carrying charge based upon the overall rate of return on that part of Coal Unit No. 3 not allowed in rate base. The Company continued accruing carrying charges from May 1, 1985 through April 6, 1987 on the portion of its investment in Coal Unit No. 3 not allowed in rate base.

In an order that was effective April 7, 1987 (Docket No. 9454 sub 30) the PSC approved the inclusion of all Coal Unit No. 3 in rate base and permitted the amortization of $3,352,530 of deferred carrying charges accrued from May 1985 through March 1987 in rates over a ten-year period.
DEFERRED ASSETS

Carrying Charges in Lieu of AFUDC

Accounting for Carrying Charges on Coal Generating Unit (Continued)

From January 10, 1984 through April 7, 1987, the Company had recorded $4,641,774 of AFUDC in Account 186, Miscellaneous Deferred Debits. The Company did not adjust the recorded amounts downward by $1,289,244 to reflect the $3,352,530 of carrying charges approved for collection by the PSC.

Under the requirements of the Commission's Uniform System of Accounts, the Company should have ceased the accrual of AFUDC on Coal Unit No. 3 and related common plant facilities effective with the January 10, 1984 in-service date of the unit.

The cost of Unit No. 3 and the facilities common to Coal Unit Nos. 3 and 4 were properly recordable in Account 101, Electric Plant in Service, at the in-service date of Unit No. 3 and AFUDC ceased at such time.

The Commission has approved special accounting to accommodate the ratemaking orders of public utility regulatory commissions in instances when there was sufficient assurance that such actions created regulatory assets that the company would recover in future rates.

The Division of Audits concluded that the accrual of carrying charges on Coal Unit No. 3 and related common plant facilities attributable to PSC jurisdic-
tional portion of Coal Unit Nos. 3 and 4 subsequent to the in-service date was contrary to the requirements of the Uniform System of Accounts. The PSC did not provide the Company with the prerequisite rate recovery assurances that are necessary to support the capitalization of $632,598 carrying charges accrued on Coal Unit No. 3 and related common plant facilities as a regulatory created asset.

The Division of Audits concluded that the accrual of carrying charges for the January 10, 1984 to April 30, 1985 period on the OPSC jurisdiction portion of Coal Unit No. 3 was also contrary to the requirements of the Uniform System of Accounts. The PSC provided the Company with the prerequisite rate recovery assurances that were necessary to support the capitalization and amortization of only $3,352,530 of the $4,641,774 of carrying charges accrued during this period.

We recommend that the Company revise procedures to ensure that (a) adequate regulatory assurance of rate recoverability is present for the accrual of carrying charges on property placed in operation and/or ready for service and (b) the carrying charges are recorded in the proper accounts.
DEFERRED ASSETS

Carrying Charges in Lieu of AFUDC

Accounting for Deferred Costs Related to a Generating Station

The PUC permitted the Company to recover 85 percent of its investment in Unit No. 3 construction, including AFUDC accrued through April 23, 1986. The PUC allowed the Company to accrue carrying costs through June 30, 1986, (the date new retail rates were effective) on the recoverable portion of the plant and include it in rate base. The PUC also allowed in rates all operating and maintenance expenses, including administrative and general expenses, and nuclear fuel relating to Unit No. 3 from April 23, 1986 through June 30, 1986.

In Docket No. ER87-611, the FERC permitted the Company to recover 100 percent of its investment in Unit No. 3 through June 30, 1986.

The Company did the following accounting to reflect the PUC's rate actions:

(1) Reduced the investment in Unit No. 3 by 15 percent reflecting the PUC's action by charging Account 426.5, Other Deductions, and crediting Account 101, Electric Plant in Service.

(2) Accrued carrying charges from April 23, 1986 through June 30, 1986, as a regulatory asset by debiting Account 186, Miscellaneous Deferred Debits, and crediting Accounts 419.1, Allowance for Other Funds Used During Construction, and 432, Allowance for Borrowed Funds Used During Construction-Credit.

(3) Deferred operation and maintenance expenses incurred from April 23, 1986 through June 30, 1986, by debiting Account 186.

(4) Failed to accrue depreciation expense or record the deferral of such amounts for the period April 23, 1986 through June 30, 1986.

(5) Began amortizing amounts deferred in Account 186 over the life of the plant by charging Account 524, Miscellaneous Nuclear Power Expenses.

Under the Commission's accounting requirements, the Company should have ceased accruing AFUDC on its investment in Unit No. 3 at the in-service date of the unit. Also, the Company should have recorded all expenses in operating the unit in the appropriate operation and maintenance expense accounts detailed in the Uniform System of Accounts. Finally, the Company should have begun accruing depreciation on its remaining investment in Unit No. 3 as of the in-service of the unit by charges to Account 403, Depreciation Expense, and credits to Account 108, Accumulated Provision for Depreciation of Electric Utility Plant.

Accounting Release No. AR-5, issued by the Chief Accountant on January 1, 1968, requires that a company cease the accrual of ADUDC when facilities are tested and placed in, or are ready, for service.
DEFERRED ASSETS

Carrying Charges in Lieu of AFUDC

Accounting for Deferred Costs Related to a Generating Station (Continued)

Therefore, the Company should have ceased the accrual of AFUDC (in Accounts 419.1 and 432) on its investment in Unit No. 3 on April 23, 1986. With respect to operation and maintenance expenses, the Commission intended that utilities use the 500 series expense accounts to classify the current costs of operating and maintaining electric utility plant. The Company’s use of Account 524 to amortize the deferred charges was not appropriate since the amortized costs were not current costs.

With respect to depreciation expense, the instructions to Account 108, Accumulated Provision for Depreciation of Electric Utility Plant, states in part:

A(2). . .as provided herein, the service life during which depreciation is computed commences with the date property is includible in electric plant in service.

The Commission has approved special accounting to accommodate the rate actions of public utility regulatory commissions in instances when there was sufficient assurance that such actions created regulatory assets that the company would recover in future rates.

We concluded that the PUC's rate order of Unit No. 3 provided the Company with the necessary assurance of rate recovery to use the following special accounting approved by this Commission in other cases to recognize a regulatory created asset:

(1) Classify all operating expenses, including depreciation, to the appropriate expense account beginning with the in-service date of the unit.

(2) Compute a carrying charge on the portion of the investment in Unit No. 3 subject to the PUC's rate jurisdiction by charges to Account 186 and credits to Account 421, Miscellaneous Nonoperating Income.

(3) Classify the effects of the PUC's approval to defer expensing a portion of the operating expenses by debiting Account 186 and crediting Account 406, Amortization of Electric Plant Acquisition Adjustments.

(4) Amortize the amounts deferred in Account 186 to Account 406 over the period that such amounts are recovered in rate levels. If the cost of deferrals is subsequently disallowed, the Company should remove the unamortized costs included in Account 186 by charging Account 426.5, Other Deductions.

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Deferred Assets

Carrying Charges in Lieu of AFUDC

Accounting for Deferred Costs Related to a Generating Station (Continued)

It was recommended that the Company:

1. revise its procedures to ensure that carrying charges and deferred costs are recorded in the proper accounts as described above; and
2. record a correcting entry to correct the accounts to reflect the proper accounting for the asset created by the rate actions of the PUC.

Accounting for Carrying Charges on Unit No. 6

The State Commission allowed the Company to include 67 percent of the total costs of Unit No. 6 in its rate base on the date the unit was placed in service. The State Commission allowed the Company to continue to accrue AFUDC (carrying charges) on the remaining 33 percent until the costs were included in rate base. The State Commission approved recovery of the deferred carrying charges in rates over a ten-year period.

The Company accounted for the accrual of the carrying charges by debiting Account 186, Miscellaneous Deferred Debits, and crediting Accounts 419.1, Allowance for Other Funds Used During Construction and 432, Allowance for Borrowed Funds Used During Construction. As the Company recovered the costs, it began amortizing the carrying charges deferred in Account 186 to Account 404, Amortization of Limited-Term Electric Plant, over the period authorized for rate recovery.

The Commission's accounting requirements under Electric Plant Instruction No. 3(17) of the Uniform System of Accounts restrict the use of Accounts 419.1 and 432 to the recording of AFUDC on projects actively under construction.

The Commission and its Chief Accountant have approved special accounting to accommodate the ratemaking orders of public utility regulatory commissions in instances when there was sufficient assurance such actions created regulatory assets that the Company would recover in future rates. Under the special accounting approved by the Commission and its Chief Accountant for regulatory created assets, a company receiving approval from its regulatory commission to accrue carrying charges should record the amounts by debiting Account 186 and crediting Account 421, Miscellaneous Nonoperating Income. Also, under the Commission's accounting regulations, a company would amortize the regulatory created asset recorded in Account 186 by charges to Account 406, Amortization of Electric Plant Acquisition Adjustments.

It was recommended that the Company:

1. revise accounting procedures to properly account for the accrued carrying charges resulting from the action of the State Commission; and
2. record memorandum entries for prior periods to properly reflect the accrual of the carrying charges on Unit No. 6 and the related amortization to the proper accounts.
DEFERRED ASSETS

Carrying Charges in Lieu of AFUDC

Accounting for the Investment in a Generating Unit

The Company's accounting for its investment in a Coal Generating Station was deficient as follows:

(1) it improperly reversed depreciation expense accrued on its investment; and

(2) it retroactively accrued carrying charges on its investment.

The station met the in-service criteria on May 21, 1985. On May 21, 1985, the Company transferred its investment from Account 107, Construction Work in Progress-Electric, to Account 101, Electric Plant in Service, and it ceased capitalizing allowance for funds used during constructions (AFUDC) and operating expenses. Also, it commenced recording depreciation expense.

The Public Service Commission authorized the Company to continue to record AFUDC and defer depreciation on the unit until October 28, 1985. Subsequently, the Company reversed depreciation expense on the PSC portion of the recorded cost of the unit between May 22, 1985 and October 28, 1985, by debiting Account 108, Accumulated Provision for Depreciation of Electric Utility Plant, and crediting Account 403, Depreciation Expense. Also, the Company capitalized AFUDC from May 22, 1985 to October 28, 1985, by debiting Account 107, Construction Work in Progress-Electric, and crediting Accounting 419.1, Allowance for Other Funds Used During Construction and Account 432, Allowance for Borrowed Funds Used During Construction.

Under the Commission's accounting requirements, the Company should not have retroactive accrued AFUDC on its investment in the station after the in-service date. Also, the Company should have continued accruing depreciation on its entire investment in the station during the period May 22, 1985 through October 28, 1985, by charges to Account 403, Depreciation Expense, and credits to Account 108, Accumulated Provision for Depreciation of Electric Utility Plant.

Electric Plant Instruction No. 3(17) addresses the proper period for the accrual for AFUDC:

Allowance for funds used during construction includes the net cost for the period of construction . . . . [emphasis added]

Furthermore, Accounting Release No. AR-5 requires that a company cease the accrual of AFUDC when facilities are tested and placed in or are ready for service.

Therefore, the Company should have ceased the accrual of AFUDC (in Accounts 419.1 and 432) on its investment in Unit No. 3 on April 23, 1986.

The Commission has approved special accounting to accommodate the rate actions of public utility regulatory commissions in instances when there was sufficient assurance that such actions created regulatory assets that the company would recover in future rates.
Carrying Charges in Lieu of AFUDC

Accounting for the Investment in a Generating Unit (Continued)

The special accounting would require a company to adopt the following procedures:

1. Transfer the entire investment related to a completed project from Account 107 to Account 101 at the time of the in-service date.

2. Compute and record depreciation on the entire cost of facility by charges to Account 403, Depreciation Expense and credits to Account 108, Accumulated Provision for Depreciation of Electric Utility Plant.

3. Record operation and maintenance, expenses in Accounts 401, Operation Expense and 402, Maintenance Expense.

4. Recognize the effects of the regulatory created asset by debiting Account 186, Miscellaneous Deferred Debits, and crediting Account 406, Amortization of Electric Plant Acquisition Adjustments, in an amount equal to the depreciation expense deferred for future collection.

5. If also permitted by the regulatory commission, accrue a carrying charge (and not AFUDC) by debiting Account 186, Miscellaneous Deferred Debits, and crediting Account 421, Miscellaneous Nonoperating Income, for any regulatory commission approved carrying costs.

6. Amortize the amount deferred in Account 186 to Account 406 over the period recovered in rate levels. If, in the event the cost deferrals are subsequently disallowed, the unamortized cost included in Account 186 should be charged to Account 426.5, Other Deductions.

The PSC provided sufficient guarantees in its rate order to ensure that the Company would collect the deferred amounts in future rates. Therefore, the Company should have used the special accounting discussed above with respect to depreciation expense and carrying charges computed on the station from May 22, 1985 until the PSC placed the revised rates in effect.

It was recommended that the Company:

1. revise procedures to ensure that carrying charges and depreciation are recorded in the proper accounts as described above; and

2. record correcting entries to reclassify the regulatory created asset related to the rate action of the PSC to the proper accounts and to record the proper amortization through December 31, 1988.
Carrying Charges in Lieu of AFUDC

Accounting for Carrying Charges and Sale/Leaseback Deferrals Related to Unit Nos. 1 and 2 and Common Plant

The Company used the wrong accounts to classify post-operational cost deferrals and related carrying charges.

The Company received approval from the FERC and state regulatory commissions to recover certain deferred operating expenses and carrying charges in connection with the in-service date of Unit No. 1 and 2, common plant and sales and leaseback of Unit No. 2.

The Company used the following accounting to record the post-operational cost deferrals:

(1) It recorded the deferral of operating costs related to Unit Nos. 1 and 2 and common plant by charging Account 186, Miscellaneous Deferred Debits, and crediting the various operation, maintenance and administrative expense accounts.

(2) It recorded the deferral of miscellaneous lease costs related to Unit No. 2 by charging Account 186 and crediting Account 525, Rents.

(3) It accrued carrying charges by debiting Account 186 and crediting Account 419.1, Allowance for Other Funds Used During Construction and Account 432, Allowance for Borrowed Funds Used During Construction–Credit.

(4) It recorded depreciation on the portion of Unit No. 1 and common plant subject to the FERC jurisdiction beginning with the in-service date of facilities and postponed commencing depreciation on the portion subject to state jurisdiction until the effective date the Company included that portion in rates.

Under the requirements of the Commission's Uniform System of Accounts, the Company should have recorded all expenses in operating the facility in the appropriate operating expense accounts beginning with the in-service date of Unit Nos. 1 and 2.

With respect to the accounting for Allowance for Funds Used During Construction (AFUDC,) Accounting Release No. AR-5, issued by the Chief Accountant on January 1, 1968, requires a company stop accruing AFUDC when facilities have been tested and are placed in, or are ready for, service.

The Commission has approved special accounting to accommodate the ratemaking orders of public utility regulatory commissions in instances when there was sufficient assurance that such actions created regulatory assets that the company would recover in future rates.
DEFERRED ASSETS

Carrying Charges in Lieu of AFUDC

Accounting for Carrying Charges and Sale/Leaseback Deferrals Related to Unit Nos. 1 and 2 and Common Plant (Continued)

The special accounting would require the Company to adopt the following procedures:

(1) record operation, maintenance and taxes in the appropriate operating expense accounts;

(2) record depreciation on the entire cost of Unit No. 1 and common plant effective with the in-service date of the facilities by charging Account 403, Depreciation Expense, and crediting Account 108, Accumulated Provision for Depreciation of Electric Utility Plant;

(3) recognize the effects of the regulatory created assets by debiting Account 186, Miscellaneous Deferred Debits, and crediting Account 406, Amortization of Electric Plant Acquisition Adjustments, in an amount equal to the deferred operating expenses; and

(4) accrue a carrying charge (and not AFUDC) by debiting Account 186 and crediting Account 421, Miscellaneous Nonoperating Income, for any regulatory commission approved carrying charges.

The FERC approved the above accounting guidelines in Opinion No. 279, issued to the Union Electric Company on July 20, 1987.

It was recommended that the Company:

(1) revise its procedures to properly record cost deferrals and carrying charges approved by regulatory commissions as follows:

   (a) charging the various operating expense accounts for all operating expenses and crediting Account 406 for any authorized cost deferrals;

   (b) accruing carrying charges as permitted by each of the regulatory commissions by crediting Account 421 rather than using Accounts 419.1 and 432; and

   (c) amortizing the deferred amounts to Account 406 over the period approved for rate recovery.

(2) record the necessary memorandum entries to correct its accounts for the deferral of post operational costs and carrying charges related to Unit Nos. 1 and 2.
DEFERRED ASSETS

Carrying Charges in Lieu of AFUDC

Accounting for Post-Operational Cost Deferrals

The Company used the wrong accounts to classify a portion of its investment, post-operational cost deferrals and related carrying charges related to Unit No. 3. Unit No. 3 met the accounting in-service date on January 7, 1988.

The Company transferred the portion of its investment in Unit No. 3 subject to the jurisdiction of the FERC and the Public Service Commission (PSC) to Account 101, Electric Plant in Service, at the accounting in-service date. It began expensing the operation and maintenance costs and commencing depreciation on the portion of the unit subject to the jurisdiction of the FERC and the PSC. Also, the Company stopped the accrual of allowance for funds used during construction (AFUDC) on the portion of the unit subject to FERC and PSC jurisdiction.

Although the plant was in-service, the Company continued to record the portion of the Unit No. 3 investment subject to the rate jurisdiction of the Public Utility Commission (PUC) in Account 107, Construction Work in Progress-Electric. It continued to capitalize a portion of the operation and maintenance costs on the unit and accrue AFUDC after the in-service date by charging Account 107. Also, the Company did not begin depreciation on the portion of the unit subject to the PUC's jurisdiction.

The PUC concluded that Unit No. 3 did not meet the PUC's in-service criteria. The PUC ordered the Company to consider the unit in construction until the completion of the Interconnection Project anticipated for 1989.

Since Unit No. 3 was in-service on January 7, 1988, the unit no longer met the accounting requirements for classification as construction work in progress. With respect to the accounting for AFUDC, Electric Plant Instruction No. 3(17) of the Uniform System of Accounts, the requirements for AFUDC were not met.

Accounting Release No. AR-5, issued by the Chief Accountant on January 1, 1968, requires a company to stop accruing AFUDC when facilities are tested and placed in, or are ready, for service.

Commission regulations contemplate that depreciation commences when a plant facility is determined to be in service.

The Commission has approved special accounting to accommodate the ratemaking orders of public utility regulatory commissions in instances when there was sufficient assurance that such actions created assets that the company would recover in future rates.
Carrying Charges in Lieu of AFUDC

Accounting for Post-Operational Cost Deferrals (Continued)

The special accounting would require the Company to adopt the following procedures:

1. transfer the entire investment related to a completed project from Account 107 to Account 101 (or Account 106, Completed Construction Not Classified) at the time of the in-service date;

2. record depreciation on the entire cost of the facility by charges to Account 403, Depreciation Expense, and Account 108, Accumulated Provision for Depreciation of Electric Utility Plant;

3. record operation, maintenance and taxes in the appropriate operating expense accounts;

4. recognize the effects of the regulatory created asset by debiting Account 186, Miscellaneous Deferred Debits, and crediting Account 406, Amortization of Electric Plant Acquisition Adjustments, in an amount equal to the deferred operating expenses; and

5. accrue a carrying (and not AFUDC) by debiting Account 186 and crediting Account 421, Miscellaneous Nonoperating Income, for any regulatory commission approved carrying charge.

We concluded that the Company had the necessary rate assurances to support deferral of the post-operational costs and carrying charges. Therefore, the Company should have followed the above accounting for the post-operational costs deferrals and carrying charges related to Unit No. 3.

It was recommended that the Company:

1. revise its procedures to properly account for regulatory created assets resulting from the deferral of costs incurred after the plant in-service date as follows:

   a. classify the investment in Account 101 at the in-service date;

   b. charge the various operating expense accounts for all operating expenses and credit Account 406 for any authorized cost deferrals;

   c. accrue carrying charges as permitted by each of the regulatory commissions by crediting Account 421 rather than using Accounts 419.1 and 432; and

   d. amortize the deferred amounts to Account 406 over the period approved for rate recovery.

2. record the necessary memorandum entries to correct its accounts for the deferral of post operational costs and carrying charges related to Unit No. 3.
 Regulatory Assets/Regulatory Liabilities

Accounting for Regulatory Study Costs

The Company owns a 25.2 percent interest in the nuclear project. In 1986 the Public Utility Commission (PUC) began a proceeding for the purpose of determining the prudence and efficiency of the planning, management and construction of the nuclear station.

Also, in March 1985 the PUC initiated a proceeding for the purpose of gathering evidence concerning the economic viability of Unit No. 2.

The Company directly incurred approximately $7.3 million of expenditures related to the prudence inquiry on Unit No. 1 and the viability studies on Unit No. 2. It initially recorded the $7.3 million, plus $434,000 of allowance for funds used during construction (AFUDC), in Account 107, Construction Work in Progress - Electric. In February and March 1988 the Company reclassified the $7.3 million to Account 186, Miscellaneous Deferred Debits. The Company did not transfer the related AFUDC. The Company intends to apply for rate recovery of the deferred costs recorded in Account 186.

It was inappropriate for the Company to include the $7.3 million of expenses related to hearings before the regulatory commission in Account 107.

EPI No. 3 does not list expenses related to regulatory proceedings as includible construction costs.

The instructions to Account 928, Regulatory Commission Expenses, state in part:

A. This account shall include all expenses ... incurred by the utility in connection with formal cases before regulatory commissions, or other regulatory bodies, ....

B. Amounts of regulatory commission expenses which by approval or direction of the Commission are to be spread over future periods shall be charged to Account 186, Miscellaneous Deferred Debits.

We concluded that the Company's decision to reclassify the $7.3 million of expenditures related to the PUC proceedings to Account 186 until they could apply for rate recovery appeared reasonable. In the event that rate recovery is denied, the Company should write-off the costs immediately to Account 426.5, Other Deductions.

Because the regulatory commission expenses are not properly includible in Account 107 as a cost of construction, the Company should not have capitalized AFUDC on such amounts.

The Company was required to record a correcting entry to reclassify $6,218,853 of expenditures related to the prudence inquiry to the proper account and to reverse all AFUDC improperly accrued thereon.
DEFERRED ASSETS

Regulatory Assets/Regulatory Liabilities

Accounting Classification for Ratemaking Assets

During 1986 and 1987, the Company incurred $7,061,519 of expenses for rotobeening (the high speed bombardment of the internal portions of the pipes in the steam generators with small metal balls, as a means to stop or prevent stress cracking in the pipes.)

The Public Service Commission authorized the Company to amortize the charges in rates over the remaining life of the plant.

The Company deferred the rotobeening expenses in Account 186, Miscellaneous Deferred Debits, and was amortizing the amounts by debiting Account 404, Amortization of Limited-Term Electric Plant, and crediting Account 111, Accumulated Provision for Amortization of Electric Utility Plant.

The rotobeening charges are maintenance items that the Company would normally expense as incurred, except for rate assurances provided by the PSC. The Commission has approved special accounting to accommodate the rate actions of regulatory commissions. Under the special accounting, the Company should amortize the regulatory created asset by charges to Account 406, Amortization of Electric Plant Amortization Adjustments, and credits to Account 186. However, since rotobeening is a maintenance procedure, Account 531, Maintenance of Electric Plant may be charged with the amounts recorded in Account 186, as amortized in lieu of using Account 406.

The Company was required to (1) revised procedures to ensure that regulatory created assets are amortized to the appropriate account according to the requirements of the Uniform System of Accounts, and (2) Record an entry to reclassify the accumulated amortization from Account 111 to Account 186.
DEFERRED ASSETS

Pensions

Accounting for Pension Cost

The Company made a number of changes in accounting for pension cost. In 1985, the Company's pension plan was merged with that of its parent company and the following changes were made: (1) the method of determining pension cost was changed from a Projected Unit Cost Credit Method to an Entry Age Normal Frozen Initial Liability method, (2) the pension benefit formula was changed, and (3) certain assumptions used in determining pension costs were changed (i.e. investment return, salary escalation rate, et. al.). Recorded pension expense in 1985 decreased by $7.5 million from 1984 (from $18.3 million to $10.8 million) primarily as a result of the aforementioned changes in methods and assumptions. However, the level of pension expenses included in the Company's rate filing for rates effective during 1985 of $16 million, did not reflect the 1985 changes in methods and assumptions of determining pension expenses.

Effective January 1, 1986, the Company adopted the provisions of Statement of Financial Accounting Standards No. 87, Employer's Accounting for Pensions (SFAS No. 87). The Company's recorded pension expenses decreased between 1985 and 1986 by $8.3 million (from $10.8 million in 1985 to $2.5 million in 1986).

The Company did not establish a liability to reflect possible future action by the FERC to capture, for the benefit of the Company's ratepayers, any differences between pension cost determined for accounting purposes and that allowed in establishing the Company's rates. To date the Commission has not issued a policy statement addressing the appropriateness of SFAS No. 87 for ratemaking purposes. Without a definitive position from the Commission, DOA lacks a supportable basis for objecting to the Company's accounting for pension costs during the audit period, and therefore has not proposed any corrective recommendations.
Pensions

Accounting for Pension Costs

The Company did not establish a ratemaking liability in its accounts when it adopted the principles of SFAS No. 87 effective January 1, 1987.

The Company made a change in accounting for pension expense beginning in 1986. Prior to 1986, the Company had used the aggregate cost actuarial method to determine the amount of pension cost for accounting purposes. In Docket RP83-104, the Company filed its proposed rates based upon pension costs included in its accounts. Pension costs were not at issue in this docket.

In 1986 the Company changed its actuarial cost method for accounting purposes, going from the aggregate cost method to the projected unit credit method. In 1987 the Company adopted prospectively the Financial Accounting Standards Board Statement No. 87, Employers' Accounting for Pensions.

The Company made a rate filing with the Commission in 1986. Article VI of the Stipulation and Agreement that settled this docket (effective January 1, 1987) had the following provision addressing pension cost:

The Company is currently using the "projected unit credit" actuarial method to calculate its pension plan funding needs. ... If the Company, in adopting FAS No. 87, changes its method of calculating its pension funding needs, and/or the accounting for the pension plan costs, the Company will report complete details on such changes in the method of calculating, and/or the accounting for the pension funding needs and also the funding level in its next filed rate case.

Based upon the terms of the above Stipulation and Agreement, DOA concluded that it did not have a basis for taking exception to the changes the Company made in its accounting for pension expense during the audit period.
DEFERRED ASSETS

Pensions

Accounting For Pension Expense

The Company had two deficiencies in its accounting for pension expense recorded in Account 926, Employee Pensions and Benefits.

The Company participates in a separate pension plan for the regulated entities of its parent. The plan is under the direction of an affiliate.

The Company charged its allocated portion of the amount funded each year to Account 926. The amount allocated to the Company included the following provisions:

(1) A one-time funding of $4.5 million to cover the cost of a special early retirement program that was available to certain affiliate employees.

The Commission concluded that it was inappropriate to charge pension expense for any portion of the cost of the special retirement program since the Company's employees did not participate in the program. The Company should have recorded the $48,186 assigned for this program in 1987 to Account 426.5, Other Deductions.

(2) A change in policy to begin funding an amount of postemployment benefits for retired and current employees.

The policy prior to 1987 was to charge postemployment benefits for retired persons to expense on a "pay as you go" basis. In 1987 the Company changed its policy and began funding postretirement benefits. The Company recorded the additional payment in Account 926, Pensions and Employee Benefits.

We concluded that it was not appropriate for the Company to recognize any additional expense related to the change in policy for postemployment benefits in billings to customers without specific Commission approval.

The Commission has approved the Company's rates based upon the "pay-as-you-go" method of recognizing all postemployment benefits and in our opinion, the Company should not automatically reflect the change in funding policy in billings to customers without specific Commission approval.

The Company was required to:

(1) revise procedures to ensure that amounts charged to Account 926 are limited to costs that are properly assigned to Company operations and have previously received Commission approval.

(2) record an entry correcting the accounting for the allocated cost of both the early retirement program and the funding of postemployment benefits.

(3) recompute tariff billings for pension and benefit costs consistent with the above discussion and make appropriate refunds, with interest, for any overcollected amounts.
Other

Distribution of Building Service Expense

The Company accumulated in Account 184, Clearing Accounts, building service expenses. These expenses were distributed on a monthly basis to certain operating expense accounts under each functional group. The expenses were distributed on a square footage basis determined by the amount of space used by each functional group.

The Company could not provide staff with a current study used to determine the percentage allocation to each functional group.

The Company was required to perform a study, on a periodic basis, to determine the proper allocation of building service expenses accumulated in Account 184.

Use of Account 184, Clearing Accounts

The Company accumulated in a subaccount of Account 184, Clearing Accounts, expenditures applicable to building services and administration. Such expenditures included salaries of building management personnel, general repairs, lawn maintenance, janitorial services, parking lot and plaza maintenance. These charges were then allocated monthly to various operating expense accounts.

A substantial portion of these costs were allocated to Account 921, Office Supplies and Expenses. NARUC Interpretation No. 32 states, "No salaries or wages of any kind should be charged to Account 921, Office Supplies and Expenses." NARUC Interpretation No. 31 states, "Wages paid to janitors and other building service employees should be distributed as far as practicable to the appropriate operating expense account under the functional groups..." Such wages applicable to buildings used for customer accounts, sales and administrative and general functions should be charged to Account 920, Administrative and General Salaries.

In addition, NARUC Interpretation No. 29 states, "The cost of maintaining a parking lot should be charged to Account 932, Maintenance of General Plant."

In the future, the Company was required to comply with the accounting as set forth in the NARUC Interpretations noted above.
DEFERRED ASSETS

Other

Accounting for Cancellation Costs

The Company initially transferred certain costs related to Nuclear Unit No. 2 to Account 182, Extraordinary Property Losses. The costs recorded in Account 182 were allowed in rates. On January 27, 1982, the Company received approval from the Commission's Chief Accountant to record these costs in Account 182, Extraordinary Property Losses.

Subsequent to the transfer to Account 182, it was determined that an additional cost amounting to $50 million should be assigned from the cost of Unit No. 1 to the cancelled Unit No. 2. The Company did not reclassify the additional $50 million from Account 101 to Account 182. The Company has sought rate recovery of the additional amounts in rates.

At December 31, 1985, the Company included approximately $100 million in Account 186 that represents additional costs of Unit No. 2 that were not currently included in rate levels. The Company plans to request rate recovery of the $100 million in subsequent rate proceedings.

Commission Order No. 390, effective January 1, 1984, established Account 182.2, Unrecovered Plant and Regulatory Study Costs. The instructions to Account 182.2 state in part:

A. This account shall include: (1) nonrecurring costs of studies and analyses mandated by regulatory bodies related to plants in service, transferred from Account 183, Preliminary Survey and Investigation Charges, and not resulting from construction, and (2) when authorized by the Commission, significant unrecovered costs of plant facilities where construction has been cancelled or prematurely retired.

The Company should classify all amounts related to the cancelled Unit No. 2 to Account 182.2. In the event that the rate recovery assurances are not obtained with respect to any amounts related to Unit No. 2, the Company should expense any unrecoverable amounts by charges to Account 426.5, Other Deductions, in the year of disallowance.

The Company was required to revise procedures to comply with the instructions of Account 182.2 of the Uniform System of Accounts.
Other

Costs Related to Preliminary Survey and Investigation Projects

The Company charged the legal and engineering expenses associated with active preliminary surveys and investigation projects to Account 923, Outside Services Employed.

The Uniform System of Accounts Instruction A of Account 183, Preliminary Survey and Investigation Charges, states, "This account shall be charged with all expenditures for preliminary surveys, plans, investigations, etc., made for the purpose of determining the feasibility of utility projects under contemplation. If construction results, this account shall be credited and the appropriate utility plant account charged. If the work is abandoned, the charge shall be made to Account 426.5, Other Deductions, or to the appropriate operating expense account."

In the future, the Company was required to record all charges associated with preliminary surveys and investigation projects in Account 183 as required by the Uniform System of Accounts.

Preliminary Survey

The Company had recorded in Account 183, Preliminary Survey and Investigation Charges, the cost of preliminary engineering incurred for a future coal fired station. The project was deferred for at least 10 years. Since the project was delayed, the cost without future value should not be included in this account. The adjusting entry records in Account 186 the costs without future value pending action by the Public Utility Commission on the Company's request to amortize these costs in rates.

Retroactive Accounting for PS&I Costs Previously Written-Off

The Company wrote off preliminary survey and investigation charges (Account 183) to Account 930.2, Miscellaneous General Expenses. In a subsequent rate increase filing, the write-off was normalized and a three-year amortization period was allowed.

The Company recorded an entry which reversed the write-off, and reinstated the total amount written-off during 1978. A subsequent amortization then followed.

Electric Plant Instruction No. 1B prohibits such retroactive accounting. Also see General Instruction No. 7.1(B).
DEFERRED ASSETS

Other

Recording of Expenses of Temporary and Minor Incidental Services

The Company's procedure was to record charges for labor, materials and expenses incurred in relation to temporary facilities and minor or incidental services in Account 451, Miscellaneous Service Revenues, and Account 456, Other Electric Revenues, respectively.

The Uniform System of Accounts provides that Account 185, Temporary Facilities, include, ".....Amounts shown by work orders for plant installed for temporary use in utility service for periods of less than one year. Such work orders shall be charged with the cost of temporary facilities and credited with payments received from customers and net salvage realized on removal of the temporary facilities. Any net credit or debit resulting shall be cleared to Account 451, Miscellaneous Service Revenues."

Account 587, Customer Installation Expenses, provides that "Amounts billed to customers for any work, the cost of which is charged to this account, shall be credited to this account. Any excess over costs resulting therefrom shall be transferred to Account 451, Miscellaneous Service Revenues."

The Company was required to charge labor, materials and expenses incurred for temporary and minor or incidental services to Account 185, Temporary Facilities, and Account 587, Customer Installation Expenses, respectively. The excess over costs should be recorded in Account 451, Miscellaneous Service Revenues, and Account 456, Other Electric Revenues.

Accounting for Temporary Facilities

The Company accounted for the installation and removal of temporary facilities by recording the cost in Account 101, Electric Plant in Service, and Account 108, Accumulated Provision for Depreciation of Electric Utility Plant. Any net gain or loss resulting from this transaction remained recorded in Account 108. Most of the temporary facilities remained in-service less than one year. However, during the in-service period depreciation was calculated and recorded on amounts included in Account 101.

The instruction to Account 185, Temporary Facilities, states, "This account shall include amounts shown by work orders for plant installed for temporary use in utility service for periods of less than one year. Such work orders shall be charged with the cost of temporary facilities and credited with payments received from customers and net salvage realized on removal of the temporary facilities. Any net credit or debit resulting shall be cleared to Account 451, Miscellaneous Service Revenues."

The Company was required to establish procedures to record the cost of installation and removal of temporary facilities in Account 185 as required by the Uniform System of Accounts.
DEFERRED ASSETS

Other

Misclassification of Costs of Temporary Facilities

The Company recorded charges for labor, materials, and expenses incurred to install temporary facilities in Account 456, Other Electric Revenues. The Uniform System of Accounts provides that Account 185, Temporary Facilities, include "...amounts shown by work orders for plant installed for temporary use in utility service for less than one year. Such work orders shall be charged with the cost of temporary facilities and credited with payments received from customers and net salvage on removal of the temporary facilities. Any net credit or debit resulting shall be cleared to Account 451, Miscellaneous Service Revenues."

In the future, the Company was required to account for temporary facilities in accordance with the Uniform System of Accounts.

Accounting for Interest Earned on Insurance Proceeds

Property insurance proceeds were deposited with a trustee by the insurance company. The monies were subsequently drawn down from the trustee by the Company when expended for repair of damages or construction of other facilities which are bondable. Interest income was earned on the insurance proceeds while on deposit with the trustee.

The interest earned on the insurance proceeds was accounted for as interest income in Account 419.

In staff's opinion, monies received by the Company as a result of damages, including interest earned on funds deposited with the trustee, should be credited to Account 186 as an offset to the accumulated costs of the repair effort.

Financing Charges in Account 186, Miscellaneous Deferred Debits

Included in Account 186, Miscellaneous Deferred Debits, were preliminary charges for a financing arrangement with a group of banks in which the banks would lend money to the Company and the Company would use the money to enter into an interest rate exchange. This financing arrangement is no longer being actively pursued.

The text of Account 426.5, Other Deductions, provides accounting for the above preliminary type charges which cannot be properly written off to an operating expense account.

The Company was required to write off these charges to Account 426.5 for financing arrangements no longer being pursued.
DEFERRED ASSETS

Other

Accounting for Contract Work

The Company records in Account 186, Miscellaneous Deferred Debits, expenses and revenues associated with miscellaneous service work done for customers or other companies. The staff's examination disclosed that after consideration of revenues received, the remaining costs in certain job orders were transferred to Account 107, Construction Work in Progress - Electric, for redistribution to electric construction projects. The amounts transferred to Account 107 represented either unbillable overheads or overheads which were erroneously assigned to billing job orders in the first place.

Electric Plant Instruction No. 4 states: "All overhead construction costs...shall be charged to particular jobs or units on the basis of the amounts of such overheads reasonably applicable thereto..." In staff's opinion, overheads properly assigned to contract work, but unbillable, cannot be considered "reasonably applicable" to electric utility construction projects and therefore should not be included in Account 107. The Uniform System of Accounts requires costs of this nature to be included in Account 416, Costs and Expenses of Merchandising, Jobbing and Contract Work.

The Company was required to revise its accounting procedures to insure that miscellaneous billing job orders are only charged for those overheads reasonably applicable thereto. Any amounts remaining after consideration of all revenues and expenses related to work performed should be accounted for in accordance with the requirements of the Uniform System of Accounts.

Accounting for Preliminary Survey and Investigation Charges

The Company transferred preliminary survey cost related to several cancelled projects from Account 107 to Account 186, Miscellaneous Deferred Debits. The Company is amortizing the cancelled project costs to operating expense in accordance with the ratemaking orders of the Public Utility Commission.

The instructions to Account 182.2, Unrecovered Plant and Regulatory Study Costs, state in part:

A. This account shall include the cost: ... (2) when authorized by the Commission, significant unrecovered costs of plant facilities where construction has been cancelled or which have been prematurely retired.

The Company should also have requested Commission approval to defer all cancelled project costs to Account 182.2.

The Company was required to record an entry to reclassify the costs of previous cancelled projects that are subject to rate recovery to Account 182.2.
Abandoned Scrubber Study Cost Included in R&D

The Company has deferred in Account 188, Research, Development and Demonstration Expenditures, $5,745,941 incurred on research and development regarding a new dry scrubber technology. Facts have shown that the scrubber will not work. The Company's planned accounting for the abandoned and nonrecurring dry scrubber demonstration unit research phase costs is to include these costs as part of the wet scrubber system that now will be built.

Account 188, Paragraph C, states in certain instances a company may incur large and significant research, development, and demonstration expenditures which are nonrecurring and which would distort the annual research, development, and demonstration charges for the period. In such a case the portion of such amounts that cause the distortion may be amortized to the appropriate operating expense account over a period not to exceed 5 years unless otherwise authorized by the Commission.

The Company was required to begin amortizing the $5,745,941 of deferred research and development costs over a five year period to the appropriate operating expense account.

Accounting for Cost of Abandoned Projects

The Company did not obtain Commission approval to record costs of an abandoned project in Account 182.2, Unrecovered Plant and Regulatory Study Costs.

The Company was a part owner of a proposed coal plant to be constructed. The owners abandoned the project.

The Company recorded its share of the abandoned project costs in Account 186, Miscellaneous Deferred Debits. The Public Service Board allowed the Company to amortize the costs to operating expense over a five-year period. The Company reclassified the costs from Account 186 to Account 182.2.

The instructions to Account 182.2 state in part:

A. This account shall include . . . when authorized by the Commission, significant unrecovered costs of plant facilities where construction has been cancelled or which have been prematurely retired . . . [emphasis added]

The Company did not receive Commission approval to reclassify the costs to Account 182.2. The Company should obtained the approval of the Commission prior to reclassifying the costs of the abandoned project from Account 186 to Account 182.2.

It was recommended that the Company revise procedures to ensure that it obtains Commission approval before recording future costs of a similar nature in Account 182.2.
CHAPTER 7

TAXES OTHER THAN INCOME

Failure to Allocate Property Taxes to Account 408.2

The Company did not charge property taxes on nonutility property to Account 408.2, Taxes Other Than Income Taxes, Other Income and Deductions, but instead included these taxes in Account 408.1, Taxes Other Than Income Taxes, Utility Operating Income.

Instructions to Account 408.2 provide that this account be charged with taxes other than income taxes which relate to other income and deductions.

In the future, Company was required to charge Account 408.2 for property taxes applicable to nonutility property.

Procedures Related to the Capitalization of FICA Taxes

The Company's procedures for determining the rate for loading payroll charges to construction work orders to capitalize FICA taxes disclosed that during the first quarter, a loading rate of 6.95% was utilized, whereas, the statutory FICA rate was only 6.65%.

The Company was required to revise its procedures to ensure that the FICA loading rate never exceeds the statutory rate in the future.

Accounting for Annual Assessment Fees

The Company was assessed annually by the Public Service Commission for an amount to cover the general operating costs of that regulatory body. This assessment in the past, was charged to Account 928, Regulatory Commission Expenses.

The text of National Association of Regulatory Utility Commissioners (NARUC) Interpretation No. 4, states, "remainder assessments made on behalf of state regulatory bodies for general purposes of public utility regulation which are not identified with specific services performed in special or formal cases shall be charged to Account 408, Taxes Other Than Income Taxes."

In the future, the Company was required to charge Account 408.1 with the payments made to cover its general operating costs.
Gross Receipts Tax

The Company changed their method of accounting for gross receipts tax. Prior to the change, the Company expensed gross receipts tax based on the previous year's revenue. The Company started to expense gross receipts tax based on current year revenue under the new method. The Company recognized the gross receipts tax applicable to 1977 revenue as a prepayment to be amortized over a ten-year period. The recovery of the 1977 gross receipts tax recorded in a prepaid account was addressed in the state Rate Case Order, issued December, 1979. Recovery was disallowed.

As recoverability of the 1977 Gross Receipts Tax had been disallowed by the Public Service Commission in establishing rates, the Company was required to record an entry to charge to Account 408.1, Taxes Other Than Income Taxes, Utility Operating Income, gross receipts tax recorded in Account 165, Prepayments, for which rate recovery has been denied.

Failure to Adjust Property Tax Accruals to Actual Amounts

The Company charged property taxes to Account 107, Construction Work in Progress-Electric, 408.1, Taxes Other Than Income Taxes, Utility Operating Income, Steam Heating Department and 408.2, Taxes Other Than Income Taxes, Other Income and Deductions, based on estimates of such amounts.

When final information was received related to the proper amount of property taxes, the Company recorded its adjustment between the estimated and actual amounts to Account 408.1, Taxes Other Than Income Taxes, Utility Operating Income, without adjusting amounts chargeable to Accounts 107, 408.2 or 408.1, Steam Heating Department to reflect the actual amounts chargeable thereto. The special instructions to Accounts 408.1 and 408.2 required the Company to charge the related construction accounts, utility department and nonutility operations with the actual amount of taxes related thereto. In the future, the Company was required to adjust its procedure of accounting for property taxes so as to charge each account or function with the actual amount of tax related thereto. Amounts overcapitalized as a result of the Company's procedure were not so large as to warrant adjustment of the plant accounts.
Need to Revise Method of Accounting for Public Utility Excise Taxes on Wholesale Revenues

The Company followed the practice of charging Public Utility Excise Taxes to operations over a twelve-month period beginning May 1, of a year. The taxes were based on gross receipts collected in the previous twelve months ending April 30.

The staff noted that for wholesale ratemaking purposes, the excise taxes were a calculated amount which was added to the revenue requirement after all other components thereof were determined. In addition the staff noted that the wholesale fuel adjustment clauses provided for the excise taxes to be added to amounts collected through the clauses. The Company billed the excise taxes to its wholesale customers on a current basis, and accordingly should have recognized such taxes as an expense when billed.

The Company was required to revise its accounting for Public Utility Excise Taxes applicable to wholesale customers so as to recognize the taxes as an expense when revenues including such taxes are billed to wholesale customers, and record an entry to adjust the accounts to reflect the expensing of the Public Utility Excise Taxes on a current basis and to record the related income tax effects applicable to FERC jurisdictional customers.
CHAPTER 8

INCOME TAXES

CURRENT INCOME TAXES

Improper Accounting for Entries to Adjust Accrued Income Taxes to Actual per the Return

In recording the entries to adjust the accrued income taxes to actual per the income tax return, the Company debited or credited Account 236, Taxes Accrued, with the contra entry to the appropriate account for accumulated deferred income taxes. No entry was made to the income statement in recording the adjustments. By recording the adjustments as indicated above, the Company never properly stated the current and deferred income tax expense accounts.

The instructions of the Uniform System of Accounts requires that the adjustments of accrued income taxes to actual be made by adjusting the current tax accrual. In order to correctly account for these adjustments, the appropriate entries must be recorded in the current and deferred income tax expense accounts.

The Company was required to record the entries to adjust the accrued income taxes to actual per the return through the income statement.

Income Tax Accruals Not Adjusted

An examination of income tax accruals (Federal and State) recorded in Account 236, Taxes Accrued, indicated that the Company did not adjust over/under accruals for years when Revenue Agent Reports (RARs) were issued nor when such years were settled and closed by the Internal Revenue Service (IRS).

The text of Account 236 states that adjustments of tax accruals should be made from time to time when facts become known so that charges to income tax expense and credits to Account 236 include as close as possible the actual tax liability incurred. Maintaining accruals for prior years' taxes which cannot be supported by contingencies is unwarranted.

The Company was required to revise its income tax accrual procedures so as to adhere to the requirements of the text of Account 236.

The Company was also required to adjust, through current accruals, the indicated overaccrual of approximately $1.8 million.
Current Income Taxes

Accounting for Adjustments to Tax Accruals to Reflect the Filed Income Tax Returns

The Company recorded journal entries annually to correct taxes accrued (Account 236), Accumulated Deferred Taxes (Accounts 190, 282 and 283), and Accumulated Deferred Investment Tax Credits (Account 255) to reflect amounts included in the filed income tax return. The entries were treated as direct balance sheet reclassifications rather than recording the adjustments through the applicable income accounts (Accounts 409.1, 409.2, 410.1, 410.2, 411.1, 411.2 and 411.4).

The Special Instructions for the tax accounts require that income statement accounts as well as balance sheet accounts shall be used for adjustments of income tax accruals for prior accounting periods.

Accounting for Interest Received on a Tax Refund

The Company received interest on a tax refund from the Internal Revenue Service. The Company recorded this transaction by crediting Account 236, Taxes Accrued.

The text of Account 236, Taxes Accrued, requires that interest on tax deficiencies or refunds be recorded in Account 431, Other Interest Expense, or Account 419, Interest and Dividend Income, respectively. As referenced in this letter directive, the balance in Account 236 at December 31, 1980 was reasonable. Therefore, correction of the Account 236 balance for $32,997 was not warranted.

The Company was required to comply with the text of Account 236 and in the future record interest on tax deficiencies or refunds in Accounts 431 or 419.

Tax Penalties Assessed by the Internal Revenue Service

The Internal Revenue Service assessed penalties of $149,549 and $43,007 for the years 1978 and 1979, respectively. The penalty assessed was for negligence and intentional disregard of Internal Revenue Code rules and regulations. The Company recorded the penalties by debiting Account 409.1 and crediting Account 236.

The instruction to Account 426.3, Penalties of the Uniform System of Accounts, states "This account shall include payments by the company for penalties or fines for violation of any regulatory statutes by the company or its officials."

The Company was required to record an entry to charge the penalties to Account 426.3.

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Current Income Taxes

Accounting for Tax Effects of Interest Accrued on Tax Deficiencies

The Company accrued for estimated interest expense on income tax deficiencies on a "net-of-tax" basis. The accruals were recorded as a debit to Account 431, Other Interest Expense, and a credit to Account 237, Interest Accrued. At December 31, 1980, the Company estimate of the interest expense on tax deficiencies was $4,501,403 although the balance in Account 237 reflected only $2,281,997.

General Instruction No. 18A of the Uniform System of Accounts states, "Where there are timing differences between the periods in which transactions affect taxable income and the period in which they enter into the determination of pretax accounting income, the income tax effects of such transactions are to be recognized in the periods in which the differences between book accounting income and taxable income arise and in the periods in which the differences reverse using the deferred tax method."

The Company was required to (1) revise its procedures to comply with the provisions of the Uniform System of Accounts, (2) adjust Account 237 to reflect the gross estimate of interest expense on income tax deficiencies and (3) record the necessary deferred income taxes applicable to the adjusted balance in Account 190, Accumulated Deferred Income Taxes.

Improper Accounting for Section 1341 Federal Tax Refunds

The Company credited to Account 409.2, Income Taxes, Other Income and Deductions, refunds of Federal income taxes obtained under Section 1341, Claim of Right Rule, of the Internal Revenue Code. These refunds resulted from the Company including in prior years' taxable income, operating revenues which were subsequently refunded in accordance with regulatory commission orders. The Section 1341 credit arose due to a difference in the Federal income tax statutory rates from the year(s) the revenues were included in taxable income and the year(s) the revenues refunds were reflected as reductions of taxable income.

In staff's opinion, Claim of Right Rule tax refunds should have been recorded as a credit to Account 409.1, Income Taxes, Utility Operating Income, as these amounts related to reductions in prior years' taxes on utility operating revenues.

In the future, the Company was required to record in Account 409.1 refunds of Federal income taxes resulting from the claim of Right Rule.
INCOME TAXES

Current Income Taxes

Unrecovered Tax Deficiencies Related to NGPA Pricing

Pursuant to a 1983 Supreme Court decision in State of New York v. Mid Louisiana Gas Company (Mid-La) in case No. 3024, issued June 28, 1983, the Company converted some of its company owned gas production to NGPA pricing. As a result, the cost of these production properties were excluded from rate base and the cost-of-service in setting the Company’s gas sales tariff rates. Prior to the change from cost-of-service to NGPA pricing, the Company had included these production properties in the determination of its unfunded future tax liability in wholesale rates.

As of October 1, 1983, there was approximately $32 million of unfunded future tax liability that, because of the change to NGPA pricing, could no longer be recovered from ratepayers. The Company grossed-up the $32 million of unfunded future tax liability (by dividing it by a combined federal and state tax rate), charged Account 101, Plant in Service, and credited Account 282, Accumulated Deferred Income Taxes—Other Property, with the resulting $61,451,923. The deferred tax deficiency was included in calculations of unit of production depreciation, and the amount in Account 282 was amortized as book/tax timing differences reverse.

The Company stated that it will adopt the successful efforts method of accounting for these production properties in 1987 that will result in the establishment of the proper level of income taxes and the elimination of the "Mid-Louisiana Adjustment".

Since the Company's financial statements were improperly stated at December 31, 1985, because utility plant and deferred taxes included deferred tax deficiency, the Company was required to reverse the entry establishing the deferred tax deficiency and correct the depreciation taken on such amount by charging Account 282 and crediting Account 101. The staff did not recommend refiling of the Form 2 because this transaction did not affect the Company's rate base and the cost-of-service.

Allocation of State Income Taxes Between Utility Operating Income and Other Income and Deductions

The Company's State income tax liability was determined based on the portion of Federal taxable income applicable to operations in the state. The Federal taxable income allocated to operations in the State was based on a three part formula without analyzing specific components of taxable income. The Company did not charge a portion of the State's income taxes attributable to other income and deductions to Account 409.2, Income Taxes, Other Income and Deductions.

Uniform System of Accounts Instructions require that income taxes attributable to other income and deductions be charged to Account 409.2.
Current Income Taxes

Allocation of Income Taxes Between Utility Operating Income and Other Income and Deductions

Current income tax expense charged to Account 409.1, Income Taxes, Utility Operating Income was overstated. This resulted from the Company's practice of (1) not allocating Federal income tax expense related to amounts included in Account 419, Interest and Dividend Income to Account 409.2, Income Taxes, Other Income and Deductions, and (2) not allocating any state income taxes to Account 409.2.

Paragraph B of Special Instructions, Accounts 409.1, 409.2, and 409.3 of Account 409 of the Uniform System of Accounts, states, in part, "The accruals for income taxes shall be apportioned among utility departments and to Other Income and Deductions so that, as nearly as practicable, each tax shall be included in the expenses of the utility department or Other Income and Deductions, the income from which gave rise to the tax."

The Company was required to revise its procedures to ensure compliance with the above mentioned instruction of the Uniform System of Accounts.

Procedures for Allocating the Tax Deductions for Interest Expense Among Departments

The Company allocated interest expense in determining the income taxes assigned to the electric, gas, steam and nonutility departments on the basis of net investment in plant. However, the Company included Account 136, Temporary Cash Investments, as a component of nonutility plant. The temporary cash investments represented bonds and other commercial paper.

The Special Instructions to Accounts 409.1, 409.2, and 409.3, of the Uniform System of Accounts state in part:

B. The tax effects relating to interest charges shall be allocated between utility and nonutility operations. The basis for this allocation shall be the ratio of net investment in utility plant to net investment in nonutility plant.

The Company should not have considered the temporary cash investments as an investment in nonutility plant for purposes of the allocation of interest charges.

The Company was required to revise procedures for allocating interest expenses among departments for purposes of assigning income tax cost in accordance with the requirements of the Uniform System of Accounts.
Current Income Taxes

Improper Accounting for Income Taxes Related to Affiliated Winter Gas Service Transactions

Under its Winter Gas Service tariffs, the Company nominated gas for its affiliated companies (Aff. Co's.). Aff. Co's. paid for the gas but the Company retained possession of the gas. However, the Aff. Co's. had the right to call for this gas at any time. The Company recorded this transaction as a sale of gas whereas Aff. Co's. recognized a prepayment for this amount. In preparation of the consolidated Federal income tax return this transaction was eliminated to the extent nominated gas remained in the Company's possession, thereby reducing the consolidated group's taxable income. Subsequently, when all the nominated gas was taken by Aff. Co's., the need for the consolidated adjustment for this sale was eliminated.

The income recognized by the Company on sale of nominated gas to Aff. Co's. was reported as such in the consolidated financial statements. Since no taxes were paid on the income, deferred income taxes related thereto were also recognized on the consolidated financial statements. However, no deferred income taxes were assigned to the operating companies within the group. Instead, the Company debited Account 236, Taxes Accrued, and credited Account 409.2, Income Taxes, Other Income and Deductions, to recognize the fact that income taxes collected in revenues and charged to Account 409.1, Income taxes, Utility Operating Income, were not, in fact, paid out by the system.

Since income taxes were collected and not paid, it was the staff's view that deferred income taxes should be recognized in determining utility operating income. It was the staff's view that such deferred income taxes should be recognized on the books of Aff. Co's., where the related payments were recorded. Therefore, it was not appropriate for the Company to record such income tax benefits in Account 409.2 and Account 236.

The Company was required to record appropriate correcting entries so that the income tax benefits of affiliated winter service nominations are not recognized on its books.
INCOME TAXES

Current Income Taxes

Accounting for Income Tax Expense

The Company joined with its subsidiaries in filing consolidated Federal income tax returns. The Company calculated its current and deferred income tax provisions based on taxes payable on a separate return basis less its proportionate share of the difference between consolidated taxes payable and total taxes payable computed on a separate return basis by the individual members of the consolidated group. The latter amount was recorded in Account 409.2, Income Taxes, Other Income and Deductions.

The method used to determine income tax provisions did not reflect properly on the Company's books the income tax effects of revenues and expenses which were utilized in determining the consolidated tax liability.

The staff recommended that the Company determine its current and deferred income tax provisions based on the revenues received and tax deductions generated by the Company to the extent they were actually utilized in determining the consolidated tax liability. The staff's method is consistent with the Commission's "stand-alone" policy for the allocation of consolidated income taxes.

The Commission addressed the "stand-alone" versus the "separate return" basis in Opinion No. 173, Docket Nos. RP75-105-002 and RP75-106-006, issued June 22, 1983. The Commission developed a "stand-alone" method in order to give effect to the "benefits/burdens" principle that underlies its ratemaking methods.

Procedures for Allocating Income Taxes

The Company understated the income tax expense charged to Account 409.1, Income Taxes, Utility Operating Income. This resulted from the Company's practice of determining the allocation of interest charges to nonutility operations by taking the sum of (1) Account 431, Other Interest Expense, and (2) interest charges on long-term debt associated with nonutility investments. This amount would then be tax effected and appropriately allocated to Account 400.2, Income Taxes, Other Income and Deductions.

The Special Instructions to Account 409.1, 409.2 and 409.3 of the Uniform System of Accounts, state in part:

(B) The tax effects relating to interest charges shall be allocated between utility and nonutility operations. The basis for allocation shall be the ratio of net investment in utility to net investment in nonutility plant.

The Company was required to revise procedures to ensure that the income tax effect of interest expense be allocated in accordance with Special Instructions to Account 409.1, 409.2 and 409.3, of the Uniform System of Accounts.
Current Income Taxes

Accounting For Income Taxes

Service Corporation (SC) provides services to the operating companies at cost. Therefore, SC does not generate any profit (net income) for either accounting or income tax purposes. However, due to differences between the periods in which transactions enter into the determination of accounting income and the periods in which transactions enter into the determination of taxable income, SC generates greater tax deductions than revenues during some years and greater taxable revenues than deductions in other years.

In accordance with the Tax Allocation Agreement, the income tax savings realized from the inclusion of Service Corporation deductions in consolidated tax returns were used to reduce "positive taxable income" of the companies of the Tax Group rather than being allocated to Service Corporation. In years in which SC generated excess deductions, it did not record any accounting entries in its income tax accounts. In 1985, SC generated greater taxable revenues than deductions and was allocated a portion of consolidated tax liability. SC improperly recorded this tax liability in Account 408, Taxes Other Than Income Taxes, and included the amount in billings to the operating companies. SC did not record an offsetting deferred income tax credit to reflect the fact that the tax liability was the result of book-tax timing differences.

SC should not have billed any net income tax expense to the operating utilities. If SC had properly recorded both current and deferred income taxes, there would have been no net income tax expense billed to the operating companies.

Therefore, the Company should have recorded SC related current income taxes in Account 409.1 and deferred income taxes in the appropriate deferred income tax accounts in accordance with the instructions of the FERC's Uniform System of Accounts.

The Company was required to revise procedures to ensure that current and deferred income taxes associated with services billed by SC are recorded in the appropriate income tax accounts in compliance with the requirements of the FERC's Uniform System of Accounts.
Current Income Taxes

Accounting for Income Taxes Related to Affiliated Purchase of Nuclear Fuel

In 1979 the Company purchased nuclear fuel from an affiliate. Under the terms of the purchase agreement, the pricing for the nuclear fuel was at the affiliate's original cost. In addition, the Company reimbursed the affiliate for any income taxes due on the transaction. The Company paid the affiliate $124,560 for income taxes in each of the years it amortized the nuclear fuel to expense.

The Company accounted for the income tax payments to the affiliate by debiting Account 120.1, Nuclear Fuel in Process of Refinement, Conversion, Enrichment and Fabrication, and crediting Account 234, Accounts Payable to Associated Companies. It subsequently assigned the amounts in Account 120.1 to Account 518, Nuclear Fuel Expense, and included such amounts in billings under the UPSA.

We concluded that the Company's accounting for the $124,560 annual payments to an affiliate was not consistent with the requirements of the Uniform System of Accounts.

The tax payments resulted in the investment in nuclear fuel being stated at an amount in excess of the original cost. The Company should not have recorded the excess of the amount paid over original cost in its nuclear fuel accounts.

The Company should have recorded the income taxes payable on the transfer to Account 409.1 instead of Account 120.1.

It was recommended that the Company:

(1) revise procedures to ensure that income taxes are recorded in the proper accounts consistent with the requirements of the Uniform System of Accounts; and

(2) record an entry to adjust its nuclear fuel accounts at December 31, 1988; and charge Income Tax Expense.
ACCOUNTING FOR TAX DEFICIENCIES AND RELATED INTEREST EXPENSE

The Company was assessed additional Federal and state income taxes, sales tax payments, and related interest for the years 1974-81 as a result of tax audits.

The Company recorded the additional assessments, including the related interest, in Account 186, Miscellaneous Deferred Debits, pending recovery in a retail rate case. It amortized the deferred amounts to Account 408.1, Taxes Other Than Income Taxes, Utility Operating Income and Account 409.1, Income Taxes, Utility Operating Income, over the three year period that the Public Service Commission allowed for amortization of both taxes and interest when establishing retail rates.

Under the Commission's accounting requirements the Company should have recorded the additional taxes in Account 408.1 or Account 409.1, as appropriate, and all interest expense in Account 431, as period costs.

The Commission has approved special accounting to recognize an asset where the action of a regulator provides sufficient assurance that amounts are recoverable in future rates. The action of the PSC provided the Company with sufficient assurance that it would recover an amount equal to the tax deficiencies and related interest in future rates.

Under the Commission's accounting for regulatory created assets, the Company should have recorded the PSC allowed amounts for tax deficiencies and related interest by debiting Account 186, Miscellaneous Deferred Debits and crediting Account 421, Miscellaneous Nonoperating Income. The amounts recorded in Account 186 should then be amortized to Account 406, Amortization of Electric Plant Acquisition Adjustments, over the period the amounts are recoverable in rates.

It was recommended that the Company:

1. revise accounting procedures to classify additional tax assessments and related interest consistent with the requirements of the Uniform System of Accounts; and

2. revise accounting and financial reporting procedures to ensure that regulatory assets are recognized in accordance with the Commission approved special accounting set forth above.
INCOME TAXES

Current Income Taxes

Accounting Procedures for Recording Income Taxes

The Company followed the procedures of recording corrections to income tax expense to reflect actual tax liability shown on income tax returns, IRS audits and rate change adjustments, by debiting or crediting Account 236, Taxes Accrued, with the contra entry to the appropriate account for accumulated deferred income taxes. The Company did not make any entry to the income statement in recording the adjustments as reported in the FERC Form 1.

The text of Account 236 of the Uniform System of Accounts requires that the adjustments of accrued income taxes to actual be made by adjusting the current accruals for income taxes charged to Accounts 409.1, 409.2 and 409.3. Furthermore, the instructions to Accounts 190, 281 and 283, specify that a utility debit or credit Accounts 410.1, 410.2, 411.1 or 411.2 as appropriate.

By recording the adjustments as indicated above, the Company did not properly state the current and deferred income tax expense accounts. Also, it recorded some entries adjusting the accumulated deferred income tax accounts using income statement accounts other than the specific accounts for deferred income taxes.

It was recommended that the Company implement procedures to record income tax adjustments in conformance with the requirements of the Uniform System of Accounts as of 1989.


In computing annual Federal Income Tax provisions by department, the Company allocated interest expense and the preferred stock dividend paid credit on the basis of average net plant for the year. However, in computing these allocations, plant balances classified in Account 105, Electric Plant Held for Future Use, were included in the allocation base of nonutility property.

The Special Instructions, Accounts 409.1, 409.2 and 409.3 state, "The tax effects relating to Interest Charges shall be allocated between utility and nonutility operations. The basis for this allocation shall be the ratio of net investment in utility plant to net investment in nonutility plant."

The Company was required to include Account 105 in the base of utility property in future allocations of interest expense and preferred stock dividend credits for income tax provision computations.
ACCOUNTING FOR THE ALLOCATION OF CONSOLIDATED INCOME TAXES

The Company and other members of the Group joined in filing consolidated Federal income tax returns. The Group determined the cash contribution or entitlement that each member needed to meet the consolidated tax liability on the basis of the Intercompany Tax Allocation Agreement (ITA) filed with the Securities and Exchange Commission (SEC). In general, under the ITA each member was entitled to receive cash from the group to the extent its activities contributed to the reduction of consolidated taxable income computed at the current income tax rates.

The Company recorded the difference between the tax effects of the deductions it generated and the amount of cash it received pursuant to the ITA in Account 186, Miscellaneous Deferred Debts.


In 1988, the Group amended the tax allocation agreement so as to permanently reduce the amounts that the Company would receive from other group members for use of its tax deductions that reduced consolidated income tax liability for years prior to 1987. Under the amended ITA, the group paid the Company a reduced amount for its tax deduction and assigned the amounts to other members that were precluded from using their ITC on the consolidated return because of the Company's tax deductions. 1/

The Company received reduced payments amounting to $119,946,982. It accounted for the $119,946,982 as follows:

During 1987, 1988 and 1989, it reclassified $94,626,999 of the amount recorded in Account 186 to Account 101, Electric Plant in Service. The Company included the $94,626,999 loss in value of the receivable that it assigned to utility plant in the base for computing depreciation charges and rate base for tariff billings under the UPSA. It reassigned $25,319,983 to another subaccount within Account 186, where it had recorded the investment in Unit No. 2.

1/ Under the existing tax law, the use of ITC to reduce consolidated income tax liability is limited to specified percentages of income taxes otherwise payable. Accordingly, a situation can arise where tax losses (tax deductions exceed taxable revenues) of a group member could reduce consolidated taxable income to such an extent that ITC generated by another member, which could have used the ITC to reduce taxes it would have paid if it filed a separate return, could not be used in determining consolidated income tax liability. This is precisely what occurred in the Group. The Company's tax losses precluded the use of ITC generated by other group members to reduce consolidated income tax liability, which the members could have used to reduce taxes had they filed separate returns.
Accounting for the Allocation of Consolidated Income Taxes (Continued)

Under the accounting procedures provided in the Uniform System of Accounts, a utility must recognize income tax expense based upon comprehensive interperiod income tax allocation procedures. However, the Uniform System of Accounts permits an alternate procedure for recognizing deferred income taxes related to the interest component of AFUDC. Under the alternate procedure, a utility may recognize the tax effects of deducting on a tax return the interest portion of AFUDC capitalized in the plant accounts by recording AFUDC on a net-of-tax basis; that reduces the amount of interest capitalized by the tax effect of the current deduction for interest. The Company used this alternate procedure in determining the borrowed funds component of AFUDC.

Under the alternate procedure, the utility records amounts related to such timing difference by reducing plant costs capitalized rather than by recording credits in the prescribed deferred income tax account.

Under the Uniform System of Accounts, deferred ITC are to be accumulated in a separate account (Account 255, Accumulated Deferred Investment Tax Credits) apart from those used to record deferred income taxes. A utility is not to recognize ITC in the tax accounts until the ITC are realized by using them to reduce income taxes otherwise payable at statutory tax rates. The utility is required to amortize the deferred credits recorded in Account 255 to income over the average service life of the related property or over such periods as directed by regulatory authorities.

We concluded that the Company's accounting was not in accordance with the provisions of the Uniform System of Accounts for recording income taxes in the following respects:

1. Net-of-tax accounting for interest capitalized during construction is an alternate method of accounting for deferred income taxes for book/tax timing differences rather than the use of deferred income tax accounts prescribed by the Commission. Provisions applicable to deferred income taxes do not authorize removal of amounts from the accounts to recognize the reduction in value of carried forward unutilized ITC because of tax law changes. Therefore, the Company had no authority to add amounts to plant accounts as a substitute for the loss in value of ITC, whether generated by the Company or an affiliate.

2. The Company's presentation of information in its financial statements was not representative of facts underlying the transaction.

   It was not the value of the Company's tax deductions that the Group lost as a result of the Tax Reform Act of 1986. Instead, what the Group members lost was the value of the ITC.

   The Company's presentation of the Group's loss of tax benefits in its utility plant accounts did not faithfully represent to the readers of the financial statements the nature of the loss.
Accounting for the Allocation of Consolidated Income Taxes (Continued)

The Company should have recorded the loss of the intercompany receivable in Account 426.4, Other Deductions.

In summary, it was not appropriate for the Company to reclassify the intercompany amounts recorded in Account 186 to Account 101. Because the additional amounts were not properly included in utility plant, it was improper for the Company to include such amounts in rate base or accrue depreciation charges under the UPSA, without specific Commission authorization.

It was recommended that the Company:

1. record an entry to expense the loss of the intercompany receivable by charges to Account 426.5;

2. revise procedures for computing future tariff billing to ensure that the loss of the intercompany receivable is not collected in such billings, unless the Company obtains specific Commission approval to do so; and

3. recompute billings under the UPSA for the years 1987 to date to correct for the overcollections of depreciation expense and return related to the amounts incorrectly classified in Account 101.
Deferred Income Taxes

Property Related Deferred Taxes Improperly Recorded

As of December 31, 1981, the Company had recorded in Account 283, Accumulated Deferred Income Taxes - Other $3,438,053 of deferred taxes related to payroll taxes, pensions and other benefits that are capitalized on the books but deducted for tax purposes.

The text of Account 282, Accumulated Deferred Income Taxes - Other Property, states, "This account shall include the tax deferrals resulting from adoption of the principle of comprehensive interperiod income tax allocation . . . which are related to all property other than accelerated amortization property."

In the future, the Company was required to record deferred taxes related to the above items in Account 282.

Improper Calculation of Deferred Income Taxes Related to Unbilled Revenue

The Company recorded deferred income taxes in Account 283, Accumulated Deferred Income Taxes - Other, related to unbilled revenue. In calculating the deferred taxes on the unbilled revenue, the Company established vintage years for the timing differences. Accordingly, the Company applied to each vintage year that year's effective Federal income tax rate.

Unbilled revenue is a current deferred item. The unbilled revenue recorded at the end of any one month is subsequently collected in the next month. As such, the deferred taxes on the unbilled revenue recorded at the end of the month should have been recorded at the effective Federal Income Tax Rate as of month end.

The Company was required to record an entry to correct Account 283 as it relates to unbilled revenue, to reflect the current Federal income tax rate.

Failure to Record Deferred Taxes for Unbilled Revenues

The Company recognized, as book revenues each year, an estimated amount for revenues applicable to unread, unbilled meters. These revenues were not recognized for tax purposes until the following year when the meters were read, hence a book/tax timing difference occurred. The Company recorded the tax effects of these revenues in Account 236, Tax Accrued.

The Uniform System of Accounts' General Instruction No. 18B requires utilities to utilize comprehensive interperiod income tax allocation when the deferred income taxes are included as an expense in the rate level by the regulatory authority having rate jurisdiction over the utility.

The Company was required to comply with the requirements of General Instruction No. 18B, and record the tax effect of unread, unbilled revenues in Account 283, Accumulated Deferred Income Taxes - Other.
Deferred Income Taxes

Deferred Taxes on Decommissioning Costs

The Company normalized the timing differences on the nuclear plant decommissioning cost by debiting the deferred taxes to Account 283, Accumulated Deferred Income Taxes - Other, and crediting Account 410.1, Provision for Deferred Income Taxes, Utility Operating Income. This timing difference resulted in taxable income being higher than book income.

The text of Account 190, Accumulated Deferred Income Taxes, states that this account shall be debited and Account 411.1, Provision for Deferred Income Taxes - Credit, Utility Operating Income, shall be credited with an amount equal to that by which income taxes payable for the year are higher because of the inclusion of certain items in income for tax purposes, which items for general accounting purposes will not be fully reflected in the utility's determination of annual net income until subsequent years.

The Company was required to record an entry to reclassify the deferred income taxes on decommissioning costs to Account 190, and, in the future, account for these deferred taxes in the accounts prescribed by the Uniform System of Accounts.

Account Classification of Deferred Income Tax Balances

Staff examination of Account 283, Accumulated Deferred Income Taxes - Other, disclosed that two items were misclassified as of December 31, 1981. Included in the account was a debit balance of $1,597,355 for Deferred Income Taxes applicable to nuclear fuel disposal costs and a debit balance of $1,894,366 applicable to deferred income taxes for overrecovered fuel costs under the retail fuel clause.

Nuclear fuel disposal cost provisions were expenses currently for book purposes as nuclear fuel was burned. For income tax purposes, nuclear fuel disposal costs will not be deducted until disposal costs are incurred. The overrecovery of fuel costs was treated for tax purposes as income in the period recovered, whereas for book purposes, the advanced revenue recovery was recorded in Account 242, Miscellaneous Current and Accrued Liabilities, pending refund.

The text of Account 190, Accumulated Deferred Income Taxes, states, "This account shall be debited...with an amount equal to that by which income taxes payable for the year are higher because of the inclusion of certain items in income for tax purposes, which items for general accounting purposes will not be fully reflected in the utility's determination of annual net income until subsequent years."

The Company was required to record deferred income taxes applicable to nuclear fuel disposal costs and overrecovered fuel costs in Account 190.
Deferred Income Taxes

Accounting for Deferred Income Taxes Related to Property

The Company classified deferred taxes related to the amortization of land rights, cost of removal, payroll overheads, and the allowance for funds used during construction - debt component in Account 283, Accumulated Deferred Income Taxes--Other.

The instructions to Account 282, Accumulated Deferred Income Taxes--Other Property, of the Uniform System of Accounts, states in part:

A. This account shall include the tax deferrals resulting from adoptions of the principle of comprehensive interperiod income tax allocation described in General Instruction 10 of this system of accounts which are related to all property other than accelerated amortization property.

The Company should have classified the above deferred income taxes in Account 282.

The Company was required to (1) revise procedures to ensure that deferred income taxes related to property, other than accelerated amortization property, are recorded in Account 282 in accordance with the instruction of the Uniform System of Accounts; (2) record a correcting entry to reclassify the balances to proper account as of December 31, 1987.

Utilization of Improper Account for Reversals of Deferred Income Taxes

The Company was not following Uniform System of Accounts instructions for Account 282, Accumulated Deferred Income Taxes - Other Property. Account 411.1, Income Taxes Deferred in Prior Years - Credit, Utility Operating Income, was not used to reflect the increased taxes resulting from the use of liberalized depreciation for tax purposes in prior years as required by Paragraph B of the instructions to this account. Instead, Account 410.1, Provision for Deferred Income Taxes, Utility Operating Income, was charged with the net amount for the year, resulting from the current year's deferral less the reversal of prior years amounts.

In the future the Company was required to record the reversal of tax benefits from the use of liberalized depreciation in Account 411.1.
Deferred Income Taxes

Accounting For Deferred Income Taxes

The Company incorrectly classified certain depreciation related timing differences.

The Company placed its offshore pipeline facilities in service on December 28, 1983. For income tax purposes, the Company claimed a full years' tax depreciation for 1983 under the provision of the Accelerated Cost Recovery System (ACRS). The Company recorded the proper amount of deferred income taxes for the book/tax timing differences by charges to Account 410.1, Provision for Deferred Income Taxes, Utility Operating Income, and credits to Account 282, Accumulated Deferred Income Taxes – Other Property.

In December 1986, the Company reclassified $3,894,060 of the related deferred income taxes from Account 282 to Account 236, Taxes Accrued.

The instructions to Account 282 of the Uniform System of Accounts state in part:

E. The utility is restricted in its use of this account to the purposes set forth above. It shall not transfer the balance in this account or any portion thereof to retained earnings or make any use thereof except as provided in the text of this account without prior approval of the Commission...

The Company's account was not consistent with the requirements of the Uniform System of Accounts. Until there is evidence that tax depreciation is in fact disallowed, the Company should not have recognized in its accounts any additional income taxes payable. The Company should keep the income tax payable account so that it will agree with the filed tax returns.

The Company was required to reclassify the deferred income taxes related to the excess amount of tax depreciation over book depreciation for the year 1983 to the proper balance sheet account.

The Commission did not recommend the Company recalculate tariff billings and make refunds to its customer because the parties in Docket No. RP88-42, agreed to reinstate deferred income tax deductions resulting from 1983 tax depreciation deductions if such deductions are not subsequently disallowed by the Internal Revenue Service. In addition, any income resulting from the Company's treatment of these deductions will be refunded to the ratepayer if anticipated disallowances do not occur.
Deferred Income Taxes

Accounting for Deferred Income Taxes on Construction Related Timing Differences

In the Public Service Commission rate case, dated 1980, the PSC allowed in the cost of service all deferred taxes computed on pension costs, insurance costs and taxes charged to Account 107, Construction Work in Progress—Electric. The deferred taxes computed on the items mentioned above were recorded by debiting Account 410.1, Provision for Deferred Income Taxes, Utility Operating Income, and crediting Account 107, Construction Work in Progress.

The Uniform System of Accounts requires tax deferrals resulting from the adoption of the principles of comprehensive interperiod income tax allocation which are related to all property other than accelerated amortization property to be recorded in Account 282, Accumulated Deferred Income Taxes—Other Property.

The Company was required to record the deferred income taxes on the above noted items in Account 282, in accordance with Uniform System of Accounts requirements.

Classification of Property Related Accumulated Deferred Income Taxes

The Company recorded accumulated deferred income taxes in Account 283, Accumulated Deferred Income Taxes—Other, relating to intangible drilling costs and other miscellaneous items. These deferred income taxes related to property, other than accelerated amortization property.

The text of Account 282, Accumulated Deferred Income Taxes—Other Property, states in part that "This account shall include the tax deferrals resulting from adoption of the principle of comprehensive interperiod income tax allocation... which are related to all property other than accelerated amortization property."

The Company was required to institute procedures to ensure that property related accumulated deferred income taxes are recorded in Account 282 in the future and record an entry to properly classify property related accumulated deferred income tax amounts to Account 282.
Deferred Income Taxes

Deferred Taxes on Debt Component of AFUDC

The Company recorded deferred taxes on the debt component of Allowance for Funds Used During Construction (AFUDC) by debiting Account 410.1, Provision for Deferred Income Taxes, Utility Operating Income, and crediting Account 282, Accumulated Deferred Income Taxes - Other Property. In the same year, the Company began flowing back deferred taxes on AFUDC by debiting Account 282 and crediting Account 411.1, Provision for Deferred Income Taxes - Credit, Utility Operating Income. This accounting practice was followed even on large construction projects which took several years to complete.

The timing difference for AFUDC is created when interest is expensed for tax purposes but capitalized for book accounting purposes as a component of construction cost. The timing difference reverses when the AFUDC capitalized is included in the determination of pre-tax accounting income through book depreciation accruals. Book depreciation begins when an asset is placed in service. Therefore, the flowback of deferred income taxes applicable to AFUDC capitalized should not begin prior to the in-service date of the related asset.

The Company was required to begin flowing back the deferred income taxes related to AFUDC capitalized on the date the facilities are placed in service for major projects involving construction periods of several years.

Determination of Deferred Taxes

The Company recorded income taxes related to the equity component of the Allowance for Funds Used During Construction (AFUDC) in Account 282, Accumulated Deferred Income Taxes - Other Property.

The equity portion of AFUDC represents a permanent difference between pre-tax accounting income and taxable income, and therefore, deferred tax accounting was inappropriate.

The Company was required to: (1) cease accruing deferred income taxes on the equity portion of AFUDC, and (2) record an entry to reverse the amount of deferred income taxes improperly included in Account 282.
Deferred Income Taxes

Accounting for Deferred Income Taxes Related to the Short-Term Debt Component of AFUDC

The Company changed from a net-of-tax AFUDC rate to a gross AFUDC rate based upon its interpretation of an order from the Public Service Commission. Deferred income taxes applicable to the short-term debt component of AFUDC were not recorded on the Company's books when the change was made from a net-of-tax AFUDC rate to a gross AFUDC rate.

General Instruction 18B of the Uniform System of Accounts, states in part, "Utilities are not required to utilize comprehensive interperiod tax allocation until the deferred income taxes are included as an expense in the rate level by the regulatory authority having rate jurisdiction over the utility."

The Company was required to make an entry to record deferred income taxes for the appropriate interest component of AFUDC.

Accounting for Permanent Book/Tax Difference

The Company overstated the provision for deferred income taxes included in Account 282, Accumulated Deferred Income Taxes - Other Property. The Company computed the provision as though the equity component of Allowance for Funds Used During Construction (AFUDC) constituted a timing difference.

Paragraph (a) of General Instruction No. 18, Comprehensive Interperiod Income Tax Allocation, of the Uniform System of Accounts, indicates that income tax allocation should be applied only to timing differences between the periods in which transactions affect taxable income and the period in which they enter into the determination of pre-tax accounting income.

In periods when equity allowances are capitalized as plant construction cost, they do not enter into the determination of taxable income. However, they have the effect of increasing taxable income over the plant life. This is true because as the allowances are depreciated for book purposes and recovered in revenues, tax deductions are not allowed for the equity component of book depreciation expense. As a consequence the revenues for recovery of the equity component and the related income tax effects of such revenues enter into the determination of taxable income and pre-tax accounting income in the same accounting period. For this reason, the calculation of the interperiod income tax provision should exclude the equity component of AFUDC included in book depreciation.

The Company was required to revise procedures to ensure that deferred income taxes are not provided for the difference between book and tax depreciation attributable to equity AFUDC, and record an entry to reduce deferred income taxes recorded in Account 282.
Deferred Income Taxes

Accounting for Income Tax Benefits During the Construction of the LNG Facilities

During the period that the LNG facilities were under construction, the Company participated with other subsidiaries in the filing of consolidated income tax returns wherein certain of the construction expenditures capitalized on the Company's books were claimed as deductions and reduced consolidated taxable income and reported current consolidated income tax liability. Such deductions gave rise to book/tax timing differences for which the Company should have recognized the tax effect in the accounts by charges to a deferred income tax expense and credits to an accumulated provision for deferred income tax account.

The Company's accounting for and nonrecognition in AFUDC calculations of the tax benefits realized during the construction period of the LNG facilities was contrary to the Commission's accounting and ratemaking policies.

Since the Alabama Tennessee case in 1964, the Commission has always given the time value of income tax benefits to the ratepayer. In a number of orders issued since 1964, the Commission has made it clear that the time value benefit of deferred income taxes must go to the ratepayer. This was clear from the rulemakings that resulted in Commission Order Nos. 404 and 404-A, issued in 1970; Order Nos. 530 and 530-A, issued in 1971 and 1976, Order No. 561, issued in 1977 and Order Nos. 144 and 144-A issued in 1981 and 1982. In addition, the Commission issued a number of decisions in specific rate proceedings that require that the benefit of the deferral of taxes accrues to the ratepayer. See e.g., El Paso Natural Gas Co., 22 FPC 260 (1959), Alabama Tennessee Natural Gas Co., 31 FPC 208 (1964), Alabama-Tennessee v. F.P.C. 359 F.2d 318 (1966), Texas Gas Transmission Corp., 43 FPC 824 (1970), FPC v. Memphis Light, Gas & Water Division, 411 U.S. 458 (1973), Trunkline LNG Company, Opinion No. 310, Docket Nos. RP81-85-000., RP83-93-003 and FA85-01-000, issued November 22, 1988. In all of these cases, Commission policy was to afford the full time value benefit of the deferral of income taxes associated with AFUDC and sales and use taxes to the ratepayer.

Also, the Commission in Order No. 530 clearly established its policy that the time value benefit of deferred taxes associated with interest and other construction timing differences should be given to the ratepayer.

Under the Company's accounting for income taxes during construction of the LNG facilities, the ratepayers will not realize any time-value related to the tax benefits realized during the construction period. Instead, the Company's procedures will result in the stockholders' retaining the time value of the tax benefits realized during the construction period.

The Company was required to recompute all tariff billings for the period July 1, 1978 to the present to reflect the proper original cost of the LNG facilities and make appropriate refunds, with interest computed in accordance with the Commission's regulations, for all overbilled amounts.
Deferred Income Taxes

Accounting for Federal Income Tax Rate Change

In two retail electric rate cases, the Company received amortization, over a two-year period, of the difference between deferred taxes at the current 46% federal income tax rate and the previous 48% rate. Accordingly, the Company transferred from Account 281, Accumulated Deferred Income Taxes – Accelerated Amortization Property, and from Account 282, Accumulated Deferred Income Taxes – Other Property, and from Account 283, Accumulated Deferred Income Taxes – Other, to a special sub-account of Account 283. These amounts represented 100% of the rate change effect on those accounts, i.e., the deferred taxes applicable to all rate jurisdictions.

The staff agreed that the deferred taxes applicable to the retail rate jurisdiction may be flowed back in accordance with Commission Order No. 530 and the Uniform System of Accounts (USofA). Order No. 530B and the USofA contemplates the recording of only the deferred taxes allowed by the applicable rate jurisdictions.

The staff believes, however, that the deferred taxes provided by the other rate jurisdictions should remain in the deferred tax accounts for disposal or use as the other rate jurisdictions may direct.

The Company was required to:

(1) Revise the deferred taxes applicable to rate jurisdictions from the special subaccount of Account 283 to the applicable deferred tax Account 281, 282, or 283.

(2) Adopt accounting procedures to track the applicable deferred tax by rate jurisdiction.

State Deferred Income Taxes

Prior to 1981, the Company's procedure was to normalize state income taxes for both accounting and ratemaking purposes. In State Commission Docket, issued December 1982, the Company was ordered to flow through state income tax benefits and amortize state income taxes deferred prior to 1981 over a 15-year period. The Company complied with the rate order by reversing the 1981 and 1982 state income tax deferrals for both wholesale and retail rates. For retail rates only, an amortization period for state income tax deferrals, recorded prior to 1981, was established.

In FERC Dockets, effective October, 1981, and January 1983, the Company normalized the tax effects of state income taxes in their wholesale rate filings. General Instruction No. 18C of the Uniform System of Accounts requires that if the utility is subject to more than one agency having rate jurisdiction, its accounts shall appropriately reflect the ratemaking treatment (deferral or flow through) of each jurisdiction.

The Company was required to establish a provision for the wholesale portion of state deferred income taxes, for the years through 1982 and in the future account for state income taxes as required by the Uniform System of Accounts.
Deferred Income Taxes

Deferred Taxes on Unbilled Revenues

In 1978, the Company began accruing estimated unbilled revenues for book purposes but not for tax purposes. This resulted in a timing difference and deferred taxes were recorded at the 46% federal income tax rate. Subsequently, the Company has calculated the deferred taxes for the years 1979-1982 at 46% based upon the yearly net change in the unbilled revenue account. This method resulted in an amount in Account 283, Accumulated Deferred Income Taxes - Other, in excess of the amount that would have been provided had the current federal tax rate been applied to the total unbilled revenue account balance at December 31, 1982.

The Special Instructions to Accounts 410.1, 410.2, 411.1 and 411.2, state that Account 410.1, Provision for Deferred Income Taxes, Utility Operating Income, shall be debited or Account 411.1, Provision for Deferred Income Taxes - Credit, Utility Operating Income, shall be credited and the appropriate accumulated deferred income tax account shall be debited or credited with amounts equal to any allocation of deferred taxes originating in prior periods or any current deferrals of taxes on income. There shall not be any netting of amounts appropriately includable in Account 410.1 or Account 411.1. Further, Accounting Release No. AR-2, effective August 31, 1965, prescribes that deferred tax amounts shall be restored to income at the same tax rate that was originally used to defer the amount.

The Company was required to record an entry to adjust the deferred income tax balance to reflect the 46% federal income tax rate and in the future, record the gross deferred income taxes at the current tax rate and restore the deferred tax amounts at the same tax rate that was originally used to defer the amount.

Accounting Procedures for Recording Deferred Income Taxes

The Company's wholesale rates reflected full normalization effective March 5, 1983. However, the Company did not begin recording comprehensive interperiod income tax allocation procedures until April 1984. In addition, the Company's computation of deferred income taxes, related to wholesale sales, were based on the amounts reflected in the Company's wholesale rates rather than on the wholesale portion of the actual book/tax timing difference. The Company applied this procedure to all book/tax timing differences.

General Instruction No. 18, Comprehensive Interperiod Income Tax Allocation, of the Uniform System of Accounts, requires utilities to follow comprehensive interperiod income tax allocation procedures when normalized income taxes are provided in rate levels.

The Company was required to (1) adopt procedures to ensure that (a) deferred taxes are recorded when provided for in rate levels, (b) deferred taxes are based on actual book/tax timing differences and (2) record an entry to reflect the proper amount of deferred taxes related to the Company's wholesale operations.
Deferred Income Taxes

Accounting for Deferred Income Taxes

The Company did not record a separate income tax provision for the make-up of deferred tax deficiencies. The Company tendered for filing with the FERC a transmission rate agreement.

The Company's filing included an accrual to provide a make-up for the unfunded tax liability relating to the timing differences for which the Company had not provided. The Company did not record the annual make-up provision in its deferred tax accounts.

General Instruction No. 18, Comprehensive Interperiod Income Tax Allocation, of the Uniform System of Accounts requires utilities to follow comprehensive interperiod tax allocation procedures when normalized income taxes are provided in rates.

The Company was required to (1) revise procedures to adopt comprehensive interperiod income tax allocation consistent with the methodology used to determine the tax provisions included in rates and (2) record an entry to establish the make-up provisions for the unfunded tax liability provided in wholesale rates.

Accounting for Deferred Income Taxes

In January 1981, the Public Utility Commission denied the Company recovery of normalized tax benefits produced by the Class Life Asset Depreciation Range (ADR) provisions of the Internal Revenue Code. The Company ceased the recording of deferred taxes related to ADR timing differences on a total (both retail and wholesale) basis as of January 1, 1981.

The FERC had authorized normalized recovery in rates of tax benefits of ADR from November 2, 1976, through August 9, 1981. The Company ceased collecting normalized taxes in the wholesale cost-of-service in 1981.

General Instruction 18C of the Uniform System of Accounts states that "Should the utility be subject to more than one agency having rate jurisdiction, its accounts shall appropriately reflect the ratemaking treatment (deferral of flow-through) of each jurisdiction." Under this requirement, the Company should have recorded deferred income taxes related to normalized tax benefits produced by Class Life System and cost of removal for the period January 1, through August 9, 1981, as related to FERC jurisdictional business.

The Company is required to: (1) revise its procedures to comply with General Instruction No. 18C in the future, and (2) record a correcting entry to restate deferred income taxes.
Deferred Income Taxes

Accounting for Deferred Income Taxes

The Company did not record deferred income taxes for a make-up provision provided in rate levels from July 1, 1983, through December 31, 1983.

The Company requested an additional provision for the prior flow-through of Federal and state income taxes pursuant to the Commission's policy set forth in Order No. 144. The Company placed the increased rates in this Docket into effect, subject to refund.

The Company did not record in its tax accounts the additional deferred income tax provisions that were collected in rates for the period July 1, 1983 through December 31, 1983.

General Instruction No. 18, Comprehensive Interperiod Income Tax Allocation, of the Uniform System of Accounts requires a utility to follow comprehensive interperiod tax allocation procedures when normalized income taxes are provided in rate levels.

The Company should have recorded the make-up provision in its deferred income tax accounts.

The Company was required to (1) revise procedures to assure that deferred income taxes are recorded consistent with the requirements of General Instruction No. 18; (2) record a correcting entry to establish the deferred income taxes related to the additional provisions collected in rates.

Accounting for Deferred Taxes Related to Capitalized Interest Income

The Company capitalized interest income earned on funds provided by pollution control bonds which were held by a trustee. The capitalization of interest income for book purposes created a timing difference, as the interest income was taxable when earned. The Company did not provide deferred income taxes related to the timing difference created by the capitalization of interest income. The Company's wholesale rates included deferred taxes on all timing differences.

General Instruction No. 18 of the Uniform System of Accounts requires utilities to adopt comprehensive interperiod income tax allocation procedures when normalization of income taxes is provided in rate levels.

The Company was required to record a correcting entry to establish the proper amount of deferred taxes related to wholesale rates.
Deferred Income Taxes

Accounting for Short-Term Timing Differences

The Company did not consider significant non-construction related short-term timing differences which reverse in future years, in the computation and accrual of income tax expense. Short-term timing differences were not deferred in Account 283, Accumulated Deferred Income Taxes-Other, but were, in effect, recorded in Account 236, Taxes Accrued, and charged or credited to Account 409.1, Income Taxes, Utility Operating Income. At December 31, 1984, Deferred Income taxes included in Account 236 related to cycle billing, injuries and damages reserves, building expenses capitalized for income tax purposes but expensed for book purposes, pension deductions, customers' deposits and bad debt expenses.

The Company was required to revise its procedures to recognize timing differences through use of Account 283, Accumulated Deferred Income Taxes-Other, 410.1, Provision for Deferred Income Taxes, Other Income and Deductions, 411.1, Provision for Deferred Income Taxes-Credit, Utility Operating Income, 411.2, Provision for Deferred Income Taxes-Credit, Other Income and Deductions, and 190, Accumulated Deferred Income Taxes, as appropriate and record the appropriate entry to properly state the income tax accounts as of December 31, 1984.

Accounting for Deferred Income Taxes Related to Decommissioning Costs

The Company was allowed to collect a provision in rates for the cost of decommissioning the Nuclear Plant by the State Commission. Further, the Commission approved the Company's proposal that an escrow account be set up and amounts collected from customers be placed in this account for investment in tax-free securities.

The Company recorded the accrual for decommissioning costs by debiting Account 524, Miscellaneous Nuclear Power Expense, and crediting Account 253, Other Deferred Credits. The accrual for the related deferred income taxes was recorded by debiting Account 253 and crediting Account 411.1, Provision for Deferred Income Taxes-Credit, Utility Operating Income.

The Company's accounting for deferred income taxes related to decommissioning costs was not in accordance with General Instruction No. 18E of the Uniform System of Accounts, which provides that such tax effects be recorded in Account 190, Accumulated Deferred Income Taxes.

The Company was required to: (1) establish procedures to reclassify the tax effects of future decommissioning costs accruals in Account 190 to the extent there is a book/tax timing difference, and (2) record a correcting entry to properly reclassify the tax effects of decommissioning cost accruals in Account 190.
Deferred Income Taxes

Classification of Current and Deferred Tax Expense

The Company made a number of misclassifications between current and deferred income tax accounts. The following indicates the nature of the transaction, classification by the Company and the account classification recommended.

<table>
<thead>
<tr>
<th>Description of Transaction</th>
<th>Account Used</th>
<th>Account Recommended</th>
</tr>
</thead>
<tbody>
<tr>
<td>Effects of interest expense, interest income and other capitalized overheads recorded in Account 107, Construction Work in Progress—Electric and included in the determination of current income taxes payable.</td>
<td>409.2</td>
<td>409.1</td>
</tr>
<tr>
<td>Provisions for deferred taxes related to interest expense and overheads capitalized in Account 107 but deducted currently for tax purposes.</td>
<td>410.2</td>
<td>410.1</td>
</tr>
<tr>
<td>Provisions for deferred taxes related to interest income credited to Account 107 and recognized in income for tax purposes.</td>
<td>411.2</td>
<td>411.1</td>
</tr>
<tr>
<td>Make-up provision for deferred tax deficiencies, which resulted from past flow-through of timing differences, of Account 281, Accumulated Deferred Income Taxes—Accelerated Amortization Property, and Account 282, Accumulated Deferred Income Taxes—Other Property.</td>
<td>411.1</td>
<td>410.1</td>
</tr>
<tr>
<td>Make-up provision for deferred tax deficiencies, which resulted from past flow-through of timing differences, of Account 190, Accumulated Deferred Income Taxes.</td>
<td>410.1</td>
<td>411.1</td>
</tr>
</tbody>
</table>

The Company was required to adopt procedures to record future tax transactions of the nature listed above in the accounts shown.
Deferred Income Taxes

Accounting for Accumulated Deferred Income Taxes - Other

The Company did not have adequate records to support the computation of deferred taxes related to items described as (1) stock appreciation plan, (2) gas loss, (3) club dues capitalized, and (4) taxes. The unsupported deferred taxes were recorded in Account 283, Accumulated Deferred Taxes - Other, as of December 31, 1985. The balance in Account 283 related to these items, with the exception of the stock appreciation plan, has remained the same since December 31, 1980.

Paragraph D of Account 283, Accumulated Deferred Income Taxes - Other, of the Uniform System of Accounts, states "Records with respect to entries to this account, as described above, and the account balance, shall be so maintained as to show the factors of calculation with respect to each annual amount of the item or class of items."

The Company was required to record an entry to charge deferred income tax expense for timing differences not adequately supported by the Company.

Accounting for Deferred Income Taxes Related to Percentage Repair Allowance

The Company did not record deferred income taxes resulting from the percentage repair allowance deduction until the tax return was filed. This resulted in the overstatement of Account 236, Taxes Accrued, and understatement of Account 282, Accumulated Deferred Income Taxes - Other Property, at each year-end.

General Instruction No. 18 (Comprehensive Interperiod Income Tax Allocation) of the Uniform System of Accounts requires utilities to follow comprehensive interperiod tax allocation procedures when normalized income taxes are provided in rate levels.

The Company was required to (1) revise procedures to record deferred income taxes resulting from the percentage repair allowance deduction in the current year, and (2) record an entry to properly state current and deferred income tax balances.
Deferred Income Taxes

Accounting for Income Taxes Related to Short-Term Timing Differences

The Company did not classify short-term timing differences that reversed within one year in the proper deferred tax accounts. The short-term timing differences related to such items as deferred fuel costs, pension acceleration, bad debts, FERC audit adjustments, amortization of limited-term plant, vacation accruals and salvage on repair allowance property. The Company classified the short-term timing differences in Account 236, Taxes Accrued.

General Instruction No. 18, Comprehensive Interperiod Income Tax Allocation, of the Uniform System of Accounts, states:

Where there are timing differences between the periods in which transactions affect taxable income and the periods in which they enter into the determination of pretax accounting income, the income tax effects of such transactions are to be recognized in the periods in which the differences between book accounting income and taxable income arise and in the periods in which the differences reverse using the deferred tax method....

The Company should record the above mentioned timing differences to Account 190, Accumulated Deferred Income Taxes, 281, Accumulated Deferred Income Taxes - Accelerated Amortization Property, 282, Accumulated Deferred Income Taxes - Other Property, and 283, Accumulated Deferred Income Taxes - Other, as appropriate.

The Company was required to (1) revise procedures to ensure that short-term timing differences are recorded in the appropriate deferred income tax account and (2) record the necessary entry to transfer the short-term timing differences from Account 236 to the appropriate deferred income tax accounts.

Deferred Income Taxes Related to Capitalized Interest

Not all interest capitalized on the books was deducted on the Federal income tax return. The Company used a different amount in claiming interest deductions on its income tax return than it used in calculating deferred income taxes resulting from book/tax differences of capitalized interest.

The Company's procedures resulted in an understatement of Account 282, Accumulated Deferred Income Taxes - Other Property.

The Company was required (1) revise procedures so as to record the proper amounts of deferred income taxes related to capitalized interest, and (2) record an entry to properly state deferred income taxes.
Deferred Income Taxes

Accounting for Deferred Income Taxes

The Public Service Commission (PSC) for ratemaking purposes changed from the normalized method to the flow through method for the tax reductions attributable to the debt component of AFUDC. The Company changed from a net-of-tax to a gross AFUDC rate to reflect the ratemaking treatment of debt AFUDC by the PSC.

The Company's wholesale rates were based upon the principles of full income tax normalization.

General Instruction No. 18, Comprehensive Interperiod Income Tax Allocation, of the Uniform System of Accounts requires utilities to follow comprehensive interperiod tax allocation procedures when normalized income taxes are provided in rate levels.

The Company should have provided deferred taxes on the wholesale percentage of the debt component of AFUDC. The Company wholesale rates had reflected full normalization and had not been changed to reflect the flow through of the debt AFUDC between August 1979 and December 1981.

The PSC authorized the Company to accelerate the amortization of deferred income taxes related to construction interest. The PSC permitted the Company to amortize the deferred income taxes over an 8-year period, instead of over the life of the related assets.

In 1986 the Company began charging Account 282, Accumulated Deferred Income Taxes- Other Property, and credit Account 411.1, Provision For Deferred Income Taxes-Credit, Utility Operating Income, to reflect the flowback of the deferred income taxes over the eight-year period authorized in rates.

The Company did not exclude the FERC jurisdictional portion of deferred income taxes from the accelerated flowback, although it did not have a rate order from the FERC providing for the accelerated flowback of deferred tax effects of the construction related income tax deductions.

The Company's accounting for the flowback of deferred income taxes was deficient in two respects.

1. The Commission addressed the appropriate accounting in situations when ratemaking provides for an accelerated flowback of tax benefits in an order issued to Union Electric on June 20, 1990, in Docket No. ER84-560-027. The Commission stated:

   Although we are allowing accelerated amortization of deferred income taxes for ratemaking purposes, we are not waiving our accounting requirements with respect thereto. See 19 C.F.R. Part 101, General Instruction No. 18 and Account 282 (1989).
Deferred Income Taxes

Accounting for Deferred Income Taxes (Continued)

The Company should have continued to record the flowback of deferred income taxes in accordance with the requirements of the Uniform System of Accounts. It should have recorded the difference between amounts amortized for rate and book purposes by entries to Accounts 186, Miscellaneous Deferred Debits, and 406, Amortization of Electric Plant Acquisition Adjustments.

2. The Company had not received Commission approval for the accelerated flowback of the wholesale portion of the deferred income taxes related to construction interest, it would not have a basis to establish a regulatory asset for the wholesale amount. Staff concluded that the Company should have obtained the authorization of the FERC to accelerate the wholesale portion of the related debt AFUDC tax credits.

Staff recommended that the Company:

(1) revise its procedures to ensure that the deferred income taxes are recorded consistent with General Instruction No. 18 and the specific instructions of the income tax accounts of the Uniform System of Accounts; and

(2) record correcting entry to establish the proper amount of deferred income taxes related to wholesale rates.

Accounting Classification of Deferred Income Taxes Related to Abandoned Nuclear Projects

The Company abandoned its investment in two nuclear projects. The State Commission allowed the Company to recover a portion of its investment in the two abandoned projects in rates. The Company recorded deferred income taxes related to the nuclear project (debit) as a debit in Account 282, Accumulated Deferred Income Taxes - Other Property.

The abandoned nuclear costs are not considered property in accordance with the Commission's accounting regulations and therefore, the related tax effects should not be recorded in Account 282. The appropriate classification of the deferred taxes related to the above mentioned nuclear costs is in Account 283, Accumulated Deferred Income Taxes - Other.

The Company was required to record an entry to reclassify the deferred tax balance from Account 282 to Account 283, Accumulated Deferred Income Taxes-Other.
Deferred Income Taxes

Accounting for the Excess Deferred Income Taxes

The Company improperly flowed back, without Commission approval, the wholesale portion of the excess deferred income taxes recorded in its deferred income tax accounts.

The Company obtained the approval of Public Utility Commission (PUC) to flow back the retail portion of the excess deferred taxes due to the change in income tax rates from 46 percent to 34 percent. The Company, however, began to flow back the wholesale portion in addition to the retail portion of the excess deferred income taxes recorded in Account 282, Accumulated Deferred Income Taxes—Other Property.

The Company should have obtained approval of the FERC to flow back the wholesale portion of deferred taxes recorded in Account 282.

Staff recommended that the Company:

(1) cease the flow back of the wholesale portion of the excess deferred income taxes;
(2) record correcting entry to reverse the wholesale portion of the excess deferred taxes that were incorrectly removed from Account 282; and
(3) retain any excess deferred income taxes in Account 282 until receiving Commission approval for a refunding plan. The Company should request a plan to flow back the excess amounts in its next rate filing before the FERC.

Improper Calculation of Flowbacks

The Company was calculating the flowback of deferred income taxes classified in Account 281, Accumulated Deferred Income Taxes—Accelerated Amortization Property, for pollution facilities at the current year's tax rates rather than the original tax deferral rate. Since the total flowback for a given year was minor, the difference in the flowback computation between the current year's tax rate and the original tax deferral rate was insignificant.

According to the Chief Accountant's Accounting Release No. 2, flowbacks of deferred taxes accumulated in Account 281 should be calculated using the original tax deferral rate.

In the future, the Company was required to calculate the flowback of deferred income taxes for pollution control facilities at the original tax deferral rate.
Deferred Income Taxes

Accounting Classification of Deferred Income Taxes

The Company followed the procedure of classifying all accumulated deferred income taxes and accumulated investment tax credits in Account 283. Many of the book-tax timing differences recorded in Account 283 either related to property or had debit balances. Some of the more significant items as of December 31, 1989, were:

1. Excess Tax Depreciation
2. Purchased Gas Adjustment
3. Reserve for Refund
4. Investment Tax Credits

Item No. 1 represents the excess of tax depreciation deducted over the book expense. Item No. 2 represents gas expenses recovered from customers not yet expended (and therefore not deductible currently on the tax return). Item No. 3 is the reduction in revenues recorded on the books for a potential refund obligation not reflected on the tax return. Item No. 4 is the net amount of investment tax credits utilized on the tax returns.

The Company should record the timing differences that meet this requirement, such as Items No. 2 and No. 3 above, in Account 190.

The Company should classify the property-related deferred taxes, such as No. 1 above, in Account 282.

The Company should record investment tax credits utilized on the tax returns in Account 255.

Staff recommended that the Company:

1. revise accounting procedures to ensure that deferred income taxes and investment tax credits are classified in accordance with the Uniform System of Accounts; and

2. record correcting entry to properly classify the accumulated deferred income taxes and investment tax credits.
Deferred Income Taxes

Accounting for Deferred Income Taxes Related to Contributions In Aid of Construction

The Company assessed customers a charge covering a contribution in aid of construction (CIAC) for new facilities.

The Tax Reform Act (TRA) of 1986 required natural gas companies to include any amounts received as CIAC in taxable income in the year of receipt. After passage of the TRA, the Company began charging customers an additional amount to cover the tax effect of the CIAC.

The Company's accounting for the CIAC was as follows: It credited the portion of the CIAC equal to the cost of the facilities to Account 101, Gas Plant in Service. It recorded the additional income taxes by charges to Account 409.1, Income Taxes, Utility Operating Income, and credits to Account 236, Taxes Accrued. Also, it established deferred income taxes by debiting Account 282, Accumulated Deferred Income Taxes, Other Property, and crediting Account 410.1, Provision for Deferred Income Taxes, Utility Operation Income. (It did not use a subaccount within Account 282 to permit ready identification of the deferred income taxes related to specific contributions). Finally, it credited the portion of the CIAC collected for income taxes to Account 421, Miscellaneous Nonoperating Income.

The Company included the deferred income taxes related to the reimbursement for the time value of income taxes paid on CIAC in Account 282 when it made a rate filing. The filing resulted in a settlement agreement which included the deferred income taxes related to the reimbursement for the time value of income taxes paid on CIAC in the settlement rate base.

Since the Company's intent was not to assign the cost of the CIAC to current customers, the Company should have recorded the current income taxes on the CIAC in Account 409.2, Income Taxes, Other Income and Deductions, and the deferred income taxes in Account 411.2, Provision for Deferred Income Taxes-Credit, Other Income and Deductions. Also, it should have classified the deferred income taxes in Account 190 instead of Account 282.

Staff recommended that the Company:

(1) revise procedures to ensure that deferred income taxes on CIAC are recorded in the proper account as required by the Uniform System of Accounts; and

(2) record a correcting entry to reclassify the deferred income taxes from Account 282 to Account 190.

The Company shall file a copy of the correcting entries with the Office of Chief Accountant.
Deferred Income Taxes

Accounting Classification of Deferred Income Taxes

The Company recorded debit deferred income taxes related to unearned compensation in Account 282, Accumulated Deferred Income Taxes--Other Property, and recorded property related deferred income taxes in Account 283, Accumulated Deferred Income Taxes--Other. Also, it recorded amounts representing deferred income taxes on unbilled revenues in Account 236, Taxes Accrued.

The Company should have recorded the debit deferred income taxes related to unearned compensation in Account 190 instead of Account 282 and property related deferred taxes in Account 282 instead of Account 283. The Company should have classified the deferred income taxes related to unbilled revenues in Account 283 instead of Account 236.

Staff recommended that the Company:

(1) revise its accounting procedures to ensure deferred taxes are classified in accordance with the instructions of the Uniform System of Accounts; and

(2) record correcting entry to reclassify accumulated deferred income taxes to the proper accounts.

Accounting for Deferred Income Taxes

The Company included a fully normalized income tax allowance together with a provision to make-up an existing deferred income tax deficiency.

For accounting purposes, the Company did not record the allowed make-up provision in its deferred income tax accounts by charging Account 410.1, Provision for Deferred Income Taxes, Utility Operating Income, and crediting Account 282, Accumulated Deferred Income Taxes - Other Property.

General Instruction No. 18 of the Uniform System of Accounts requires utilities to adopt comprehensive interperiod income tax allocation procedures to the extent that normalized income taxes are provided in rate levels.

The Company should have recorded an additional entry in Accounts 410.1 and 282 to reflect the annual make-up provision provided in wholesale rate levels.

Staff recommended that the Company:

(1) revise procedures to ensure that the deferred tax provisions are properly computed to reflect the make-up provisions provided in rates in accordance with Uniform System of Accounts requirements; and

(2) record a correcting entry to record the make-up allowance included in rates beginning in 1988.

The Company shall submit a copy of the correcting entry to the Office of Chief Accountants.
Deferred Income Taxes

Accounting for Deferred Income Tax Make-Up Plans

The Commission issued an order approving rate changes the Company requested. In the rate request, the Company included a provision to make-up the wholesale portion of the existing deficiency in accumulated deferred income taxes from wholesale customers over a period of years. It calculated the deficiency on which it based the make-up plan using a .4934 composite tax rate.

The Company recorded the additional deferred income taxes collected based on the make-up plan by charging Account 410.1, Provision for Deferred Income Taxes, Utility Operating Income, and crediting Account 282, Accumulated Deferred Income Taxes - Other Property.

Since receiving approval of the make-up plan the Company did not file for another rate change relating to the wholesale customers under Section 205 of the Federal Power Act.

General Instruction No. 18, Comprehensive Interperiod Income Tax Allocation, of the Uniform System of Accounts requires a utility to establish deferred income taxes to the extent that normalized income taxes are provided in the rate levels established by each regulatory jurisdiction.

Under Commission policy, a utility should record in its deferred income tax accounts the annual make-up provision provided in rate levels. The Commission approved the Company's rate levels that included an annual make-up provision based upon the 46 percent income tax rate in effect at that time. It is contrary to Commission policy for a utility to adjust the annual make-up provision, and change the amount of recorded deferred income taxes without prior Commission approval.

The Commission addressed its policy in Order No. 475, when it stated in part:

... The Commission will consider any corrections to a utility's make-up provision amortization in conjunction with the utility's next full rate change application ... Until that time, a utility should continue to accrue the deferred tax amortization amount in accordance with its previously approved plan of recovery.

The Company should have continued to utilize the .4934 composite tax rate in calculating the deferred tax make-up allowance to record in Accounts 410.1 and 282 until such time as it filed its next rate change application related to wholesale customers.

Staff recommended that the Company:

(1) revise its procedures to ensure that the annual make-up provisions included in rate levels are recorded in the deferred income tax accounts consistent with the requirements of the Uniform System of Accounts; and

(2) record a correcting entry to establish the proper amount of deferred income taxes related to the make-up of the unfunded future tax liability included in rate levels based upon a .4934 composite tax rate.
Deferred Income Taxes

Accounting Procedures for Unfunded Income Tax Liability

The Company did not account for a make-up provision for deferred income tax in accordance with Commission orders.

The FERC issued an order approving the Company's proposed make-up plan to recover the deficiency in deferred income taxes due to previous flow-through ratemaking policies over a 10-year period.

Beginning in 1984, the Company recorded an additional tax provision by charging Account 410.1, Provisions for Deferred Income Taxes, and crediting Account 282, Accumulated Deferred Income Taxes—Other Property.

General Instruction No. 18 of the Uniform System of Accounts requires a utility to follow comprehensive interperiod income tax allocation procedures to the extent that normalized income taxes are authorized by each regulatory authority in rate levels.

Staff concluded that the Company should have recorded an additional income tax make-up provision as authorized by the FERC.

Staff recommended that the Company:

(1) revise procedures to assure that it records deferred income taxes in accordance with the requirements of the Uniform System of Accounts; and

(2) record correcting entry to adjust the amount recorded for the make-up provision for years beginning with 1984 through the current date.

Incorrect Accounting for Deferred Tax Flow-backs

The Company recorded the flow-back of deferred income taxes classified in Account 190, Accumulated Deferred Income Taxes, for Test Revenue, the Acquisition Adjustment and Employee Death Benefits in Account 411.1, Provision for Deferred Income Taxes - Credit, Utility Operating Income.

The text of Account 190, Accumulated Deferred Income Taxes, Paragraph B, requires that Account 410.1, Provision for Deferred Income Taxes, Utility Operating Income, or Account 410.2, Provision for Deferred Income Taxes, Other Income and Deductions, as appropriate, shall be debited with an amount equal to that by which income taxes payable for the year are lower because of prior payment of taxes as provided by Paragraph A.

In the future, the Company was required to record in Account 410.1 or Account 410.2, as appropriate, all flow-backs of deferred income taxes classified in Account 190.
Investment Tax Credits

Amortization of Investment Tax Credits (ITC's) on Qualified Construction Progress Expenditures

The Company follows the normalization method of accounting for ITC's. Under this method, ITC's are deferred in Account 255, Accumulated Deferred Investment Tax Credits, and are amortized to Account 411.4, Investment Tax Credit Adjustments, Utility Operations, ratably over the estimated useful life of the related asset.

Under the Internal Revenue Code, a taxpayer may elect, as did the Company, to claim ITC's on progress expenditures made during the construction period of qualifying assets. The Company began amortizing its ITC's on qualified progress expenditures in the year the credit was utilized even though the related asset was not placed in service until a subsequent year.

Uniform System of Accounts instructions for Account 255 state in part: "this account shall be debited and Account 411.4 credited with a proportionate amount determined in relation to the average useful life of electric utility property to which the tax credits relate..." The staff was of the opinion that the useful life of an asset begins when it is placed in service. Accordingly, the amortization of ITC's on qualified progress expenditures should begin on the in-service date of the related asset. This accounting practice should result in an equilibration between the amortization of the ITC, and depreciation of the portion of the asset financed by the credit.

In the future, the Company was required to begin amortizing the ITC's taken on significant qualified progress expenditures on the date the related asset is placed in service. (Application of this procedure to minor construction projects was considered an undue accounting refinement.)

Recording Unused Investment Tax Credits

During the audit period, the Company offset its deferred income tax balances by recording unused investment tax credits (ITC carry-forwards). As a result of this procedure $23,900,000 of ITC carry-forwards were recorded in Account 255, Accumulated Deferred Investment Tax Credits, deferred income taxes were recorded at less than the statutory tax rate, and approximately $8,300,000 of deferred income taxes were flowed through to income during the audit period.

The Uniform System of Accounts does not permit recording ITC carry-forwards as an offset to deferred income taxes. Furthermore, the instructions to the accumulated deferred income tax accounts state that a utility "shall not transfer the balance in this account or any portion thereof to retained earnings or make any use thereof to retained earnings or make any use thereof except as provided in the text of this account without prior approval of the Commission." The Company did not receive approval of the Commission to offset accumulated deferred income tax accounts by ITC carry-forwards.

The Company was required to adjust its books and records to reflect the proper accounting procedures as prescribed by the Uniform System of Accounts for the accumulated deferred income tax and investment tax credits accounts.
INCOME TAXES

Investment Tax Credits

Accounting for Unused Investment Tax Credits

The Company's accounting policy was to reduce the balance in Account 283, Accumulated Deferred Income Taxes - Other, by investment tax credits (ITC) generated but which could not be utilized to reduce the current tax liability. The unused ITC was simultaneously credited to Account 420, Investment Tax Credits. The balance in Account 283 was restated to an amount without reduction for unutilized ITC for rate making purposes.

Although the policy of reducing accumulated deferred tax balances by unused ITC is permitted by FASB Interpretation No. 25, the Uniform System of Accounts makes no provision for the recognition of ITC before it is utilized. In addition, by following the policy prescribed by FASB Interpretation No. 25, the Company's financial statements did not reflect the current rate making treatment afforded accumulated deferred income taxes.

The Company was required to revise its procedures to assure that the amount of unused ITC is not recognized as a reduction of accumulated deferred income tax balances and record an entry to reinstate accumulated deferred income tax amounts which were reduced by unutilized investment tax credits.

Accounting for Investment Tax Credit (ITC)

When filing its 1981 tax return, the Company elected to recover nuclear fuel cores under the Accelerated Cost Recovery System (ACRS). Under ACRS, the Company recorded more ITC than was available under the previous method. The Company had estimated its tax liability for 1981 without considering the use of ACRS. In 1982, the Company credited Account 255, Accumulated Deferred Investment Tax Credits, for $1,248,797, to reflect the increased ITC. The contra debit was to Account 236, Taxes Accrued. The income accounts were not used.

The Special Instructions Account 409.1, 409.2, and 409.3 of the Uniform System of Accounts state, in part, "...as the exact amounts of taxes become known, the current tax accruals shall be adjusted by charges or credits to these accounts, so that these accounts as nearly as can be ascertained shall include the actual taxes payable by the utility."

The Company was required to revise its procedures to record future adjustments to prior year(s) tax accruals through the current income and expense accounts.
INCOME TAXES

Investment Tax Credits

Accounting for Deferred Taxes Related to Investment Tax Credits

The Company was permitted to "flow through" to the stockholders the retail portion of investment tax credits. For income tax purposes, the Company elected to claim the 10 percent investment tax credit. The Company's election resulted in a 5 percent basis reduction for property. The Company did not record deferred taxes related to the tax basis reduction caused by its election of the 10 percent investment tax credit.

The Uniform System of Accounts requires Companies to record normalized income tax allowance to the extent provided by the ratemaking process. Deferred income taxes were provided for the basis reduction resulting from the investment tax credit election in the Company's rate levels. Additionally, generally accepted accounting principles (FASB Technical Bulletin 83-1) require companies that recognize investment tax credits by the "flowthrough" method to provide deferred taxes for the reduction in the tax basis of assets in the year the related investment tax credits are recognized as a credit to income tax expense.

The Company was required to record an entry to recognize the additional deferred taxes resulting from the tax basis reduction.

Accounting for Income Taxes

The Company's procedures for accruing income taxes and investment tax credits in its accounts were not consistent with the requirements of the Uniform System of Accounts.

The Company is part of a holding company that is registered under the Public Utility Holding Company Act of 1935. The Company joined with other group members in filing annual consolidated Federal income tax returns during each year under audit.

During the years prior to 1983, the group generated enough tax liability for income tax purposes to use all the ITC generating by the Company and other group members. However, in 1983, 1985 and subsequent years the Company (and the other group members) generated more ITC than the group as a whole could use to reduce its consolidated Federal income tax liability.

Under the group's tax allocation procedures, the Company received credit for the ITC that it could have realized if hypothetically it had always filed a separate tax return. The amount that the Company received credit for was in excess of its pro rata share of the ITC that was actually used on the consolidated tax return for 1983, 1985 and subsequent years.
INCOME TAXES

Investment Tax Credits

Accounting for Income Taxes (Continued)

The Company accounted for the credit it received under the tax allocation agreement for both the used and the unused ITC as follows:

(1) It recorded the used and unused amounts as ITC by entries to Account 411.4, Investment Tax Credit Adjustments, Utility Operations, and Account 255, Accumulated Deferred Investment Tax Credits.

(2) It reduced the amount of current income tax expense recorded in Account 409.1, Income Taxes, Utility Operating Income, and Account 236, Taxes Accrued, to reflect both the used and unused amount of the ITC.

We concluded that the Company's income tax accounts for the period 1983-1988 were not maintained in accordance with the requirements of the Uniform System of Accounts.

The Uniform System of Accounts permits a company to record investment tax credits in the account only when ITC is actually used to reduce the company's Federal income tax liability. Since the Company joined in the filing of the consolidated tax returns, it should have recorded investment tax credits in its tax accounts only to the extent that the ITC was actually used on the consolidated tax return to reduce the group's consolidated income tax liability. Because certain amounts of ITC were not used on the consolidated Federal income tax returns for 1983, 1985 and subsequent years to reduce the group's actual tax liability, the Company should not have recorded the unused amounts as ITC in its income tax accounts.

Under the requirements of the Uniform System of Accounts the Company should have classified the cash received from the group members for amounts of unused ITC in the accounts provided for associated company payables.

The Company was required to (1) revise its procedures to ensure that during each accounting period ITC or other credits recorded in the tax accounts reflect only the Company proportionate share of credits used to reduce consolidated income taxes; (2) record a correcting entry to reclassify the unused ITC amounts to the appropriate affiliated company payable accounts at December 31, 1986; (3) refile corrected pages of the FERC Annual Report showing the correct amount of ITC actually used on the consolidated tax returns for the audit period.
INCOME TAXES

Investment Tax Credits

Accounting for Investment Tax Credits (ITC)

The Company elected Option 3, Special Rule for Immediate Flow Through in Certain Cases, for ITC generated and utilized for the years 1971 through 1980.

For accounting purposes prior to 1983, the Company followed the practice of deferring ITC, using Account 255, Accumulated Deferred Investment Tax Credits, to classify the deferred amount. It amortized the ITC to income over 30 years by crediting Account 411.4, Investment Tax Credit Adjustment, Utility Operations. For ratemaking purposes, the Company used the balance recorded in Account 255 to reduce the cost of service in rates subject to PSC jurisdiction.

In 1983 and 1984, the Company proposed to the PSC changes in its accounting and ratemaking treatment of ITC. The Company's proposed changes would accelerate the amortization of pre-1981 ITC from 30 years to 5 years, and effectively flow through immediately the unamortized balance in Account 255. The PSC approved the Company's request in orders effective February 15, 1984 and December 20, 1984. As a result, the Company transferred $26 million and $47 million from Account 255 to Account 411.4 in 1983 and 1984, respectively.

In 1986 the PSC notified the Company that the previous accounting approvals were not ratemaking decisions. The PSC required the Company to obtain formal rate approval to retain the ITC benefits. In a subsequent case, the PSC rejected the Company's arguments for retaining the ITC benefits and ordered the Company to reinstate the ITC for the benefit of ratepayers. The PSC required ITC adjustments of $47.9 million as of June 30, 1986, to reduce rate base and cost of service.

The Company did not record any entries in its accounts to reflect the PSC September 30, 1987, ratemaking order. The instructions to Account 255 of the Uniform System of Accounts state in part:

A. This account shall be credited with all investment tax credits deferred by companies which have elected to follow deferral accounting, partial or full, rather than recognizing in the income statement the total benefits of the tax credit as realized. After such election, a company may not transfer amounts from this account, except as authorized herein and in accounts 411.4, Investment Tax Credit Adjustments, Utility Operations, 411.5, Investment Tax Credit Adjustments, Nonutility Operations, and 420, Investment Tax Credits, or with approval of the Commission.

B. Where the company's accounting provides that investment tax credits are to be passed on to customers, this account shall be debited and account 411.4 credited with a proportionate amount determined in relation to the average useful life of electric utility property to which the tax credits relate or such lesser period of time as allowed by a regulatory agency having rate jurisdiction....
ACCOUNTING FOR INVESTMENT TAX CREDITS (ITC) (Continued)

The PSC’s order imposed a liability on the Company to amortize the ITC to ratepayers over future periods. Under the requirements of the Uniform System of Accounts, the Company should have corrected its accounts to reflect the amount of the PSC imposed ratemaking liability.

On October 2, 1987, the Company appealed the PSC’s order to the Circuit Court. In its appeal, the Company argued that the PSC findings of fact was not supported by substantial evidence in the record and erred in conclusions of law with respect to that portion of the decision denying the Company ratemaking recognition of the acceleration in amortization of the ITC. The court had not acted on the Company’s appeal at the time of this writing.

The Company was required to make appropriate corrections to its accounts to reflect the PSC’s ratemaking action on the ITC in the event that the State Circuit Court upholds the PSC’s order and the Company chooses not to appeal the ruling. The Company will notify the Office of the Chief Accountant of its accounting actions within 30 days of any subsequent court order resulting from the Company’s appeal.

ACCOUNTING FOR UNUSED INVESTMENT TAX CREDITS

The Company filed a consolidated tax return with its parent.

For income tax purposes, the Parent capitalized most of the Company’s construction period expenditures, including interest and taxes. Once operations began, the Parent depreciated the construction cost of the Company’s facilities over a five-year period for income tax purposes.

The Parent was in a tax net operating loss (NOL) position for each year since 1982. As a result of the consolidated tax situation, the Parent was unable to use the Company’s generated ITC to reduce its consolidated income tax liability.

For accounting and financial reporting to the FERC, the Company claimed to have recorded income tax expense on a “stand-alone” basis. The Company defined “stand-alone” as if it was a separate taxpayer to the Government, but subject to the consolidated tax accounting rules of the Internal Revenue Code.

The Company recorded income tax expense as if the Parent had used the full amount of its income tax losses and the ITC that it generated. The Company flowed through the ITC to income by debiting Account 411.4, Investment Tax Credit Adjustments, Utility Operations, and crediting Account 420, Investment Tax Credits.

The Company computed the full value of the unused ITC under existing tax regulations. As a result of the Tax Reform Act (TRA) of 1986, the value of the Company’s unused ITC was reduced by about 35 percent. The Company did not make any adjustments in its income tax accounts to reflect the effect of the loss of tax credits as a result of the TRA.
INCOME TAXES

Investment Tax Credits

Accounting for Unused Investment Tax Credits (Continued)

The instructions to the income tax accounts of the Uniform System of Accounts for public utilities and natural gas companies provide for the recognition of ITC on an "as realized basis," i.e. when a company uses the amounts to reduce its Federal income tax liability for the period. The Uniform System of Accounts for natural gas companies and public utilities does not provide for a jurisdictional company to record the effects of unused ITC in determining net income.

As authority for recognizing unused ITC, a number of jurisdictional companies have relied on the provisions of Financial Accounting Standards Board (FASB) Interpretation No. 25, Accounting for Unused Investment Tax Credit, which in effect allows a company to offset the amount of unused investment tax credits against the balances of deferred income taxes.

In a decision issued to Public Service Company of New Mexico, an Administrative Law Judge (ALJ) drew the following conclusion after relying on the restrictions imposed in the instructions of the accumulated deferred income tax accounts (Accounts 281, 282 and 283) (13 FERC 63,041 at page 65,164):

PNM's offset of deferred income taxes with unused investment tax credits appears, therefore, to conflict with proper accounting procedure, as established by this agency.

Although relevant, generally accepted accounting principles are not to be blindly followed in determining the appropriate treatment of transactions for ratemaking purposes. The FASB Interpretation, relied upon by PNM, contains a caveat recognizing the distinction between accounting and ratemaking, stating:

9. The Addendum to APB Opinion No. 2 states that "differences may arise in the application of generally accepted accounting principles as between regulated and nonregulated businesses, because of the effect in regulated businesses of the ratemaking process . . . ."

In Opinion No. 133 the Commission adopted the ALJ's conclusion.

In summary, we concluded that it was improper for the Company to record unused ITC in its accounts for the following reasons:

(1) The Company's only line of business was the transportation of natural gas. Therefore, it would be inappropriate to apply the GAAP standard to the Company's regulated activities.

(2) One of the basic principles underlying the accounting requirements of the Uniform System of Accounts is to have the financial statements present the economics of transactions.
Investment Tax Credits

Accounting for Unused Investment Tax Credits (Continued)

There were no tax benefits realized by the stockholders as a result of the Company's generated ITC. Therefore, it was inappropriate for the Company to recognize the benefit in net income and to enhance its common equity balances.

It was recommended that the Company:

(1) revise its procedures so as to preclude it from recording unused ITC in its accounts and financial reports to the Commission; and

(2) record a correcting entry to correct the accounting for unused ITC.

Accounting for Unused Investment Tax Credits

The Company filed as part of the consolidated income tax return of the Group.

Because of the limitations on use of ITC under the Internal Revenue Code, the Group was not able to "realize" the Company's ITC on the consolidated income tax return to reduce the Group's consolidated income tax liability.

Pursuant to the consolidated income tax allocation procedures, Group members that could use ITC to reduce their tax liabilities on a separate tax return (rather than consolidated return), received reimbursement as if they had used the ITC. This method of allocation resulted in the Company paying less toward actual consolidated income tax liabilities than it would have based on the actual use of its credits on the consolidated income tax return.

The Company accounted for the reimbursements received from the Group for the unused ITC as a reduction of current income tax expense. Then it deferred the effect on net income by charging deferred income tax expense and crediting Account 255, Accumulated Deferred Investment Tax Credits.

The Company included the balances recorded in Account 255 as a component of rate base in rate proceedings before the FERC.

The Uniform System of Accounts for public utilities and natural gas companies provides for the recognition of ITC only on an "as realized basis," i.e. when a company uses the amounts to reduce its Federal income tax liability for the period. The Uniform System of Accounts for natural gas companies and public utilities does not provide for a jurisdictional company to record the effects of unused ITC in determining net income.

There is no basis, other than realization provided in the Uniform System of Accounts, for reflecting the effects of ITC, whether the Company follows the flow-through or the deferred method of recording ITC.
Investment Tax Credits

Accounting for Unused Investment Tax Credits (Continued)

The Company should not have recorded the unused investment tax credits in net income prior to realization on the consolidated income tax return.

For ratemaking purposes, the unused ITC recorded in Account 255 was used as a component of the cost-of-service in rate proceedings after 1985. Under the circumstances, the Company should have recorded the economic effects of a regulators use of the unused ITC in setting rates by recording a liability in Account 253, Other Deferred Credits.

It was recommended that the Company:

(1) revise procedures to ensure tax amounts recorded in the accounts represent the Company's share of the income tax liability as shown on the consolidated income tax return for each year; and

(2) record a correcting entry to correct the accounting for unused investment tax credits by charging Account 255 and crediting Account 253, Other Deferred Credits.

Accounting for Investment Tax Credit Carryforwards

The Company's accounting for investment tax credit carryforwards was not consistent with the requirements of the Uniform System of Accounts.

In 1987, the Company adopted the principles of Statement of Financial Accounting Standards (SFAS) No. 96 -- Accounting for Income Taxes, for accounting and financial reporting to its stockholders. With the adoption of SFAS No. 96, the Company recorded investment tax credit carryforwards in its income tax accounts for the year.

In reporting to the FERC, the Company made an entry to its balance sheet accounts by debiting Account 283, Accumulated Deferred Income Taxes-Other, and crediting Account 255, Accumulated Investment Tax Credits, to recognize the investment tax credit carryforwards.

The Uniform System of Accounts permits investment tax credits to be recorded in the accounts only when actually used to reduce the Company's income tax liability. Because the unused investment tax credits were not "realized" and did not reduce the Company's actual tax liability during the period, the Company should not have recorded the unused amounts in Account 255.

Furthermore, the Company's accounting for the investment tax credit carryforwards understated the deferred income tax amounts recorded in Account 283.
INCOME TAXES

Investment Tax Credits

Accounting for Investment Tax Credit Carryforwards (Continued)

To correct the Company's accounting for ITC carryforwards to comply with the Uniform System of Accounts and to accommodate the Company's recording of ITC carryforwards under SFAS No. 96 -- Accounting for Income Taxes -- the ITC carryforwards should be recorded in Account 253.

It was recommended that the Company:

1. revise procedures to ensure that the accounting for income taxes is consistent with the requirements of the Uniform System of Accounts; and

2. record a correcting entry to eliminate the effects of recording ITC carryforwards in Account 255 and 283, and record the ITC in Accounts 186 and 253.
CHAPTER 9

FUEL AND FUEL ADJUSTMENT CLAUSES

FOSSIL FUEL CONTRACT SETTLEMENTS/Buy-Outs

Fuel Adjustment Clause Billing of Contract Settlement Costs

The Company improperly included certain payments made to fuel suppliers as part of settlements of contract renegotiations as a component of fuel cost in calculating wholesale fuel adjustment clause (FAC) billings.

In 1986 the Company entered into three agreements to settle four pending lawsuits filed by fuel suppliers against the Company or its agent. The Company accumulated the settlement cost in Account 186, Miscellaneous Deferred Debits. During 1986 it charged the settlement costs to Account 501, Fuel. Also, it included the costs as a component of fuel cost in calculating FAC billings to wholesale customers.

Section 35.14 of the Commission's Regulations under the Federal Power Act defines the elements of allowable fuel cost that are includable in the FAC billing computations. Under Section 35.14(a)(6), the cost of fuel is limited to the following:

The cost of fossil fuel shall include no items other than those listed in Account 151 of the Commission's Uniform System of Accounts for Public Utilities and Licensees.

The payments made to the fuel suppliers to settle the contract disputes involving take-or-pay claims were not properly includable in Account 151, Fuel Stock. The amounts did not relate to the current deliveries of fuel nor did such amounts represent payments for the invoice price of gas or other items of cost listed in Account 151. Because the payments were not properly includable in Account 151, the Company should not have included such amounts in computing wholesale FAC billings.

The Company was required to (1) revise procedures to exclude similar costs from the calculation of fuel costs for future wholesale FAC billings; (2) recalculate tariff billings to wholesale customers for each affected period by eliminating the contract settlement costs from the cost of fuel and refund, with interest computed in accordance with the Commission's regulations, any amounts overcollected.

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FUEL AND FUEL ADJUSTMENT CLAUSES

Fossil Fuel Contract Settlements/Buy-Outs

Accounting for Coal Contract Buy-Out Costs

The Company negotiated a buy-out of a coal supply agreement. The total cost of
the buy-out was financed by Coal Co. which borrowed the funds for the Company's
use. As part of the transaction, the Company and Coal Co. also entered into a
long-term coal supply agreement in which the Company will purchase from Coal
Co. one million tons of coal per year for nine years. The invoice price for
c煤 will include an amount to amortize both the principal and interest over
the nine-year term of the coal supply agreement, plus certain administrative
costs for accounting and other services rendered by Service Company, an
affiliate to the Company.

In accounting for the buy-out, the Company recorded an asset in Account 186,
Miscellaneous Deferred Debits, and a liability in Account 224, Other Long-Term
Debt, equal to the funds advanced by Coal Co. The Company records the entire
amount invoiced each month by Coal Co. to recover the cost of fuel, plus
amortized principal and interest on the debt related to the buy-out and the
administrative costs in Account 151, Fuel Stock.

Under the requirements of the Uniform System of Accounts, costs incurred to
buy-out a fuel contract are not considered as a cost to be assigned to fuel. A
company must record buy-out costs in operating expenses in the period that the
costs were incurred, unless the company has appropriate regulatory assurances
that such amounts are recoverable in rates over future periods.

The Company received authorization from the Public Service Commission to
recover the buy-out costs over a nine-year period from retail customers as part
of fuel adjustment clause billings. On October 6, 1987, and March 23, 1988,
the Commission issued orders granting the Company waiver of Section 35.14 of
the Commission's Regulations to include the buy-out costs in FAC billings to
certain wholesale customers.

The invoice price should not be construed as including all charges invoiced by
a fuel supplier but only those charges related to the cost of fuel delivered
and on hand. The inclusion of buy-out costs, interest on the related debt and
administrative expenses as part of the invoice price does not mean that such
costs are a proper charge to Account 51.

The Commission addressed the issue of financing fuel inventory in an order
issued to Southern California Edison Company in Docket No. E-8570, issued
April 26, 1978 (3 FERC 61,075). In the order the Commission stated:

Based on a strict interpretation of Account 151, we find that
Edison's financing charges associated with its Trust arrangement
are not within the ambit of the Company's "invoiced price of fuel" as contemplated by Account 151(1). We reject Edison's contention that all component costs of Edison's fuel invoices are automatically proper entries in Account 151(1); this argument emphasizes the mere form of the Company's invoices over the substance of the various component costs which underlie the total invoice expense.
Fossil Fuel Contract Settlements/Buy-Outs

Accounting for Coal Contract Buy-Out Costs (Continued)

As a result of the regulatory approvals received, the Company has a basis for deferring the buy-out costs in Account 186. The Company should record the portion of the invoiced price of coal that covers amortization of the debt to support the buy-out in Account 506, Miscellaneous Steam Power Expenses, and the related interest on the debt in Account 431, Other Interest Expense. The Company should record the administrative expenses billed by Service Company, in the appropriate administrative and general expense accounts.

The Company was required to revise procedures to account for the principal and interest related to the coal contract buy-out and the related administrative costs in conformance with the requirements of the Uniform System of Accounts requirements.

Accounting and Fuel Adjustment Clause Billings for Payments Made to Cancel Coal Contracts

In August 1985, the Company and coal supplier signed an agreement to cancel deliveries on the coal contract that originally was to expire in mid-1986. The agreement provided that the Company pay $20 per ton not to take deliveries on 720,387.35 tons of coal or a total of $14,407,747.

Also, the Company signed an agreement to cancel the transportation agreement covering the coal. Under the agreement, the Company paid $305,000 to buy-out the associated transportation related to the coal.

The Company accounted for the $14,407,747 settlement with the coal supplier by debiting Account 186, Miscellaneous Deferred Debits and crediting Account 242, Miscellaneous Current and Accrued Liabilities. As replacement coal was received, the Company reclassified a portion of the amount deferred in Account 186 to Account 151, Fuel Stock. When the Company burned the replacement tons, it amortized the coal buy-out costs to Account 501, Fuel Expense, and included such amounts as a component of fuel costs for billings under its wholesale fuel adjustment clause.

The Company charged the transportation buy-out to Account 151 when it was paid in February 1986. It amortized the transportation buy-out to Account 501 as replacement coal was delivered to the related power stations.

The Commission's fuel adjustment regulations are contained in Section 35.14 of the Commission's Regulations.
Fossil Fuel Contract Settlements/Buy-Outs

Accounting and Fuel Adjustment Clause Billings for Payments Made to Cancel Coal Contracts (Continued)

The buyout payments did not qualify as a cost of fuel for the following reasons:

The Commission addressed the subject of fuel cost recovery of contract buyouts to coal vendors in an order issued to Kentucky Utilities Company (KU) and Nevada Power Company (NPC) on December 13, 1988 (Docket No. EL88-20-000 and EL88-32-000). In the order the Commission stated:

KU and NPC are in error when they assert that buyout costs are always eligible for fuel clause treatment if the amounts are properly booked in Account 151. Section 35.14 limits fuel clause recovery to the cost of fossil and nuclear fuel consumed in the utility's own plants and the identifiable cost of fossil and nuclear fuel associated with purchases. The cost of fossil fuel is further limited to include no items other than those listed in Account 151.

...Buyout costs are payments to vendors in consideration for purchasing fuel required by contract. As such, buyout costs are the very antithesis of the cost of fuel consumed. Accordingly, waiver of the fuel clause regulations is required whenever a utility seeks to recover buyout costs in the fuel clause regardless of the accounting treatment which may be permitted.

The Company received specific approval from the State Commission to amortize the cost of the buyout in retail fuel adjustment clause billings. As a result of the Commission approval the Company should have deferred the retail portion of the buyout in Account 186, Miscellaneous Deferred Debits. Since the Company did not have the rate approval of the FERC, it should have charge the wholesale portions of the buyout costs as incurred to Account 506, Miscellaneous Steam Power Expense and not have included the expensed amount in wholesale FAC billings.

The Company was required to:

1. revise procedures to ensure that coal and transportation buy-out costs are expensed when incurred to Account 506, Miscellaneous Steam Power Expenses, unless deferral in Account 186, Miscellaneous Deferred Debits, is appropriate, consistent with rate recognition.

2. recalculate wholesale fuel adjustment clause billings by eliminating the above buy-out costs from the cost of fuel and make the appropriate refunds, together with related interest, for any overbilled amounts.
FUEL AND FUEL ADJUSTMENT CLAUSES

Fossil Fuel Contract Settlements/Buy-Outs

Accounting and Fuel Adjustment Clause Billings of Costs Related to Deferred Coal Shipments

The Company improperly recorded payments for the deferral of coal deliveries required under long-term coal supply agreements in Account 151, Fuel Stock. It also included the additional cost in fuel adjustment clause (FAC) billings to wholesale customers.

The Company deferred delivery of up to 140,000 tons of coal for which it was obligated to purchase under contract, for up to three years. In return, the Company agreed to pay $12 for each ton of coal for which it deferred delivery. Half of the charge was compensation for deferring delivery of the coal and the other half the Company could apply as a credit against future purchases of coal.

The Company paid $1,402,753 for deferred delivery of 115,293 tons of coal. The Company recorded $701,376 in Account 151 and subsequently included the $701,376 as a component of fuel cost in computing FAC billings to wholesale customers.

The Company recorded the remaining $701,376 in Account 165, Prepayments, to use as a credit against future coal purchases. However, the Company terminated the contract before it could purchase any additional coal. The Company subsequently entered into an agreement in which it received credit for the $701,376 as part of the final payment for terminating the coal contract. The Commission approved a special "rider" to the Company's tariff for recovery of the final payment associated with the contract termination payment.

The Company's payments that related to the deferred delivery of coal did not represent a cost of fuel on hand. The payments were expenses that the Company should have charged as incurred to Account 506, Other Steam Power Expenses.

Section 35.14 (a)(6) of the Commission's regulations covering fuel adjustment clauses states,

The cost of fossil fuel shall include no items other than those listed in Account 151 of the Commission's Uniform System of Accounts for Public Utilities and Licensees.

Therefore, the payments the Company made for the deferred delivery of coal did not meet the criteria for inclusion in a fuel adjustment clause under Section 35.14 of the Regulations of the Federal Power Act.

The Company was required to (1) revise procedures to ensure that expenditures for the deferred delivery of coal are recorded in Account 506, Other Steam Power Expense; (2) recalculate the wholesale FAC billings, excluding the aforementioned costs for all periods in which such improper costs were included in billings to wholesale customers and, refund, with interest, the overcollected amounts in accordance with Section 35.19(a) of the Commission's regulations.
FUEL AND FUEL ADJUSTMENT CLAUSES

Fossil Fuel Contract Settlements/Buy-Outs

Accounting and Tariff Billing for Payments Related to Coal Not Taken

The Company improperly recorded additional payments made to a coal supplier for coal not taken in Account 151, Fuel Stock, and as a component of fuel cost in wholesale fuel adjustment clause (FAC) billings.

The Company is one of four Owners of the three coal-fired generating units. The original coal supply agreement negotiated and executed between Coal Company and the Owners was a "take or pay" contract. In accordance with the provisions of the original agreement, the Owners were obligated to pay the full contract price on the specified minimum annual tonnage requirements, whether the minimum quantities of coal were taken or not. After the contract became effective, the Owners saw that they would not meet the minimum annual tonnage requirements included under the contract due to delays in construction of the generating units and lower than anticipated demand. Therefore, the Owners amended the agreement to reduce the minimum annual tonnage requirements in the early years and increase the annual tonnage requirements in the later years. As part of this agreement, the Owners also agreed to a "deficient tonnage" payment in the event that they did not purchase the minimum tonnage set forth in the contract.

The Company initially recorded the "Deficient Tonnage" payments in Account 151, Fuel Stock. In December 1984 the Company expensed the amounts previously recorded in Account 151 by a charge to Account 501, Fuel, and included these amounts in the computation of the fuel cost for FAC billings to wholesale customers.

The instructions to Account 151 limit the costs included therein to that related to the inventory of fuel purchased and on hand at the Company. The supplemental payments made to the coal supplier represent a charge for the Company's failure to purchase all the coal specified under the terms of the contract. As such, the Company should not have assigned the additional payments to the inventory cost of coal actually delivered and on hand. Under the requirements of the Uniform System of Accounts, the Company should have considered the additional payments as a period expense properly recordable in either Account 501, if such amounts were deemed to be just and reasonable, or otherwise in Account 426.5, Other Deductions.

The supplemental payments to coal company did not qualify for inclusion in the fuel adjustment clause under the above quoted instructions since such payments did not meet the definition of cost properly includible in Account 151 nor were the payments related to fuel delivered and consumed in the Company's operations.

If the Company wanted to recover the supplemental payments through the wholesale FAC it should have sought waiver of the Commission's FAC regulations. This option is provided to the Company pursuant to Section 35.14(a)(10).

The Company was required to (1) revise procedures to record future payments of a similar nature as a period cost to the appropriate expense account, (2) discontinue including the DTP in the calculation of fuel cost for the wholesale FAC billings, and (3) recalculate tariff billings to its wholesale customers and refund, with interest, any amounts overcollected.
Accounting and Tariff Billing for Coal Analysis Costs

The Company improperly included costs associated with the analysis of coal in Account 151, Fuel Stock.

The Company included payroll charges of the Chief Chemist and Assistant Chemist in Account 151, Fuel Stock for their time spent on the analysis of the coal after it was unloaded from the shipping medium. The Company also included charges for coal analysis performed by two outside firms in Account 151. The charges described above were included in the computation of fuel cost in wholesale fuel adjustment clause (FAC) billings.

Under the requirements of the Uniform System of Accounts, the cost of fuel analysis should either be recorded in Account 152, Fuel Stock Expenses Undistributed or charged directly to Account 501, Fuel. The instruction to Account 152 states, in part, "A. This account may include the cost of labor and of supplies used and expenses incurred in unloading fuel from the shipping medium and in the handling thereof prior to its use."

Section 35.14(a)(6) of the Commission's Regulations under the Federal Power Act, which relates to the fuel adjustment clause, states in part, "The cost of fossil fuel shall include no items other than those listed in Account 151 of the Commission's Uniform System of Accounts." Because the fuel analysis expenses were not proper charges to Account 151, the Company should not have included the expenses in the computation of fuel cost for FAC billings.

The Company was required to (1) revise procedures to record fuel analysis expenses either in Account 152 or 501 in accordance with the requirements of the Uniform System of Accounts, (2) discontinue including the fuel analysis expenses in the calculation of fuel cost for the wholesale FAC billings, and (3) recalculate tariff billings to wholesale customers for the entire periods that fuel analysis expenses were included in such billings and refund, with interest, any amounts overcollected as a result of including the fuel analysis expenses in wholesale FAC billings.

Accounting and Tariff Billings for Coal Contract Buyout Costs

The Company incurred costs of buying out coal contracts for supplying fuel to generating plants, described as follows:

The Companies negotiated a buyout of the coal supply agreements. The Companies financed the total cost of the buyouts through a third party. As part of the transaction, the Companies also entered into a long-term coal supply agreement to purchase one million tons of coal per year for nine years, the approximate remaining term of the original agreements.
Fossil Fuel Contract Settlements/Buy-Outs

Accounting and Tariff Billings for Coal Contract Buyout Costs (Continued)

The Company accounted for its share of the fuel buyouts and the cost related to the subsequent fuel supply agreement as follows:

(1) recorded an asset in Account 186, Miscellaneous Deferred Debits, and a liability in Account 224, Other Long-Term Debt, equal to its share of the buy-out and related costs financed.

(2) recorded an additional amount in Account 151, Fuel Stock, for its share of costs in excess of the note proceeds, including interest earned on the proceeds received.

(3) increased the inventory price of fuel purchased for the Plant on the open market by recording in Account 151, the amounts billed for:
   (1) amortization of the principal of the note and interest, (2) an industrial fuel tax assessment, and (3) administrative expenses.

(4) recorded an entry each month reducing the principal amounts of the notes recorded in Accounts 186 and 224 by the amounts paid for the amortization of the principal amounts of the notes.

(5) amortized the amounts recorded in Account 151 to Account 501, Fuel and included such amounts in tariff billings to wholesale and retail customers.

Through December 31, 1988, the Company charged its share of the payments to Account 151.

The Company owns a 25 percent undivided interest in another Plant. The Operator operates and maintains the Plant for both itself and as an agent for the Company and other owners. The Operator negotiated a buyout of the coal supply agreement. The Operator billed the Company its share of the buyout agreement. The Company recorded the amount paid to buyout the contract in Account 151. It then amortized this amount to Account 501. It included the amortized amounts in tariff billings to wholesale and retail customers.

Under a third negotiated buy-out agreement for another Plant, the Company paid for a full contract release. The Company financed this buy-out with a debt issue and a capital contribution. The Company accounted for the contract buy-out and the cost related to the subsequent fuel supply agreement as follows:

(1) recorded the termination payment as an asset in Account 186, Miscellaneous Deferred Debits.

(2) recorded the capital contribution in Account 211, Miscellaneous Paid-in Capital and the debt issue in Account 221, Bonds.

(3) recorded monthly in Account 186 the accrued bond interest credited to Account 237, Interest Accrued, and related debt issuance expense amortized from Account 181, Unamortized Debt Expense.
Fossil Fuel Contract Settlements/Buy-Outs

Accounting and Tariff Billings for Coal Contract Buyout Costs (Continued)

(4) recorded monthly an accrued return on the capital contribution (based on the most recently approved retail rate of return on equity) along with the tax effect of the return by entries to Accounts 186, Miscellaneous Deferred Debits and 253, Other Deferred Credits.

(5) transferred the recorded debt principal, interest, capital contribution and return accumulated in Account 186 to Account 151 based on an adder to the cost of coal purchased each month. The amount of the adder was arrived at by dividing the total anticipated amount to be charged to Account 186 by the total number of tons the Company was scheduled to receive over the 10-year contract period.

(6) assigned the amounts transferred to Account 151 to the cost of fuel subsequently purchased and amortized such amounts to Account 501 as fuel recorded in Account 151 was burned fuel.

(7) included the amounts amortized in Account 501 in tariff billings to wholesale and retail customers.

(8) amortized the amount of return and taxes included in Account 253 to Account 557, Other Expenses, over the same period that it included the related amounts in Account 501.

Under the requirements of the Uniform System of Accounts, all costs incurred to buyout a fuel contract are not includible in Account 151.

The Commission addressed the issue of accounting for buy-out cost in an order issued to Kentucky Utilities Company and Nevada Power Company in Docket Nos. EL88-20 and EL88-32, issued December 13, 1988 (45 FERC ¶ 61,409). In the order the Commission stated:

... the Commission notes that the purpose of Account 151 is to accumulate the cost of fuel on hand, whereas, buyout costs are for the purpose of terminating a contract to purchase future coal. Buyout costs would therefore be includible in Account 151 only to the extent that we were to interpret our accounting regulations to contemplate that costs of future fuel purchases should include some portion of previously incurred buyouts costs. We have not so interpreted our accounting regulation in the past, nor do we believe that it would be wise to do so here. We believe that buyout costs should be expensed as incurred or, in the event that rate recognition is given in an appropriate proceeding, amortized to expense from a deferred charge account consistent with the rate recognition.
FUEL AND FUEL ADJUSTMENT CLAUSES

Fossil Fuel Contract Settlements/Buy-Outs

Accounting and Tariff Billings for Coal Contract Buyout Costs (Continued)

In accounting for the costs related to the foregoing contract buy-outs, the Company should have used the following operating expense accounts:

<table>
<thead>
<tr>
<th>Type of Cost</th>
<th>Proper Account Charged</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of fuel purchased on the open market</td>
<td>Account 151, Fuel Stock</td>
</tr>
<tr>
<td>Buyout payments</td>
<td>Account 506, Miscellaneous Steam Power Expenses</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>Account 920 - 932</td>
</tr>
<tr>
<td>Bond interest and expense on debt to support buyouts</td>
<td>Account 427, Interest on Long-Term Debt</td>
</tr>
<tr>
<td>Return earned and related taxes on capital contribution</td>
<td>Account 421, Miscellaneous Non-Operating Income</td>
</tr>
<tr>
<td>Taxes on the buyouts</td>
<td>Accounts 408.1, Taxes Other Than Income Taxes, Utility Operating Income</td>
</tr>
</tbody>
</table>

The Company should have recorded the costs related to buy-outs of fuel contracts in the above operating expense accounts in the period that it incurred the costs, unless it had appropriate regulatory assurances that such amounts were recoverable in rates over future periods.

The Company received authorization from the Public Service Commission to recover the above mentioned buy-out costs from its retail customers as part of the fuel adjustment clause billings. However, the Company did not specifically request nor did it receive FERC permission to recover the buy-out costs from wholesale customers under the above mentioned tariffs.

As previously mentioned, the Commission addressed the accounting for buy-out costs in an order issued to Kentucky Utilities Company and Nevada Power Company in Docket Nos. EL88-20 and EL88-32, issued December 13, 1988 (45 FERC ¶ 61,409). Also, the Commission addressed the appropriateness of including buy-out costs in fuel adjustment clause billings. On this matter, the Commission stated:

Section 35.14 limits fuel clause recovery to the cost of fossil and nuclear fuel consumed in the utility's own plants and the identifiable cost of fossil fuel is further limited to include no items other than those listed in Account 151. The Account 151 limitation is simply an additional constraint beyond the threshold requirement that amounts reflect only the cost of fossil fuel consumed. To the extent amounts are booked to Account 151 which are not part of the cost of fossil and nuclear fuel consumed, those costs do not meet the requirements of Section 35.14 and are not eligible for fuel clause recovery.
FUEL AND FUEL ADJUSTMENT CLAUSES

Fossil Fuel Contract Settlements/Buy-Outs

Accounting and Tariff Billings for Coal Contract Buyout Costs (Continued)

Buyout costs are payments to vendors in consideration for not purchasing fuel required by contract. As such, buyout costs are the very antithesis of the cost of fuel consumed. Accordingly, waiver of the fuel clause regulations is required whenever a utility seeks to recover buyout costs in the fuel clause regardless of the accounting treatment which may be permitted.

It was improper for the Company to include the buy-out and the other related costs as a component of fuel cost in fuel adjustment clause billings to wholesale customers without a waiver from the FERC.

Unit / Bulk Sale Contracts

Cost recovery under unit and bulk sale contracts is based upon the specific formula provided in each contract (the unit power sales contracts specify the generating unit(s) and amount of power to be sold while bulk power agreements do not specify the source or quantity of the power transactions). The formulas rely on the accounting classifications and the requirements contained in the Uniform System of Accounts as a basis for defining the amounts properly includible in the tariff billings.

The Company did not comply with the requirements of the Uniform System of Accounts for recording the buy-out costs and related amounts. In accounting for the costs related to the foregoing contract buy-outs, the Company should have used the following operating expense accounts:

<table>
<thead>
<tr>
<th>Type of Cost</th>
<th>Proper Account Charged</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buy-out payments</td>
<td>Account 506, Miscellaneous Steam Power Expenses</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>Account 920 – 932</td>
</tr>
<tr>
<td>Bond interest and expense on debt to support buyouts</td>
<td>Account 427, Interest on Long-Term Debt</td>
</tr>
<tr>
<td>Return earned and related taxes on capital contribution</td>
<td>Account 421, Miscellaneous Non-Operating Income</td>
</tr>
<tr>
<td>Taxes</td>
<td>Accounts 408.1, Taxes Other Than Income</td>
</tr>
<tr>
<td></td>
<td>Taxes, Utility Operating Income</td>
</tr>
</tbody>
</table>

Only to the extent that the formula for a unit sale agreement contained the above accounts did the Company have a basis for including the related buy-out amounts in tariff billings under the contract. To the extent that the formula for a particular unit sale agreement did not include the above accounts, the Company was precluded from including the related amounts in the tariff billings without obtaining specific Commission approval.
Fossil Fuel Contract Settlements/Buy-Outs

Unit / Bulk Sale Contracts (Continued)

Furthermore, the Company should have obtained specific Commission approval to amortize the costs related to the contract buy-outs over a period of years. However, we are not taking exception to the Company's decision to amortize certain of the costs that it would otherwise be allowed to include in operating expense accounts in the year incurred under the existing formula. The Public Service Commission had approved the amortization periods selected by the Company. Also, from our initial review Staff concluded that such periods appear reasonable under the circumstances.

Staff recommended that the Company:

(1) revise accounting procedures to ensure that costs incurred in buying out fuel contracts (including amounts paid contractors, administrative expense, and costs of financing the payments) are classified according to the requirements of the Uniform System of Accounts;

(2) record a correcting entry to reclassify any buy-out related costs improperly included in Account 151 at December 31, 1988, to either Account 186 or to the appropriate expense account;

(3) record a correcting entry to expense any buy-out amounts deferred in Account 186 that are not subject to rate recovery under the existing FERC approved tariffs; and

(4) unless otherwise authorized by the Commission, recompute billings to wholesale customers with FAC for any period that fuel buy-out costs were improperly included in such billings and make refunds to customers, with interest computed in accordance with Section 35.19(a) of the Commission's regulations, for any overcollected amounts.
Fossil Fuel Contract Settlements/Buy-Outs

Accounting for Coal Contract Termination Payments

The Company paid termination costs on behalf of all the participants and recorded the amounts in Account 151, Fuel Stock. Subsequently, it assigned the termination payments to the other owners and deferred its share by transferring such amounts to Account 174, Miscellaneous Current and Accrued Assets.

The Company notified the Public Service Commission (PSC) of its intention to recover the retail portion of the accumulated deferred termination payments over a six month period, as a component of retail FAC billings.

The Company did not request FERC approval to recover from wholesale customers the wholesale portion of the termination payments deferred in Account 174.

At December 31, 1989, the FERC wholesale portion of the deferred termination payments remained in Account 174.

In January 1990 the Company began expensing the deferred termination payments to Account 501, Fuel Expense. Also, it began excluding the FERC portion of the current monthly termination costs from the calculation of the FAC billings to wholesale customers. However, as a result of clerical errors, the Company did include a portion of the termination payments in billings under the wholesale Fuel Adjustment Clause.

Staff concluded that the Company's accounting for the termination payments was not consistent with the requirements of the Uniform System of Accounts.

The Company should have recorded the termination payments to an operating expense in Account 506, Miscellaneous Steam Power Expenses, when it canceled the contract.

If the Company planned to seek and believed it would be successful in receiving approval by its regulatory commissions for specific recovery of the termination payments in rates charged customers over future periods, it should have used the special accounting approved by the Commission for regulatory created assets by debiting Account 186, Miscellaneous Deferred Debits, and crediting Account 406, Amortization of Electric Plant Acquisition Adjustments.

Since the Company sought and obtained the PSC's approval for the recovery of the termination payments from retail customers, Staff concluded that it was appropriate for the Company to defer the retail portion of the termination payments. However, it was not appropriate for the Company to defer the FERC portion of the termination payments.
FUEL AND FUEL ADJUSTMENT CLAUSES

Fossil Fuel Contract Settlements/Buy-Outs

Accounting for Coal Contract Termination Payments (Continued)

Staff's conclusion on the appropriate accounting for the payments is consistent with the Commission's policy of fuel adjustment clause treatment of utility payments to reduce or eliminate contract purchase commitments to buy coal. On December 13, 1988, the Commission issued a decision to Kentucky Utilities Company (Docket No. EL88-20-000) and Nevada Power Company (Docket No. EL88-32-000) addressing both the accounting and ratemaking for coal contract buyout costs. Also, the Commission focused on the subject of fuel buydowns and buyouts of coal contracts in orders issued to Northern States Power Company (Wisconsin) (Docket No. EL88-39-000), and Northern States Power Company (Minnesota) (Docket No. EL89-9-000).

The Commission set forth the following policy guidance with respect to coal termination costs:

1. The purpose of Account 151 is to accumulate the cost of fuel on hand, whereas, termination costs are for the purpose of terminating a contract to purchase future fuel.

2. Termination costs are payments to vendors in consideration for not purchasing fuel required by contract. As such, termination costs are the very antithesis of the cost of fuel consumed.

3. Termination costs should be expensed as incurred or, in the event that rate recognition is given in an appropriate proceeding, amortized to expense from a deferred charge account consistent with the rate recognition.

Staff recommended that the Company:

(1) adopt procedures to ensure that any future coal contract termination costs are accounted for according to the requirements of the Uniform System of Accounts;

(2) record a correcting entry to expense the remaining wholesale rate portion of the termination costs recorded in Account 174 and to reclassify the retail rate portion to Account 186; and

(3) recalculate the monthly wholesale FAC billings for any periods that termination costs were included as a component of the cost of fuel and make refunds, with interest computed in accordance with Section 35.19(a) of the Commission's Regulations under the Federal Power Act, to the wholesale customers for any overcollected amounts.
Fossil Fuel Contract Settlements/Buy-Outs

Accounting and Tariff Billings of Costs Related to Contract Cancellation

In 1973 the Company entered into a long-term contract to purchase coal. Also, the contract obligated the Company to make lease payments for mine equipment until the coal contract expired on December 31, 1996.

In 1986 the Company entered into an amendment to the contract that set a new expiration date of December 31, 1989. However, the amended contract did not alter the provision related to the Company's liability to make the lease payments for mine equipment until December 31, 1996.

In January 1987, the Company recognized that it had an additional liability for the mine equipment payments so it began adding an accrual to the cost of coal taken from the mine. The purpose of the accrual was to recover the lease payments that it would have to make on the mine equipment from 1990 through 1996 during the remaining fuel deliveries.

The Company recorded the accrual in Account 151, Fuel Stock. As it burned the related fuel, it amortized the total cost of the delivered coal and the accrued mine equipment costs recorded in Account 151 by charges to Account 501, Fuel. Also, the Company included the amortized amounts as a cost of fuel in determining FAC billings to wholesale customers.

The Company did not comply with the requirements of the Uniform System of Accounts by keeping its accounts for the above transaction on the accrual basis.

General Instruction No. 11 of the Uniform System of Accounts states in part:

A. The utility is required to keep its accounts on the accrual basis. This requires the inclusion in its accounts of all known transactions of appreciable amount which affect the accounts. If bills covering such transactions have not been received or rendered, the amounts shall be estimated and appropriate adjustments made when the bills are received.

Under General Instruction No. 11, a company is required to make provisions in its accounts for all known transactions of appreciable amounts that affect the accounts, using estimates in recording the transactions in the event bills are not rendered.

The Company should not have deferred recognizing the expense related to the lease payments for mine equipment covering the period 1990 through 1996 to future accounting periods unless it had received regulatory approval to recover the termination payments in rates charged to customers over future periods. Absent such approval it should have expensed the amounts by charges to Account 501 during 1986 when it amended the contract.
FUEL AND FUEL ADJUSTMENT CLAUSES

Fossil Fuel Contract Settlements/Buy-Outs

Accounting and Tariff Billings of Costs Related to Contract Cancellation
(Continued)

The Company planned to seek approval by its regulatory commissions for
recovery of the termination payments in rates charge customers over future
periods. Therefore, it should have used the special accounting approved by
the Commission for regulatory created assets. Under the special accounting,
the Company should have debited Account 186, Miscellaneous Deferred Debits,
and credited Account 406, Amortization of Electric Plant Acquisition
Adjustments, for the amounts that it expected to received in rates charged to
customers.

In an order issued to Northern States Power Company in Docket Nos. EL88-39-000
and EL89-9-000, the Commission summarized the two criteria that must be
present for fuel cost recovery. The first of the two criteria mentioned by
the Commission is that the fuel costs must reflect the cost of fuel "consumed".
The second criteria is that the fuel costs must be among the items listed in
Account 151.

The Company’s accrual for the future lease payments did not meet the criteria
for including the amount as a cost of fuel for billings to wholesale customers
under the FAC. The accrual of $1.69 per ton was not properly includable in
FAC billings because the amounts were not related to the cost of fuel burned
during the periods the Company included the amounts in FAC billings.

The Commission has issued several decisions addressing its policy of
prohibiting fuel adjustment clause treatment of utility payments to reduce or
eliminate contract purchase commitments to buy coal. On December 13, 1988,
the Commission issued a decision to Kentucky Utilities Company (Docket No.
EL88-20-000) and Nevada Power Company (Docket No. EL88-32-000) addressing both
the accounting and ratemaking for coal contract buyout costs. Also, the
Commission focused on the subject of fuel buydowns and buyouts of coal
contracts in orders issued to Northern States Power Company (Wisconsin)
(Docket No. EL88-39-000), and Northern States Power Company (Minnesota)
(Docket No. EL 89-9-000).

Staff recommended that the Company:

(1) adopt procedures to ensure that any future coal contract termination
costs are accounted for according to the requirements of the Uniform
System of Accounts; and

(2) recalculate the monthly wholesale FAC billings for any periods that
termination costs were included as a component of the cost of fuel and
make refunds, with interest computed in accordance with Section 35.19(a)
of the Commission's Regulations under the Federal Power Act, to the
wholesale customers for any overcollected amounts.
Fossil Fuel Contract Settlements/Buy-Outs

Accounting and Fuel Adjustment Clause Billing of Settlement Payments to A Fuel Supplier

On July 3, 1968, the Company entered into a 34-year agreement for coal supply.

The Company scheduled an outage at the plant. The Supplier agreed to cut back its mining operations during the period of scheduled outage to reduce coal deliveries. However, the plant did not return to normal operation as anticipated.

After negotiations, the parties reached an agreement in which the Company agreed to reimburse the Supplier for certain fixed costs and lost profits.

The Company included the surcharge when invoiced in Account 151 as part of the cost of coal delivered. Subsequently, it amortized the amounts to Account 501, Fuel, and included the amounts in computing the cost of coal burned for FAC billings to wholesale customers.

As previously mentioned, the Supplier's claims of gross inequity were for coal deliveries during the period June 1, 1982, through November 30, 1983. Therefore, the settlement relates to the Supplier's costs incurred prior to 1984. In substance, it reflected the parties agreement that payments take place over time rather than in a lump-sum.

Since the obligation to pay was known and measurable at the latest by April 1, 1984, we concluded that the Company should have charged expense and recorded a liability for the amount at least by that date.

The Company's procedure of recognizing the cost related to past periods as the cost of coal incurred in periods as the coal supplier was paid, was contrary to the accrual method of accounting required by General Instruction No. 11 of the Uniform System of Accounts.

The gross inequity payments made to the Supplier in settlement of a contract dispute were not proper charges to Account 151 since the payments did not relate to the inventory of fuel delivered and on hand during that period and were not a cost of fuel consumed during those periods. Therefore, the Company's subsequent inclusion of the gross equity amounts in wholesale FAC billings were contrary to the Commission's regulations.
FUEL AND FUEL ADJUSTMENT CLAUSES

Fossil Fuel Contract Settlements/Buy-Outs

Accounting and Fuel Adjustment Clause Billing of Settlement Payments to A Fuel Supplier (Continued)

If the Company wanted to recover the gross inequity amounts from its wholesale customers it should have petitioned the Commission at the time for a declaratory order to deviate from the above requirements. Subsection 35.14(a)(10) states:

Whenever particular circumstances prevent the use of the standards provided for herein, or the use thereof would result in an undue burden, the Commission may, upon application under §385.207 of this chapter and for good cause shown, permit deviation from these regulations.

In an order issued to Minnesota Power & Light Company the Commission addressed the proper procedures a utility should use to request guidance on whether an item is properly included in Account 151 (Docket No. FAB4-15-003, issued December 6, 1988, 45 FERC ¶ 61,369). The Commission stated:

. . . A utility that has a legitimate question concerning whether an item is properly accounted for in Account 151, or in any other account, has two procedural avenues available to resolve any uncertainties. It should promptly bring its question to the Commission by either requesting an opinion from the Commission's Chief Accountant or by filing a petition for declaratory order with the Commission. In this case, the Company did neither. Rather, it determined on its own that the attorney's fees and A&G expenses were properly accounted for in Account 151 and thus could be recovered through its FAC.

As a general matter, we believe that it is appropriate to hold the management of utilities accountable for their actions. We presume that all utilities subject to our jurisdiction are familiar with the Commission's procedures, discussed above, that allow questions of doubtful interpretation covering our accounting regulations to be resolved. In addition, utilities are presumed to know the fuel adjustment clause regulations. See 18 C.F.R. § 35.14(a)(10)(1988) . . .

Staff recommended that the Company:

(1) revise procedures to ensure that in the future when contract of obligations and costs of similar nature are established, the cost is expensed in the proper accounting period; and

(2) recompute FAC billings to wholesale customers for the period by eliminating the surcharge amount improperly included in the cost of fuel included in such billings and make appropriate refunds, including interest computed according to the Commission's regulations, to all wholesale customers for any overcollections.
FUEL AND FUEL ADJUSTMENT CLAUSES

Mine Reclamation Costs

Accounting and FAC Billing for Reclamation Study Cost

The Company improperly recorded payments for a study of coal mine reclamation costs in Account 151, Fuel Stock. Also, the Company included the payment in fuel adjustment clause (FAC) billings to wholesale customers.

The Company terminated a coal supply agreement. As a result of the contract termination, the Company was obligated to pay for a share of the cost of reclaiming the mine used to supply coal under the terminated agreement. It hired a consulting firm to provide an opinion on the reasonableness of a proposed settlement.

The Company recorded the payment made for the study in Account 151, Fuel Stock. Also it included the payment as a component of fuel cost in computing FAC to wholesale customers.

The instructions to Account 151 do not permit payments for reclamation studies. The Company should have recorded the reclamation study costs in Account 923, Outside Service Employed.

Section 35.14(a)(6) of the Commission's regulations covering fuel adjustment clauses states,

The cost of fossil fuel shall include no items other than those listed in Account 151 of the Commission's Uniform System of Accounts for Public Utilities and Licensees.

The Company was required to (1) revise procedures to ensure that expenditures for mine reclamation study cost are recorded in Account 923, Outside Services Employed; (2) recalculate the wholesale FAC billings, excluding the aforementioned cost for all periods in which such improper costs were included in billings to wholesale customers, refund, with interest, the overcollected amounts in accordance with Section 35.19(a) of the Commission's regulations.
FUEL AND FUEL ADJUSTMENT CLAUSES

Mine Reclamation Costs

Tariff Billing For Mine Reclamation Costs

The Company improperly included accrued mine reclamation costs in fuel adjustment clause (FAC) billings to wholesale customers.

Under the terms of a contract, the Company is obligated to pay final mine reclamation costs when the coal agreement terminates and the mine is closed. The reclamation work will take place over a period of 20 months and the cost is estimated at approximately $6 million. The Company is obligated to pay these reclamation costs at the time the coal mining incurs the reclamation costs.

The Company began accruing mine reclamation costs in its accounts. The accruals for reclamation costs were subsequently amortized to Account 501, Fuel, and included in the calculation of fuel cost in wholesale fuel adjustment clause (FAC) billings.

Section 35.14 of the Commission's regulations identifies the fuel costs that may be included in a utility's fuel adjustment clause. Under the requirements of Section 35.14, the costs of fossil fuel is restricted to those cost elements listed in Account No. 151 of the Commission's Uniform System of Accounts.

In Docket No. EL81-11-000, Kansas Municipal and Cooperative Electric Systems, order dated September 24, 1981, the Commission addressed the accounting and fuel adjustment clause treatment of coal mine land reclamation costs. In the order the Commission stated:

In view of the fact that coal mine land reclamation is presently required by law, the Commission finds that the legitimate cost of reclaiming surface mines should be considered an appropriate expense incurred by a coal producer. Insofar as the coal supplier actually collects such a charge as a component of the unit cost of fuel, the reclamation costs, in turn, would qualify as "other expenses directly assignable to the cost of fuel" for purposes of fuel clause treatment by a jurisdictional utility.

Under the unique arrangement at issue in the instant docket, however, Arch provides to KCPL only an estimate of reclamation costs attributable to the coal supplied to the utility. As indicated by KCPL, such charges are not immediately paid to Arch but, instead, are delayed until actual reclamation costs are incurred by Arch. Nonetheless, KCPL uses the estimate of future reclamation costs to develop its own current per unit charge for reclamation costs to be recovered through the fuel clause. Thus, KCPL has direct control over the determination of the amount of charges passed through the fuel clause to recover prospective reclamation costs. However, despite the estimated nature of KCPL's billings, the company has not provided for any adjustment to fuel clause charges in the event that actual costs differ from the estimated costs. Neither has the company submitted the estimated unit charges for reclamation costs used in the monthly fuel adjustment calculation to the Commission for approval.
Tariff Billing For Mine Reclamation Costs (Continued)

The fuel adjustment clause has never been intended as a carte blanche to recover unreviewed estimated costs where no mechanism exists to correct for erroneous estimates. Therefore, KCPL will be ordered to discontinue fuel clause pass through of charges for coal and reclamation costs. Such directive, however, will be supported by appropriate cost data, together with a provision to adjust for differences between estimated and actual costs.

In view of the Commission's ruling in the KCPL case it was the opinion of the Division of Audits that the Company improperly included cost related to mine reclamation costs in FAC billings.

The Company was required to recompute wholesale FAC billings for each period that accrued mine reclamation costs were included in such billings and make appropriate refunds, with interest computed in accordance with the Commission regulations, to all wholesale customers.

Accounting and Tariff Billing for Mine Closing Costs

In September 1983, the Mining Corporation shutdown its Mine and the Company received its final shipment of coal from the mine. As part of the coal supply agreement, the Company was required to reimburse Mining Company for the cost of closing the mine. From October 1983 through December 1988, the Company was charged over $1 million of mine closing costs.

The Company charged the mine closing costs when billed to Account 151, Fuel Stock. It then assigned the mine closing costs to other fuel included in Account 151 and expensed the assigned amounts to Account 501 as it consumed the other fuel. Also, it included the assigned amounts as a component of fuel cost for billings under its wholesale fuel adjustment clause tariff.

Under the requirements of the Uniform System of Accounts, a utility can include the book cost of fuel delivered and on hand in Account 151, Fuel Stock. The first item listed in the instructions to Account 151 is: "Invoiced price of fuel, less any cash or other discounts." It should be noted that the invoice price of fuel properly recorded in Account 151 would not necessarily include all charges invoiced by a fuel supplier, but only those charges related to the cost of fuel delivered and on hand.

The mine closing costs that the Company paid during the period October 1983 to December 31, 1988, did not relate to the quantity of fuel delivered and on hand during those periods. Rather, such amounts represented unpaid liabilities properly assignable to the coal delivered in prior periods. As such, the Company should not have assigned the mine closing costs to the inventory on hand since there was not a direct relationship between the inventory quantities purchased in the subsequent periods from other suppliers and the costs of closing the Mine.
FUEL AND FUEL ADJUSTMENT CLAUSES

Mine Reclamation Costs

Accounting and Tariff Billing for Mine Closing Costs (Continued)

To the extent the liability for mine closing costs could have been reasonably estimated and assigned to coal delivered, the Company should have accrued the liability and assigned the cost to fuel inventory as coal was delivered under the contract. In the event that the Company could not have reasonably estimated its mine closing liability during the coal delivery period, it should have accrued the liability and recorded an appropriate charge to operating expense when the liability could be reasonably estimated. However, if recovery of the mine closing costs in future rates was probable, the Company should have deferred the recoverable portion of the mine closing liability in Account 186, Miscellaneous Deferred Debts, and amortized such amounts to expense over the period of rate recovery.

Support for the accrual of the estimated liability for mine closing costs is found in General Instruction No. 11 of the Uniform System of Accounts, which states in part:

A. The utility is required to keep its accounts on the accrual basis. This requires the inclusion in its accounts of all known transactions of appreciable amount which affect the accounts. If bills covering such transactions have not been received or rendered, the amounts shall be estimated and appropriate adjustments made when the bills are received.

As a result of the regulatory approvals received from the Public Service Commission, the Company had a basis for deferring the retail portion of the Mine closing costs in Account 186, Miscellaneous Deferred Debts.

It was recommended that the Company:

(1) revise accounting procedures to ensure that contract costs related to fuel delivered are accrued during the appropriate periods and recorded in the appropriate accounts consistent with the requirements of the Uniform System of Accounts;

(2) record a correcting entry to establish the appropriate liability for any additional estimated costs related to closing the Mine; and

(3) recompute fuel adjustment clause billings to wholesale customers for the affected period by eliminating the mine closing costs included in such billings and refund, with interest computed in accordance with Section 35.19(a) of the Commission's regulations, any overbilled amounts.
Calculation of Carrying Charges on Unrecovered Purchased Gas Cost

The Company received volumes of gas from production areas in excess of the volumes billed by the producers. The Company recorded an estimated liability to recognize the volumes of gas received from these producers, but not yet paid for, by a debit to Account 806, Exchange Gas, and a credit to Account 242, Miscellaneous Current and Accrued Liabilities. The amount of the liability was based on the cost of gas in the month the volumes were received with subsequent monthly revaluations. All amounts recorded in Account 806 in connection with these transactions were included in the determination of the amounts recorded in Account 191, Unrecorded Purchased Gas Cost, and subsequent purchased gas adjustment calculations. The Company's account for these transactions may have resulted in a pre-collection of purchased gas cost, an inappropriate recovery of carrying charges on unexpended funds, and a retention of certain time value benefits applicable to gas costs collected from the Company's customers prior to the payment of such costs to its suppliers. At the present time, the staff has not concluded its review of the accounting for the above noted transactions and its effect on amounts ultimately recovered from the Company's customers. Accordingly, these matters are reserved pending the receipt of additional information and further staff review.

Accounting for Carrying Charges

The Company recorded positive/negative carrying charge provisions computed on under/overrecovered purchased gas costs by debiting/crediting Account 191, as appropriate, with contra entries to Account 483, Sales for Resale. As recovery of the carrying charge provisions occurred, the above entry was reversed in the amount of the recovery made from the customer.

The text of Account 419, Interest and Dividend income, states, "This account shall include interest revenues on securities, loans, notes, advances, special deposits, tax refunds and all other interest bearing assets...".

The text of Account 805.1, Purchased Gas Cost Adjustments, states, "This shall be debited or credited with amounts amortized from Account 191, Unrecovered Purchased Gas Costs."

The Company should record positive and negative provisions for carrying charges on unrecovered purchased gas costs in Account 419 with offsetting entries to Account 191. The amortization of these carrying charge provisions should be debited or credited to Account 805.1, as appropriate. This matter is reserved pending issuance of a proposed Accounting Release by the Chief Accountant on this subject.
FUEL AND FUEL ADJUSTMENT CLAUSES

Unrecovered Purchased Gas Cost

Interest on Unpaid Purchased Gas Accruals

Included in Account 191, Unrecovered Purchased Gas Costs, were amounts for suspended or delayed gas payments. These amounts were not paid within the Company's normal billing and payment cycle of 30 to 60 days. The unpaid amounts were included in the balance to which carrying charges were applied monthly. This resulted in the Company collecting carrying charges on amounts not yet expended.

Part 154.38 of the Regulations under the Natural Gas Act allows natural gas pipeline companies to flow-through changes in cost of purchased gas pursuant to a purchased gas adjustment clause (PGA). It further directs natural gas pipeline companies to compute carrying charges or credits on any unrecovered or overrecovered amounts in the companies' cost of purchased gas. Account 191 has been established to record the fluctuation in the purchased gas costs. The intent of this regulation was to allow natural gas pipeline companies on a timely basis to recover or refund any fluctuations in their purchased gas costs or absent immediate settlement to receive or pay compensation for the time value of monies expended or received.

The Company ceased computing carrying charges on unpaid accruals. Staff discussed with the Company the need to correct billings made to customers under PGA filings for prior periods. The Company argued that it has no obligation to make retroactive payments for prior periods. Further action on the issues related to unpaid accruals will be deferred for separate Commission action.

Adjusting Estimated Cost of Purchased Gas to Actual

Staff noted that the Company's procedure was to account for gas purchased from Transmission Corporation, an associated company, for use in the Company's operations based upon an estimated purchased cost. The current month's estimated cost was based on the actual average cost of Transmission Company's gas purchases of the second month prior to the current month. When the actual average cost of gas purchases was known, an adjustment of the estimated purchased amount to the actual purchased amount was not recorded on the Company's books of account.

The Company's FERC approved rate tariff and transportation agreement required that gas used by the Company monthly be valued at the weighted average price paid by the Company for such gas during the respective month. Further, it is staff's opinion that generally accepted accounting principles and the Uniform System of Accounts implicitly provide for the adjustment of an estimated recorded amount to the actual amount at such time as the actual amount becomes known.

The Company was required to appropriately adjust the estimated cost of purchased gas to actual cost as soon as it is known.
FUEL AND FUEL ADJUSTMENT CLAUSES

Unrecovered Purchased Gas Cost

Accounting for Purchased Gas Costs Related to Nonjurisdictional Sales

The Company had recorded in Account 191, Unrecovered Purchased Gas Cost, the overrecovered purchased gas costs and carrying credits related to nonjurisdictional sales.

The Uniform System of Accounts, Account 191, Unrecovered Purchased Gas Costs, states this account shall include purchased gas costs related to Commission approved purchased gas adjustment clauses when such costs are not included in the utility's rate schedule on file with the Commission.

In the future, the Company was required to record in Account 186, Miscellaneous Deferred Debits or Account 253, Miscellaneous Deferred Credit, unrecovered purchased or overrecovered purchased gas costs and carrying charges or credits related to nonjurisdictional sales. The Company was also required to make an entry to reclassify overrecovered purchased gas costs and carrying credits related to nonjurisdictional sales to Account 253, Other Deferred Credits.

Accounting for Purchased Gas Adjustment (PGA) Surcharge

The Company computed a carrying charge or credit on the balance in Account 191, Unrecovered Purchased Gas Costs. The carrying charge or credit was recorded monthly by debiting or crediting Account 191, as appropriate, with the contra entry to Account 805.1, Purchased Gas Cost Adjustments.

The text of Account 805.1 states, "this account shall be debited or credited with decreases or increases in purchased gas costs related to Commission approved purchased gas adjustment clauses when such costs are not included in the utility's rate schedule on file with the Commission". This account shall be debited or credited with amounts amortized from Account 191. Carrying charges are not provided for in the text of Account 805.1. The Uniform System of Accounts provides Account 419, Interest and Dividend Income, and Account 431, Other Interest Expense, for the recording of interest income and expense.

In the future, the Company was required to record carrying charges received from, or paid to, jurisdictional customers in Account 419 or Account 431, as appropriate.
Unrecovered Purchased Gas Cost

Recordkeeping for Unrecovered Gas Costs

The Company did not maintain separate subaccounts of Account 191, Unrecovered Purchased Gas Costs, on its books of account so as to differentiate and segregate transactions involving deferred gas and other related costs by Purchased Gas Adjustment Clause (PGAC) filing periods. As a result, the amounts recorded in Account 191 on the books of account could not be reconciled to amounts reported in the related PGAC Filings without considerable effort.

The text of Account 191, Paragraph D, states that "Separate subaccounts shall be maintained for the amounts relating to the period in which the increase or decrease is accumulated and for the amortization of purchase gas increases or decreases, as applicable, so as to keep each period separate." This subaccounting applies to both the books of account and PGAC Filings.

The Company was required to provide for subaccounts of Account 191 and institute procedures to ensure that, in the future, transactions involving deferred gas and other related costs booked therein are recorded in appropriate subaccounts of Account 191 corresponding to the applicable PGAC filing periods in which the transaction occurred.

Accounting for Exchange Gas

The Company has an exchange gas agreement with a wholly-owned subsidiary. At year-end, the Company was in an unbalanced exchange gas situation with this subsidiary. The Company debited Account 806, Exchange Gas, and credited Account 242, Miscellaneous Current Liabilities for its cost of gas in accordance with the text of Account 806. In addition, the Company debited Account 186, Miscellaneous Deferred Debit, and credited Account 242, Miscellaneous Current and Accrued Liabilities, for the difference in the Company's cost of gas and the subsidiary's cost of gas.

The text of Account 806, Exchange Gas, states, "this account shall include debits or credits for the cost of gas in unbalanced exchange transactions whereby gas is received from another party in exchange for delivery of gas to such other party and receipt and delivery of such gas is not completed during the accounting period. Contra entries to those in this account shall be made to Account 174, Miscellaneous Current and Accrued Assets, for Exchange Gas Receivable to Account 242, Miscellaneous Current and Accrued Liabilities, for Exchange Gas Deliverable." The Uniform System of Accounts does not provide for any entries to Accounts 242 or 174 to reflect exchange gas pricing differentials with subsidiaries companies.

The Company was required to reverse the entry recording the difference on the Company's cost of gas and the Subsidiary's cost of gas, and in the future, discontinue recording this type entry.
FUEL AND FUEL ADJUSTMENT CLAUSES

Unrecovered Purchased Gas Cost

Exchange Gas Imbalances Included in the Determination of Unrecovered Purchased Gas Costs

Staff's review of Account 191, Unrecovered Purchased Gas Costs, disclosed that the Company included the monthly balances of Account 806, Exchange Gas, in the calculation of unrecovered purchased gas costs for accounting and PGA rate purposes. Account 806 included charges and credits related to current gas and transportation exchange transactions.

Section 154.38 of the Commission's Regulations under the Natural Gas Act allows the inclusion of nonconcurrent exchange transactions in the determination of unrecovered purchased gas costs. Nonconcurrent exchange transactions are a special type of exchange transaction where one party delivers gas to another party several months or more before that party will be required to return the gas, and thus complete the exchange. This contrasts with the normal exchange agreement where each party would receive approximately, if not the same volumes, each month. Any imbalances in this type of exchange transaction would usually be corrected within 30 to 60 days. The Company's exchange gas imbalances did not relate to nonconcurrent exchange transactions and, therefore, did not qualify for inclusion in PGA calculations.

The Company was required to conform both its accounting and rate treatment to the Commission's final unappealable order.

Improper Accounting for Gas Storage Losses

The Company recorded in Account 816, Wells Expenses, the value assigned to gas losses attributable to well valve seepage.

Also, in December 1981, the Company recorded in Account 816 a retroactive loss adjustment of $2,140,000 representing gas valve losses of the Storage Fields computed from the date the fields became operational through December 1981.

The text of Account 823, Gas Losses, states, "This account shall include the amounts of inventory adjustments representing the cost of gas lost or unaccounted for in underground storage operations due to cumulative inaccuracies of gas measurements or other causes."

The staff recommended that in the future the Company record in Account 823 all gas losses attributable to underground gas storage operations.
FUEL AND FUEL ADJUSTMENT CLAUSES

Unrecovered Purchased Gas Cost

Accounting for Gas Losses

The Company's procedure was to compute an estimated amount of Transmission Company's, an associated company, gas losses incurred while the Company was transporting gas. The Company prepared a journal entry to record a purchase of gas at Transmission Company's estimated average cost of purchased gas and equal to the estimated gas loss, to replace estimated gas loss incurred in the Company's pipelines. Additionally, the Company included each month in its cost of service billing to Transmission Company's the amount of Company purchases to replace Transmission Company's estimated gas losses incurred in the Company pipelines.

It was staff's opinion that the procedures described above were improper since the procedures were not provided for in the FERC Gas Tariff, Rate Schedule T-1.

The Company was required to cease the cited accounting and billing procedure for gas losses or, alternatively, seek an appropriate amendment to its gas rate tariff.

Accounting for Gas Withheld for Fuel Usage

Staff review of transportation agreements between the Company and other shippers disclosed that for some agreements the Company retained a portion of the shippers' gas to compensate the Company for fuel used in onshore operations. The Company, by means of an inter-company memorandum, notified Transmission Corporation of the total amount of gas retained from other shippers as compensation for fuel used in onshore operations. This retainage was valued at the average purchased gas cost and recorded on the Company's books of account.

It was the staff's position that the Company's accounting procedure resulted in the effected accounts being overstated since the Company did not have to purchase all the metered volume of gas used in onshore operations because of fuel retained from other shippers.

In the future, the Company was required to reflect gas used in onshore operations on its books of account at actual purchased cost.
Unrecovered Purchased Gas Cost

Accounting For Billing Adjustment Credits For Purchased Gas Costs

The Company did not properly account for billing adjustment credits from its natural gas supplier.

The Company received billing adjustment credits from its natural gas supplier. The Company recorded the credits in Account 191, Unrecovered Purchased Gas Costs, and also excluded these credits from its calculation of carrying charges on Account 191.

The Commission approved the Company's request to eliminate its purchased gas adjustment clause and recover gas costs through the existing monthly cost-of-service tariff. The Commission also authorized the amortization of the remaining Account 191 balance, as of September 31, 1986, over a twenty-four month period. The Commission allowed the Company to compute carrying charges on the unamortized balance as if the remaining Account 191 balance was amortized over a twelve month period.

The instructions to Account 191 of the Uniform System of Accounts state in part:

A. This account shall include purchased gas costs related to Commission approved purchased gas adjustment clauses when such costs are not included in the utility's rate schedule on file with the Commission. This account shall also include such other costs as authorized by the Commission.

The Company's accounting for the billing adjustment credits was not in compliance with its tariff. It did not have Commission authorization to include the billing adjustments in Account 191. The Company should have recorded the billing adjustments in Account 800, Natural Gas Well Head Purchases, and reflected such credits in the monthly cost-of-service tariff billings to its customer.

The Company was required to recompute tariff billings and refund, with interest, the billing adjustment credits received from its natural gas supplier.
Unrecovered Purchased Gas Cost

Accounting For Unrecovered Purchase Gas Costs

The Company made a number of errors in accounting for the costs recorded in Account 191, Unrecovered Purchased Gas Costs. In deferring and amortizing the amount of unrecorded purchased gas costs recorded in Account 191 prior to October 1986, the Company used incorrect quantities of MM BTU volumes, dollar amounts and/or surcharge rates. A summary of the specific deficiencies are as follows:

1. It used incorrect quantities of volumes sold in computing the unrecovered purchase gas costs for March and August 1986.

2. It used incorrect purchased gas cost amounts in computing the deferral of unrecovered purchased gas costs for April, June and July 1986.

3. It used incorrect PGA surcharge rates to compute the amortization of unrecovered purchased gas costs for the months of July 1986 through September 1986.

4. It used incorrect volumes sold in computing the amortization of unrecovered purchased gas costs for the month of March 1986.

Subsequently, the Commission issued an order allowing the Company to eliminate its purchase gas adjustment clause (PGA) and amortize its remaining Account 191 balance and carrying charges over a twenty-four month period. Also, the Commission allowed the Company to accrue carrying charges as if the remaining Account 191 balance was amortized over a twelve month period.

The Company accrued an excess amount of carrying charges on unrecovered purchased gas costs. The Company's procedures for calculating carrying charges on the remaining Account 191 balance were deficient as follows:

1. It reduced the carrying charge base with deferred income taxes which were incorrectly computed with an incorrect composite income tax rate.

2. It calculated carrying charges using an 8.19 percent interest rate for the period September 1986 through September 1987. The Commission authorized quarterly carrying charge rates for the period were 8.19 percent, 7.50 percent, 7.5 percent and 7.80 percent.

The deficiencies resulted in an overaccrual of carrying charges for the period October 1, 1986 through September 30, 1987.

The Company was required to:

1. record an entry correcting the amount of carrying charges accrued on the unrecovered purchased gas cost account for the period under audit.

2. recalculate tariff billings to its customer and refund, with interest, any excess carrying costs collected as a result of the above errors.
Unrecovered Purchased Gas Cost

Computations of Carrying Charges Related to Unpaid Accruals

The Company did not properly compute carrying charge credits to reflect the full time value of unpaid accruals recovered through Purchase Gas Adjustment (PGA) clause billings.

Beginning with the rates established October 1, 1984, the Company included unpaid gas cost accruals in its PGA clause billings. The Company did not make appropriate changes effective October 1, 1984, to its calculation of carrying charges on unpaid gas cost accruals to properly reflect the full time value of unpaid gas cost accruals recovered through the PGA.

In determining the time value credit, the Company incorrectly reduced the carrying charge base by an assumed amount of deferred income taxes on certain of its unpaid gas cost accruals. This was not appropriate because there were no deferred income taxes associated with the unpaid accruals. The deferred income taxes that had existed when the unpaid accruals were deferred in Account 191 had reversed when the unpaid amounts were collected from the customers.

The Company was required to (1) revise procedures to ensure that the computation of the carrying charge credits related to unpaid accruals properly reflects the gross amount of the unpaid accruals that have been collected from customers, (2) recompute carrying charges, and (3) record a journal entry crediting Account 191 for any overaccrual of carrying charges.

Procedures for Computing Carrying Charges on Unrecovered Purchased Gas Costs

In calculating carrying charges on unrecovered purchased gas costs, the Company determined the base by taking the end-of-month balances in Account 191, Unrecovered Purchased Gas Costs, less deferred income taxes, and less any unpaid accruals. In determining the amounts of deferred income taxes to deduct from the carrying charge base, it eliminated any deferred tax amounts related to unpaid accruals.

Under the Commission's regulations covering Purchased Gas Adjustment Clauses, a company is allowed to accrue a carrying charge on its net out-of-pocket cost of gas not recovered to date from ratepayers. In applying the Commission's regulations, a company must deduct all deferred income tax balances related to gas costs, including amounts associated with unpaid accruals, from the carrying charge base. The Commission's policy is based upon the fact that deferred taxes represent realized cash flows from deferral of income tax payments that reduce the company's out-of-pocket cost of purchased gas.

The Company was required to (1) revise procedures, (2) recalculate the carrying charges for all periods, (3) record an entry to the credit Account 191 for the difference between the recomputed carrying charges and the original amounts, plus interest, in accordance with the Commission's Regulations Under the Natural Gas Act.
FUEL AND FUEL ADJUSTMENT CLAUSES

Unrecovered Purchased Gas Cost

Determination of Time Value of Unpaid Accruals

The Company included unpaid accruals for gas cost in its PGA clause billings throughout the period under audit. The Company made a separate computation to reduce carrying charges recorded on balances included in Account 191 (Unrecovered Purchased Gas Costs) to factor in a time value of the collection of the unpaid amounts from the customers. In determining the time value credit, the Company reduced the gross amount of outstanding unpaid accrual calculation base by an assumed amount of advanced income taxes (deferred income tax charges) that would be paid on revenues for delivery of gas related to the unpaid purchased gas cost items.

Section 154.38, paragraph 4(iv)(c), of the Commission's Regulations states, in part, "...The carrying charges shall be computed monthly on the net balance in Account No. 191 and the related amounts in Account Nos. 283 or 190, as appropriate, as of the end of the immediately preceding month." This regulation allows a company to accrue carrying charges costs on its net out-of-pocket cost of gas which have not been recovered from the ratepayer. Deferred taxes related to unpaid accruals must be recognized in carrying charge calculations because they represent realized cash flows from deferral of income tax payments and thereby reduce the out-of-pocket cost of purchased gas.

Three types of accruals (suspended gas costs, rate accruals, and (ad valorem taxes) the Company made timely deductions of the amounts in its computation of federal and state income tax payments and in the recording of current income taxes during each accounting period. Therefore, the Company realized a cash flow from claiming the above amounts for federal and state tax purposes during these periods and the assumed deduction for the carrying charge credit was not appropriate.

The Company was required to (1) modify procedures for the future to ensure that its customers receive the full time value of unpaid accruals for gas cost collected from the customer, (2) recompute carrying charges on unpaid accruals for all previous periods using the gross amount of any outstanding unpaid accruals, and (3) credit Account 191 for the interest on any amounts overcollected.
Unrecovered Purchased Gas Cost

Procedures for the Computation of Carrying Charges on Unrecovered Purchased Gas Cost

The Company used incorrect deferred income tax balances in calculating carrying charges on unrecovered purchased gas costs.

The Company followed the procedure of calculating carrying charges on the end-of-month balances in Account 191, Unrecovered Purchased Gas Costs, net of deferred income taxes. In calculating carrying charges, the Company excluded the total invoiced amounts of unpaid purchased gas cost accruals and exchange gas imbalances from the carrying charge base. However, the Company did not factor into the carrying charge calculation the amount of deferred income taxes related to unpaid accruals and exchange gas imbalances. In addition, the Company factored into the carrying charge calculations an assumed amount representing deferred taxes related to transportation revenues.

Section 154.38. paragraph 4(iv)(c) of the Commission’s Regulations states, in part,

The carrying charges shall be computed monthly on the net balances in Account 191 and the related amounts in Account Nos. 283 or 190 (Accumulated deferred income tax accounts), as appropriate, as of the end of the immediately preceding month.

This regulation allows a company to accrue carrying charges on its net out-of-pocket costs of gas which have not been recovered from the ratepayer. The Company should include deferred taxes related to unpaid accruals and exchange gas imbalances in the carrying charge calculations because such amounts represent realized cash flows from deferral of income tax payments and thereby reduce the carrying cost of purchased gas. With respect to transportation revenues, there were no timing differences between the Company's accounting and tax treatment of these amounts and therefore, there was no basis for including a deferred income tax factor in the carrying charge calculations.

The Company’s use of incorrect deferred taxes balances resulted in an excessive amount of carrying charges computed on unrecovered purchased gas costs.

The Company was required to revise procedures for computing carrying charges effective January 1, 1987, on unrecovered purchased gas costs to comply with the Commission’s regulations.
FUEL AND FUEL ADJUSTMENT CLAUSES

Purchased Power Costs/Co-Generation.

Inclusion of Purchased Power Cost in Fuel Adjustment Clause Billings

The Company improperly included in wholesale fuel adjustment clause (FAC) billings the total energy cost of all purchased power transactions.

The Company deemed all purchases of power to be made on an "economic dispatch" basis. The energy charges, which included costs other than fuel, in some instances related to purchased power did not replace available reserve capacity.

Part 35.14 of the Regulations under the Federal Power Act, and the Company's FAC tariff, provided for the inclusion in FAC calculations of the total energy costs of power purchased on an "economic dispatch" basis, when such purchases displaced available reserve capacity. The Company's FAC tariff also provided for recovery of the total energy charge of power purchased to replace generation unavailable because of scheduled outages, to the extent that the total energy charge did not exceed the fuel cost of the replaced power. However, Part 35.14 of the Commission's Regulations and the Company's filed FAC tariff did not provide for inclusion in FAC calculations of either (1) energy costs, apart from fuel costs, of power purchased on an economic dispatch basis which did not displace available reserve capacity, and (2) energy costs of purchased power, which replaced power unavailable because of a scheduled outage, to the extent such energy costs exceeded the fuel costs of the replaced power.

Accordingly, DOA concluded that the inclusion in the FAC calculations of total energy costs from purchased power transactions resulted in excessive amounts being recovered through wholesale fuel adjustment clause billings.

The Company was required to (1) revise procedures to comply with the requirements of Part 35.14 of the Regulations under the Federal Power Act and its filed tariff when determining amounts to be recorded through its wholesale fuel adjustment clause, and (2) make appropriate refunds to its wholesale customer, with interest as required by the Commission's Regulations 35.19a (a) (2) (iii).
Inclusion of Total Energy Costs of Firm Purchase Power in Wholesale Fuel Adjustment Clause (FAC) Computations

The Company improperly included in wholesale fuel adjustment clause (FAC) billings the total energy charges related to certain purchases of energy that didn't meet the Commission's "economic dispatch" criteria.

The Company followed the practice of including the entire energy cost component (exclusive of capacity or demand charges) associated with firm purchases as an element of fuel cost in computing FAC billings to wholesale customers. The Company generally scheduled the purchase power from these firm purchase power contracts on an "economic dispatch" basis; however, certain of the purchases were made on a "non-economic dispatch" basis to meet contractual requirements.

In Opinion No. 34, Docket No. ER76-398, issued January 15, 1979, the Commission explained the purpose of its economic dispatch criteria as follows:

...Order No. 517 states that Section 35.14(a)(2)(iii) was intended to benefit consumers by encouraging energy purchases when the cost of the purchased energy is less than the cost of the purchaser's own generation. Whether the purchase would be cheaper than generation is determined on an hour-by-hour basis. This is what we intended to encourage. By requiring to use the actual hour-by-hour cost in the fuel clause the consumer will benefit as intended.... (emphasis added)

The Commission's policy on economic dispatch was further explained in the Notice Of Proposed Rulemaking in Docket No. RM83-62-000, Treatment of Purchased Power in Fuel Cost Adjustment Clause for Electric Utilities.

Under the conditions of the Company's existing FAC rate schedule, the total energy component of firm purchase power can only be included in FAC tariff billings if it meets the "economic dispatch" criteria on an hour-by-hour basis. When firm purchase power doesn't meet the "economic dispatch" criteria, a company may only include the identifiable fossil and nuclear fuel costs related to such purchases in FAC tariff billings. The Company didn't request specific Commission approval to recover the entire energy payment related to individual purchases made on a non-economic basis in FAC billings.

The Division of Audits concluded that the Company's FAC billings to wholesale customers were overstated during the period under audit to the extent that such billings included payments related to energy purchases that were not on an "economic dispatch" basis based on the Commission's hour-by-hour criteria.
Purchased Power Costs/Co-Generation

Cost of Cogeneration and Small Power Purchases Included in Wholesale Fuel Adjustment Clause (FAC)

The Company improperly included the entire energy cost component of purchased power from cogeneration and small power producers in wholesale fuel adjustment clause billings.

The Company included the entire energy cost component related to the above purchases as a component of fuel cost in the computation of fuel adjustment clause (FAC) billings to wholesale customers. The Company considered that all purchases under these contracts were made under economic dispatch basis because the pricing of energy is based on marginal cost analysis using a production cost simulation model. The Company also included the energy payments to cogenerators and small power producers in the base cost of fuel in wholesale rate filings. The Company did not request specific Commission approval to recover the above mentioned costs from wholesale customers through fuel adjustment clause billings.

Special Condition 9, Fuel Cost Adjustment, paragraphs b(2) and b(3) of the Company's wholesale rate schedule defines the cost components of purchased power recoverable through FAC billings as follows:

b(2) The actual identifiable fossil and nuclear fuel costs associated with energy purchased for reasons other than identified in Paragraph b(3) ...below...

b(3) The net energy cost of energy purchases, exclusive of capacity or demand charges (irrespective of the designation assigned to such transaction) when such energy is purchased on an economic dispatch basis. Included therein may be such costs as the charges for economy energy purchases and the charges as a result of scheduled outage, all such kinds of energy being purchased by the Company to substitute for its own higher cost energy...

The Division of Audits concluded that the Company's approved wholesale fuel adjustment clause (Special Condition 9, Fuel Cost Adjustment, paragraph b(2)) allows only the actual identifiable fossil fuel component of energy purchased from cogenerators.

The Company was required to (1) revise procedures to include only the actual identifiable fossil fuel associated with purchase power from cogenerators and small power producers in future wholesale fuel adjustment clause calculations, or in the event such information is not directly available from the sellers, use a computed amount of fuel based upon factors derived for actual heat rates furnished by cogenerator and the published tariffs of the fuel suppliers of the cogenerator, and (2) recompute monthly FAC billings to all wholesale customers since January 1, 1982 by including only the actual identifiable fossil fuel costs associated with purchase power from cogenerators and small power producers in the computations, or in the event such information is not directly available from the sellers, use a computed amount of fuel based upon factors derived for actual heat rates furnished by cogenerator and the published tariffs of the fuel suppliers of the cogenerators, and (3) make refunds including interest to all wholesale customers.
**FUEL AND FUEL ADJUSTMENT CLAUSES**

**Purchased Power Costs/Co-Generation**

**Cost of Purchased Power from Qualifying Facilities Included in Fuel Adjustment Clause Billings**

The Company purchased energy from QFs on an as available basis. The Company included both the demand and energy cost of the purchases in the computation of FAC billings to wholesale customers.

The Commission addressed the question of collection of QF purchases through the FAC in Order No. 352 (Docket No. RM83-62-000, issued December, 1983), and rejected the inclusion of QF purchases in FAC billings.

Under the approved wholesale tariff, we concluded that the Company could not include the cost of the QF purchases in wholesale FAC billings.

It was recommended that the Company:

1. revise procedures to exclude the cost of QF purchased power costs from future wholesale FAC calculations; and

2. recompute monthly FAC billings to wholesale customers by eliminating the entire cost of purchased power from QFs from the current month's cost of fuel (but not from the base cost of fuel) and make appropriate refunds, with interest computed according to Section 35.19(a) of the Commission's regulations, for any overcollected amounts.
FUEL AND FUEL ADJUSTMENT CLAUSES

Minimum Take Coal Payments

Accounting and Fuel Adjustment Clause Billings for Minimum Take Coal Payments

The Company incorrectly assigned the costs related to the minimum take provision to Account 151, Fuel Stock. Also, the Company included the costs related to minimum take provisions as a component of fuel cost for fuel adjustment clause billings to wholesale customers during the wrong periods.

The Company accrued a liability for minimum take payments during December of each contract year. At the time it made the accrual, it classified the deficiency payments to Account 151, Fuel Stock. In the following year, the Company charged the amounts included in Account 151 to Account 501, Fuel Expense, as a component of the unit cost of fuel burned consistent with its normal inventory pricing procedures.

The Company included the deficient tonnage costs in wholesale fuel adjustment clause billings in the period that the costs were charged to Account 501.


Under the circumstances, the Company should not have deferred recognizing the expense related to the minimum payments to a subsequent accounting period by charging Account 151. Instead, it should have included the estimated minimum payments in Account 501, Fuel Expense, no later than the end of the contract year for at least the costs related to the deficiency in purchases that occurred that year. It would only be appropriate to postpone the recognition of this expense to a different accounting period if the Company had specific authorization from a regulatory commission to collect such amounts from its customers over a different accounting period.

Since the Company's incorrect accounting for minimum take payments affected the determination of fuel cost for FAC billings to wholesale customers, we concluded that the Company's wholesale ratepayers were billed the minimum take costs in the wrong amounts and billing periods.

It was recommended that the Company:

1. revise procedures so that future transactions of a similar nature are accounted for in accordance with the Commission requirements noted above;

2. record a correcting entry to remove the minimum payments incorrectly classified in Account 151; and

3. recalculate wholesale FAC billings during the period 1981 to date, consistent with the accounting determination regarding the proper period to expense the minimum take costs and, if necessary, correct previously rendered wholesale FAC billings.

The Company shall file a copy of the correcting entry with the Office of Chief Accountant.
Minimum Take Coal Payments

Accounting and Fuel Adjustment Clause Billings for Minimum Take Coal Payments

In 1984, the Company paid a penalty related to a purchase deficiency in tons required by the contract for 1983. In 1987, the Company paid the supplier a purchase deficiency for 1986. The Company recorded the minimum payments by charging Account 151, Fuel Stock, at the time it paid the coal supplier.

The penalty price per ton was a negotiated price and is not specified in the contract. The Company did not have any rights to the coal paid for but not taken, after the year of deficiency. Also, there were no credits given in subsequent years if coal purchased is in excess of the contract minimum required under the contract.

Under the circumstances present here, the Company should have recognized a liability and charged Account 501 for the estimated costs attendant to the coal deficiency condition during the year that the purchase deficiency resulted. The Company's postponing the recognition of the liability and expense until the following year when paid was contrary to the accrual basis of accounting prescribed by General Instruction No. 11 of the Uniform System of Accounts.


The Company should have included the estimated minimum payments in Account 501 no later than the end of the contract year for at least the costs related to the deficiency in purchases that occurred in that year. It would only be appropriate to postpone the recognition of this expense to a different accounting period if the Company had specific authorization from a regulatory commission to collect such amounts from its customers over a different accounting period.

With respect to wholesale fuel adjustment clause billings, we concluded that the Company's wholesale ratepayers were not billed the costs of the deficient tonnage in the proper periods.

It was recommended that the Company:

(1) revise procedures so that future transactions of a similar nature are recorded in the proper period consistent with the requirements of the Uniform System of Accounts;

(2) ensure that the costs of transactions of a similar nature are included in wholesale FAC billings in the proper period; and

(3) recalculate wholesale FAC billings for the years 1983 through 1984 and 1986 through 1987 consistent with the accounting determination regarding the proper period to expense the deficient tonnage amounts and, if necessary, correct previously rendered billings to wholesale customers.
Take or Pay Gas Costs

Accounting for Take-Or Pay Settlements Costs

The Company established a liability for TOP costs by debiting Account 186, Miscellaneous Deferred Debits, and crediting Account 232, Accounts Payable. When it determined the amount of TOP costs that were unrecoverable from customers, the Company recorded an entry to expense the unrecovered amounts by charging Account 813, Other Gas Supply Expenses, and crediting Account 253, Other Deferred Credits. It made another entry to reduce the balances in Accounts 186 and 253 to reflect the expense amounts. Therefore, the remaining balance in Account 186 represented the amount of TOP costs that it expected to recover from its customers under the Commission's approved recovery mechanisms.

When the Company billed the customers for TOP amounts, it debited Account 142, Customer Accounts Receivable and credited either Account 483, Sales for Resale or Account 489, Revenues From Transportation of Gas of Others. At the same time it charged Account 813 and credited Account 186 for the TOP amounts billed.

The Company accrued carrying charges each month on the balance of unrecovered TOP costs by debiting Account 186 and crediting various operating revenue accounts. When it included the accrued carrying charges in billings to its customers, the Company did not include the billed carrying charges in its operating revenue accounts. Instead, it made entries directly to balance sheet accounts, reclassifying the recovered carrying charge amounts from Account 186 to Account 142, Customer Accounts Receivable.

It did not amortize deferred carrying charge amounts to operating expense accounts.

The TOP costs constitute a cost of maintaining long-term gas supplies for customers. Therefore, the Company should have charged all producer settlement costs when incurred to Account 813.

At the time the costs were incurred it was probable that the Commission would approve recovery of a significant portion of the Company's TOP costs in rate levels in a different period. The Commission has required companies to use special accounting in instances where costs are included in rate levels in periods other than the period in which the costs are ordinarily charged to expense under Uniform System of Account requirements. Under the special accounting prescribed by the Commission, costs are recorded in the appropriate expense account designated for the item and the economic effects of the ratemaking process are separately recognized by crediting Account 406, Amortization of Gas Plant Acquisition Adjustments, and debiting Account 186, Miscellaneous Deferred Debits. (See for example, Central Louisiana Electric Company, 26 FERC ¶ 61,403 and Union Electric Company 52 FERC ¶ 61,279.)

The Company should have credited the appropriate operating revenue account and debited Account 142, Customer Accounts Receivable, for the portion of TOP costs recovered on a direct bill basis upon issuance of the Commission's order approving the tariff practice. At the same time, it should have credited Account 186 and debited Account 406 for an equal amount.
FUEL AND FUEL ADJUSTMENT CLAUSES

Take or Pay Gas Costs

Accounting for Take-Or Pay Settlements Costs (Continued)

As a result of the Commission approved rate recovery mechanism, it was appropriate for the Company to recognize carrying charges in net income each month for both the direct billed and the volumetric surcharge. However, it was inappropriate for the Company to classify the carrying charge accruals directly in operating revenue accounts.

The Company should have initially classified the accrued carrying charges approved for recovery by the Commission as interest income by crediting Account 419, Interest and Dividend Income, instead of using the operating revenue accounts.

At the time it collected the carrying charges from its customers, the Company should have credited the appropriate operating revenue account and debited Account 142, Customer Accounts Receivable. At the same time it should have separately amortized the regulatory asset for the carrying charges recorded in Account 186, by charging Account 406, Amortization of Gas Plant Acquisition Adjustments.

Staff recommended that the Company:

(1) revise procedures to ensure that:

   (a) operating expense amounts are recognized in the appropriate expense account when incurred;

   (b) ratemaking assets related to TOP or other similar costs considered recoverable in future rates are recorded in Accounts 406 and 186 consistent with the Commission's requirements;

   (c) revenues related to the collection of TOP costs under the direct bill tariff mechanisms are recorded when approved by the Commission;

   (d) carrying charges on unrecovered TOP costs are accrued by crediting Account 419;

   (e) collections of TOP costs recovered under the volume surcharge and carrying charges are recorded in operating revenues when realized; and

   (f) the regulatory assets for the carrying charges recorded in Account 186 are amortized to net income by charging Account 406.

(2) record the necessary memorandum entries for each year under audit to reflect the accruals for carrying charges on TOP settlement costs as interest income and the collections from customers in the appropriate operating revenues and operating expense accounts.
Take or Pay Gas Costs

Accounting for Take-Or-Pay (TOP) Costs Billed

The Supplier began including in its bills to the Company both the fixed TOP charge and the commodity rate surcharge.

The Supplier also filed proposing to recover a portion of its past and future TOP costs from its downstream customers.

The Company should have recorded a liability in its accounts equal to its share of fixed TOP charges. The Company should have expensed the full amount of its estimated fixed TOP liability by charging Account 813, Other Gas Supply Expenses, and crediting Account 253, Other Deferred Credits.

With respect to commodity surcharges, the Company did not have to record a liability in its accounts for its share of its supplier TOP costs assigned to the commodity surcharge. Staff based the conclusion on the fact that the commodity surcharge did not meet the criteria found in both the requirements of the Uniform System of Accounts and generally accepted accounting principals for establishing a liability.

The Company did not establish in the appropriate accounts a ratemaking asset for that portion of the TOP charges that it could recover from wholesale and retail customers. When the Commission approved the Company's tariff providing for collection of the jurisdictional portion of the fixed TOP charges, the Company should have recorded a regulatory asset by debiting Account 186, Miscellaneous Deferred Debits, and crediting Account 406, Amortization of Gas Plant Acquisition Adjustments. Also, the Company should have included in Accounts 186 and 406 the amount of TOP costs it will collect from retail customers.

Staff recommended that the Company:

1. revise procedures to ensure that fixed TOP charges are recorded in the proper accounts in accordance with the Uniform System of Accounts; and

2. make correcting entries to record a liability for its share of fixed TOP charges, and a regulatory asset for that portion of fixed TOP costs recoverable from customers.
Take or Pay Gas Costs

Accounting for Take-or-Pay (TOP) Billings from a Pipeline Supplier

In addition to the fixed monthly surcharge, the Company proposed to recover the portion of TOP costs billed as a commodity surcharge on an "as-billed" basis through its PGA mechanism.

Between May 1988 and July 1988, the Company recorded the wholesale jurisdictional portion of fixed TOP surcharges each month in Account 165, Prepayments.

As the Company paid the fixed TOP surcharge, it expensed the portion of the payments it was unable to bill under the terms of contracts with non-jurisdictional customers. When it first had notice of the amount it would have to pay, the Company should have recorded a liability for the full amount, concurrently charging it to operating expense. Then it should have credited expense and charged Account 165 for the recoverable portion of total liability.

With respect to the commodity surcharges, beginning in May 1988 the Company recorded the commodity surcharges billed in Account 803, Natural Gas Transmission Line Purchases, and recovered the costs from customers in connection with the terms of its PGA tariffs.

The Company's accounting for its share of TOP costs was not consistent with the following Commission accounting requirements.

(1) The Uniform System of Accounts requires a company to keep its accounts on the accrual basis (i.e., US of A General Instruction 11, SFAS #5, and SFAS #71).

Under the above requirements, the Company should have recorded a liability in its accounts equal to its share of fixed TOP charge, at the time the FERC approved tariffs that included recovery of the fixed portion of the TOP costs. The Company should have expensed the full amount of its liability by charging Account 253, Other Deferred Credits.

With respect to the TOP commodity surcharge, Staff concluded that the Company did not have to record a liability in its accounts for its share of TOP costs assigned to the commodity surcharge since the facts and circumstances did not meet the criteria found in both the requirements of the Uniform System of Accounts and generally accepted accounting principles for establishing a liability. Staff based the conclusion on the fact that the commodity surcharge approved by the Commission was not a liability associated with a past event since there was no obligation established until the Company purchased gas in the future to which the obligation attached.
Accounting for Take-or-Pay (TOP) Billings from a Pipeline Supplier (Continued)

(2) The Commission has approved special accounting to accommodate the ratemaking orders of public utility regulatory commissions in instances when there was assurance that such actions created regulatory assets that the utility would recover in future rates. Under the special accounting, a company would be required to charge operating expense accounts with all amounts required under the provisions of the Uniform System of Accounts. However, a company would be permitted to give effect of the rate actions of a regulatory commission by entries to separate income and balance sheet accounts so that net income for the particular periods would reflect the economics of the regulators' actions.

Staff concluded that the Company did not establish in the appropriate accounts a ratemaking asset for the portion of the TOP that it could recover from wholesale customers under FERC approved tariffs and from non-jurisdictional customers under the terms of existing contracts. When the Commission approved the Company's tariff providing for collection of the jurisdictional portion of the take-or-pay charges, the Company should have recorded a regulatory asset by debiting Account 186, Miscellaneous Deferred Debits, and crediting Account 406, Amortization of Gas Plant Acquisition Adjustments. Also, the Company should have included in Account 406 and 186 any amounts it could collect from non-jurisdictional customers under the terms of existing contracts.

Staff recommended that the Company:

(1) revise procedures to ensure take-or-pay or similar costs are recorded in accordance with the requirements of the Uniform System of Accounts; and

(2) record entry to correct the accounting for the liability and ratemaking asset related to TOP direct bill charges.
FUEL AND FUEL ADJUSTMENT CLAUSES

Recognition of Excess Fuel Costs in the Wholesale FAC

In March 1979, the Company began recognizing, over a ten month period, an inventory adjustment related to its coal stock. The staff of the Public Service Commission required the Company to disregard the portion of the inventory adjustment previously booked, and required the Company to recognize such adjustment over the six month period of July through December 1979.

Since the retail fuel adjustment clause was on a three month lag, the original portion of the inventory adjustment booked by the Company in March 1979 was adjusted before it could affect the cost of the fuel filed as a portion of the related retail fuel adjustment clause. However, the wholesale fuel adjustment clause was on a one month lag, and therefore, two filings had been made which included the inventory adjustments, which were later disregarded. The Company failed to recognize that the effect of the original adjustment booked had been passed through the wholesale fuel adjustment clause, and in July 1979, it began recognition of the same adjustment again. Therefore, the inventory adjustments booked in March and April 1979 were recognized twice in the wholesale fuel adjustment clause.

The effect of this error was that the Company passed excess fuel cost through the wholesale fuel adjustment clause calculation. This resulted in an overcollection from wholesale customers. The Company was required to make the appropriate refunds to the wholesale customers.

Wholesale Fuel Adjustment Clause Factor Calculation

The Company mixed sodium sulfate with coal prior to burning it in the boiler. The sodium sulfate was added in order to change the chemical composition of the coal and improve overall unit performance (i.e., unit capacity, precipitator, etc.) due to the characteristics of the coal. The cost of the sodium sulfate was charged directly to Account 501, Fuel, upon purchase.

The Company included the cost of the sodium sulfate in its fuel adjustment clause (FAC) factor calculation for wholesale customers. However, the cost of sodium sulfate was an improper item for inclusion in a fuel adjustment clause under Section 35.14 of the Regulations of the Federal Power Act. Account 151 does not allow for the recording of such additional materials as sodium sulfate in the account.

The inclusion of items other than fuel in Account 151, Fuel Stock, was addressed in the Commission's Declaratory Order in Docket No. EL81-2-000 (Kansas City Power and Light) dated February 26, 1981 which ordered: (1) the exclusion of limestone costs used in the anti-pollution process from all fuel cost adjustment computations, and (2) the proper account for limestone cost incurred for use in pollution control facilities was Account 154, Plant Material and Operating Supplies.

The Company was required to (1) cease the practice of including the cost of sodium sulfate in the wholesale FAC and (2) implement procedures to record sodium sulfate charges in Account 154, Plant Materials and Supplies.
Disparity Between Purchased Gas Adjustment Clause (PGA) Calculations and Tariff Provisions

Computations of unrecovered purchased gas costs did not correspond to the terms and conditions of the Company's filed FERC Gas Tariff. The tariff provided that actual purchase cost per unit of purchase volumes be compared with a base cost per unit of sales volumes to derive an unrecovered purchased gas cost amount. The Company's computations correctly used actual and base costs per unit of sales volumes.

Section 154.21 of the Regulations under the Natural Gas Act provides that:

"No natural-gas company shall directly or indirectly, demand, charge or collect any rate or charge for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, or impose any classifications, practices, rules or regulations, different from those prescribed in its effective tariff and executed service agreements on file with the Commission."

The Company was required to seek Commission approval to amend the provisions of its filed tariff to its unrecovered purchase gas cost computations.

Accounting for Deferral Fuel Costs Included in Retail Rates

It was the Company's normal practice to record deferred fuel costs applicable to state regulated retail rates in Account 186, Miscellaneous Deferred Debits. The related deferred taxes were recorded in Account 283, Accumulated Deferred Income Taxes - Other. As of December 31, 1981, because of declining current fuel prices, the Company had net overcollections of fuel costs. This resulted in a credit in Account 186 and a debit in Account 283.

This accounting was improper because deferred credits should not be recorded and reported in Account 186 and deferred debits should not be recorded and reported in Account 283. The proper accounting and reporting is to record the overcollection of fuel costs in Account 253, Other Deferred Credits, and the related deferred taxes in Account 190, Accumulated Deferred Income Taxes.

In the future, the Company was required to properly account for overcollections of fuel costs.
Other

Accounting and Fuel Adjustment Clause Treatment of Legal Fees

The Company improperly included legal costs in Account 151, Fuel Stock and in the cost of fuel in wholesale fuel adjustment clause (FAC) billings.

The legal costs represented: (1) payments made to outside attorneys for services involved with the renegotiation of existing coal purchase and rail transportation contracts and (2) payments made to outside attorneys related to a rail tariff proceeding before the Interstate Commerce Commission.

Under the requirements of the Uniform System of Accounts, the Company should limit the charges included in Account 151 to the invoice price of fuel, expenses incurred in transporting the fuel from the point of acquisition to the unloading point, excise taxes, purchasing agents' commissions, insurance and other expenses directly assignable to the cost of fuel.

The text of Account 151, Fuel Stock, does not list legal fees as a separate component of fuel stock. The legal fees were period costs that the Company should have charged to expense when incurred.

The Company was required to revise procedures to properly classify the above items in compliance with the Uniform System of Accounts and recompute FAC billings to wholesale customers by eliminating the above legal costs.
Including Nonfossil Fuel Costs in Fuel Adjustment Clause (FAC) Billings

The Company owns a 20 percent interest in a generating unit. The unit is fueled principally by wood chips from harvested trees.

The Company recorded the costs of the purchased wood chips in Account 151, Fuel Stock. The Company then amortized the costs to Account 501, Fuel, as the wood chips were burned. Also, the Company recorded in Account 501 its share of minimum payments for wood chips and transportation for accepting less than the contracted amount of wood chip deliveries.

The Company included the cost of the wood chips and the minimum payments to the supplier and the transporter in the computation of fuel cost for FAC billings to its wholesale customers.

The Commission's regulations permit a utility to include only the cost of fossil and nuclear fuel used for generating electricity in computing FAC billings to wholesale customers.

The Company's wholesale FAC conforms to Section 35.14(a)(2)(i) of the Commission's regulations under the Federal Power Act.

The Commission has previously determined that wood chips and wood waste are not a fossil fuel in interpreting the above regulation. For example, in approving an application for a cogeneration facility on September 11, 1980, in Docket No. QF80-12 (12 FERC Par. 61,260), the Commission stated:

"The primary energy source will be wood lumber waste. No fossil fuels will be used." (emphasis added)

The minimum or penalty payments were not eligible for the FAC billing because such amounts did not relate to the cost of fuel consumed. The Company incurred the payments as a result of not taking or consuming fuel.

The Division of Audits recommended that the Company:

(1) revise procedures to ensure that the costs related to the wood chips and the related minimum payments are not included in calculating the cost of fuel for wholesale FAC billings.

(2) recalculate FAC billings to wholesale customers and make appropriate refunds with interest computed in accordance with the Section 35.19(a) of the Commission's regulations.
Inclusion of Audit Expenses in Account 151, Fuel Stock, and Fuel Adjustment Clause Billings

The Company improperly recorded auditing expenses related to coal contracts in Account 151, Fuel Stock, and in wholesale fuel adjustment clause billings.

The Company has a cost-plus contract with Coal Company for the supply of coal.

At the end of the year, Coal Company furnishes the Company a statement showing its actual mining cost. The Company is authorized to audit Coal Company's claimed mining cost. During the audit period, the Company routinely contracted for audits of mining costs. The Company included the costs of performing the audits in Account 186, Miscellaneous Deferred Debits. It reclassified the audit fees to Account 151 at the time of final settlement with Peabody.

Under the requirements of the Uniform System of Accounts, the charges included in Account 151 should be limited to the invoice price of fuel, expenses incurred in transporting the fuel from the point of acquisition to the unloading point, excise taxes, purchasing agents' commissions, insurance and "other expenses directly assignable to the cost of fuel."

The instructions to Account 151 do not list audit fees as a separate component of fuel stock. The audit fees were period costs that the Company should have charged to operating expense when incurred.

Moreover, auditing fees for services in administering fuel contracts are similar in nature to the expenses related to the fuel procurement activity that are classified as administrative and general (A&G) expenses. Under the requirements of the Uniform System of Accounts, expenses related to purchasing and stores activities, if performed directly by company personnel rather than outside contractors would be includable in Accounts 920, Administrative and General Salaries, and Account 921, Office Supplies and Expenses. Other expenses related to purchasing and stores activities performed by consultants should be recorded in Account 923.

At the option of the Company, A&G expenses directly applicable to purchasing and stores may be charged first to Account 152, Fuel Stock Expenses Undistributed, and then distributed to Account 501, Fuel, as fuel held in inventory is used. The specific provisions of the Uniform System of Accounts related to the cost of administering the purchasing and stores handling functions makes it clear that the fees are not properly recordable in Account 151, Fuel Stock.

The Company was required to (1) revise procedures to properly classify auditing costs in accordance with Uniform System of Accounts requirements, (2) record an entry to expense all deferred auditing fees, and (3) recompute wholesale fuel adjustment clause billings for the periods that the auditing costs were improperly included in such billings and make the appropriate refunds, with interest, to the wholesale customer for any overcollected amounts.
Taxes, Carrying Charges and Investment Tax Credits Included in Wholesale Fuel Adjustment Clause Billings

Prior to March 1981, Power Company improperly classified carrying charges, taxes and amortization of investment tax credits applicable to nuclear fuel in Account 518, Nuclear Fuel Expense. These costs were then charged to the Company in accordance with the provisions of the power supply contract. The misclassification of these items by Power Company resulted in including these items in its wholesale Fuel Adjustment Clause (FAC) calculation. In 1981, the Chief Accountant of FERC directed Power Company to correct its accounting and billing procedures so that the cited terms would not be shown in Account 518, Nuclear Fuel Expense, and billed to sponsor companies as nuclear fuel costs. Power Company did comply with the Chief Accountant's letter. However, the Company continued to include these items in its wholesale FAC calculation.

Paragraph (1)(2) of Section 35.14 of the Commission's regulations states, "Fuel and purchased power costs (F) shall be the cost of (i) Fossil and nuclear fuel consumed in jointly owned or leased plants." Paragraph (a)(6) of this section further states, in part, "The cost of nuclear fuel shall be as shown in Account 518..." The staff objected to the Company's practice of including these items in the wholesale FAC on the basis that items of this nature are not properly includable in Account 518.

The Company was required to: (1) recalculate the applicable wholesale fuel adjustment clause billings excluding taxes, carrying charges, and investment tax credits from the date such costs were first billed by Power Company to the current date, (2) refund the overcollected amounts, with interest computed in accordance with Section 35.19(a) of the Commission's regulations, to wholesale customers which were charged, and (3) revise its procedures to exclude these items from its wholesale fuel adjustment clause in the future.
Accounting and Tariff Billings for Reimbursements for Black Lung Costs Included in the Invoiced Price of Fuel

The Coal Corporation included the estimated cost for black lung payments as a component of the invoice price for fuel delivered from the Mine. The Company included the estimated amounts as a cost of delivered fuel in Account 151, Fuel Stock. Also, the Company included such amounts as a component of fuel costs in fuel adjustment clause billings to wholesale customers.

In 1985 and 1986, the Company received $302,796 and $367,000 respectively, as reimbursements for black lung costs paid as part of the invoiced price of fuel billed in previous years. The Company recorded the reimbursements in Account 253, Other Deferred Credits. The Company did not credit any of the reimbursements to the cost of fuel for fuel adjustment clause billings to wholesale customers.

We concluded that it was not appropriate for the Company to defer the reimbursements. There was no certainty that the Company would have to repay to the coal supplier the amount included in Account 253. Even if a potential claim existed, we concluded that the Company did not have any basis to quantify the amount related to that future claim.

From an accounting standpoint, the black lung reimbursements should be credited to the same operating expense account (Account 501, Fuel) that was originally charged with the costs as fuel from the mine was burned.

Also, we concluded that the Company should refund to wholesale customers the black lung reimbursements since the black lung costs were previously included in fuel adjustment clause billings to wholesale customers.

Accounting and Tariff Billings for Pollution Liability and Property Insurance

The Company was assessed annual premiums for pollution liability and property insurance for its overall operations.

The Company began accounting for payment of the premiums by debiting Account 163, Prepayment. The Company then allocated a portion of the insurance premiums paid for pollution liability from Account 165 to Account 151. It included the allocated cost of the pollution liability insurance in calculating the average cost of oil per barrel.

The Company allocated a portion of the insurance premiums paid for property insurance from Account 165 to Account 151. It included the allocated cost of the property insurance in calculating the average cost of oil per barrel.
Accounting and Tariff Billings for Pollution Liability and Property Insurance
(Continued)

The Company expensed the insurance amounts recorded in Account 151 by charges to Account 501, Fuel Expense, based on the number of barrels of oil that it burned. It included the insurance costs as a component of fuel costs for calculating FAC billings to wholesale customers. However, it excluded the insurance costs from current fuel costs when calculating retail fuel cost adjustment billings.

We concluded that both the pollution liability and property insurance were not properly includible in Account 151 because such amounts were not within the meaning of other expenses directly assignable to the cost of fuel as intended by the above instructions.

On several occasions, the Commission has issued guidance in interpreting the meaning "other expenses directly assignable to the cost of fuel."

In an order issued in Docket No. EL81-11-000 on September 24, 1982, the Commission decided the question of whether reclamation costs were within the meaning of other expenses directly assignable to the cost of fuel. In deciding that coal reclamation costs was a proper charge to Account 151, the Commission stated:

"... the reclamation costs are charges which are added directly to the cost of purchased fuel and which could have been added to the original invoice price of the coal.

Furthermore, in an order issued in Docket No. EL81-2-000, on February 26, 1981, in the case of Electric Cooperative of Kansas, the Commission stated:

"... Moreover, we note that there are other expenses related to the quantity of fuel consumed, such as the cost of ash handling, that are neither included in Account No. 151 nor allowed in fuel cost computations.

Under the Uniform System of Accounts, the Company should have charged the expense related to the pollution liability insurance to Account 925, Injuries and Damages Expenses.

Also, the Company should have charged the amount for property insurance to Account 924, Property Insurance.

Since the insurance expenses were not properly recordable in Account 151, it was improper for the Company to include such amounts as a component of fuel expense for computing FAC billings to wholesale customers.

It was recommended that the Company:

(1) revise procedures to ensure that liability and property insurance expenses are accounted for consistent with the requirements of the Uniform System of Accounts;
Accounting and Tariff Billings for Pollution Liability and Property Insurance

(Continued)

(2) revise procedures to ensure that the costs of liability and property insurance are not included as a component of fuel expenses for FAC billings to wholesale customers when expensed.

(3) reclassify the cost of pollution liability and property insurance from Account 151 to Account 165 as of December 31, 1988; and

(4) recalculate FAC billings to wholesale customers during the period that pollution liability and property insurance as included in the wholesale FAC and make appropriate refunds, with interest computed according to Section 35.19(a) of the Commission's regulations, for any overcollected amounts.

Accounting and Tariff Billings for Wheeling Costs

The Company incorrectly included the cost of wheeling economy purchased power in Account 555, Purchased Power. Also, it improperly included the wheeling costs as a component of fuel in computing fuel adjustment clause (FAC) billings to wholesale customers.

The instructions to Account 555 state in part:

This account shall include the cost at point of receipt by the utility of electricity purchased for resale. It shall include, also, net settlements for exchange of electricity or power, such as economy energy, off-peak energy for on-peak energy, spinning reserve capacity, etc. In addition, the account shall include the net settlements for transactions under pooling or interconnection agreements wherein there is a balancing of debits and credits for energy, capacity, etc . . . .

The instructions to Account 565, Transmission of Electricity by Others, states:

This account shall include amounts payable to others for the transmission of the utility's electricity over transmission facilities owned by others.

Under the above instructions, the Company should have classified the payments it made to other utilities for wheeling electricity in Account 565 and not in Account 555.

In Opinion No. 203, Public Service Company of New Mexico, et al., Docket No. ER84-155, dated December 30, 1983, the Commission noted that wheeling charges could not be recovered through the FAC, except in compliance with Order No. 352. The Commission stated:
Accounting and Tariff Billings for Wheeling Costs (Continued)

Our currently effective regulations allow reimbursement for the cost of purchased power through the rates charged requirements customers, using a combination of rate case estimates and fuel clause adjustments. To the extent that the cost of fuel differs from the estimate on which the rate was set, it may be recovered through fuel clause adjustments. [footnote omitted] If a purchase is made on an economic dispatch basis, the net energy charges may also be recovered through the fuel clause. [footnote omitted] Purchased power capacity or other fixed charges, as well as any wheeling charges, must be estimated in rate-case proceedings and recovered in base rates; under our existing regulations, these charges cannot be recovered through the fuel adjustment clause. [emphasis added]

In Order No. 352 (Docket No. RM83-62-000 issued December 7, 1983,) the Commission permitted utilities to amend the FAC's to include transmission or wheeling charges associated with an economic purchase as a component of FAC billings. The Commission stated:

... This broadening would primarily bring transmission or wheeling charges associated with an economic purchase within the scope of the rule. Such treatment is reasonable because, transmission is an "integral part of the economic evaluation." A potential buyer would thus be able to make purchasing decisions free of regulatory distortions by comparing avoided costs with the total delivered costs of potential purchases and being assured of complete recovery of the delivered costs. [emphasis added]

However, the Company did not make the necessary revisions to amend its tariff to adopt the Commission's revised regulations. Therefore, because the Company retained its pre-existing tariff requirement that did not allow recovery of such costs through the FAC, the Company's procedure for including wheeling costs as a component of economy energy in wholesale FAC billings was contrary to the Company's filed rate tariff as well as the relevant Commission regulations and precedent.

It was recommended that the Company:

(1) revise procedures to ensure that wheeling costs are recorded in Account 565 consistent with the requirements of the Uniform System of Accounts;

(2) revise procedures to ensure that wheeling costs related to economy purchased power are excluded from calculation fuel cost for FAC billings to wholesale customers; and

(3) recompute monthly FAC billings to wholesale customers by eliminating wheeling costs of economy purchased power from the current month's cost of fuel and make appropriate refunds, with interest computed according to Section 35.19(a) of the Commission's regulations for any uncollected amounts.
Accounting and Fuel Adjustment Clause Billings for Interest Expense Related to Nuclear Fuel Held in Inventory

Prior to 1988, the Company had leased all of its nuclear fuel. During 1988, the Company purchased the leased nuclear fuel and terminated the lease. It reclassified the cost of nuclear fuel to the nuclear fuel plant accounts.

The Company recorded the amortization of the original cost of the nuclear fuel in Account 518. The Company financed the acquisition of the nuclear fuel with a combination of intermediate term notes and commercial paper. It recorded the interest expense related to the unamortized nuclear fuel in the reactor in Accounts 427, Interest on Long-Term Debt, and 431, Other Interest Expense.

On December 22, 1987, the Public Utilities Commission (PUC) issued a decision denying the Company rate base treatment for its inventory of owned nuclear fuel. Instead, the PUC permitted the Company to charge retail customers amounts equal to the nuclear fuel payments made under leasing arrangements. The PUC ordered the Company to record carrying costs on all unspent nuclear (nuclear fuel in process, unburned fuel in the reactor and fuel inventory held for future use) based on short-term debt effective January 1, 1988.

On January 1, 1988, the Company changed its accounting for the actual interest expense related to the nuclear fuel and began including a portion of the interest amounts to Account 120.2, Nuclear Fuel Materials and Assemblies-Stock Account, instead of recording the entire amount in Account 427 and 431. After it inserted the fuel in the reactor, the Company proceeded to amortize the accrued interest amount to Account 518 and include such amount as a component of fuel cost in fuel adjustment clause billings to wholesale customers.

Electric Plant Instruction No. 3(17) of the Uniform System of Accounts permits a utility to accrue AFUDC on construction work in progress included in Account 107, and on nuclear fuel in progress included in Account 120.1. There is no provision in the Uniform System of Accounts permitting the accrual of AFUDC or actual interest on balances properly recorded in Account 120.2.

In Opinion No. 79, Indiana and Michigan Electric Company (I&M) Docket No. ER76-716, dated March 18, 1980, the Commission stated its policy that the cost of a nuclear fuel core that is complete and ready for service (even though not actually used) is properly classified in Account 120.2 and entitled to rate base treatment.

Beginning in 1988, the Company did not have a basis to change its accounting and include any interest expense related to owned nuclear fuel recorded in Account 120.2. It should have continued recording the interest expense in Accounts 427, Interest on Long-Term Debt, and 431, Other Interest Expense.
Accounting and Fuel Adjustment Clause Billings for Interest Expense Related to Nuclear Fuel Held in Inventory (Continued)

The Commission has approved special accounting to accommodate the ratemaking orders of public utility regulatory commissions in instances when there was sufficient assurance that such actions created assets that the Company would recover in future rates. Under the Commission's accounting for regulatory assets, the Company should have recognized an amount equal to the PUC portion of the interest expense as a charge to Account 186, Miscellaneous Deferred Debits, and a credit to Account 421, Miscellaneous Nonoperating Income.

Since the interest expense on nuclear fuel held in inventory was properly includible in Accounts 427 and 431 and not in Account 518, the Company should not have included the interest as a component of fuel cost in determining FAC billings to wholesale customers.

It was recommended that the Company:

1. revise its procedures to ensure that interest expense on short-term debt is classified in Account 431;

2. record a correcting entry to correct the accounting for interest expense for 1986; and

3. recompute FAC billings to wholesale customers by eliminating any interest assigned to Account 120.2 that was amortized to Account 518 during the audit period and make refunds, with interest computed in accordance with Section 35.19(a) of the Commission's Regulations, to wholesale customers for any overbilled amounts.

Accounting for Nonrecoverable Gas Advance

The Company established a "loss valuation reserve" for the nonrecoverable advance by charging operating expense and crediting Account 228.4, Accumulated Miscellaneous Operating Provisions.

The Commission established Accounts 228.1 through 228.4 in Order No. 390. In addressing the purpose of the new accounts, the Commission stated:

3. The present operating reserve accounts record amounts allowed by a regulator to be accrued for contingencies such as uninsured storm damage. However, FASB 71 requires that amounts collected in rates, which are not yet expended for the intended contingency and for which the regulated company remains accountable, must be treated as liabilities. The Commission implements this requirement by removing from Parts 101 and 201 the present operating reserve accounts (Accounts 261, 262, 263, and 265) and by adding new liability accounts that may be credited only where a regulatory authority permits the collection of these amounts in a regulated company's rate levels.
Accounting for Nonrecoverable Gas Advance (Continued)

Furthermore, the special instructions to Account 228.1 through Account 228.4 state in part:

No amounts shall be credited to these accounts unless authorized by a regulatory authority of authorities to be collected in a utility's rate levels.

The Company should have expensed the advance recorded in Account 167 by charges to an appropriate gas operating expense account. It should not have established a "loss valuation reserve" in Account 228.4, since the Commission did not authorize the use of the operating provision in a rate proceeding.

It was recommended that the Company record an entry to remove the balance of the advance from Accounts 167 and 228.4 as of December 31, 1989.

Procedures for Including the Cost of Fly Ash Disposal in FAC Billings

The Company incorrectly included the cost of fly ash disposal as a component of fuel cost in determining fuel adjustment clause (FAC) billings to wholesale customers.

Section 35.14(a)(6) of the Regulations under the Federal Power Act, Fuel Cost and Purchased Economic Power Adjustments Clauses, states in part:

The cost of fossil fuel shall include no items other than those listed in Account 151 of the Commission's Uniform System of Accounts for Public Utilities and Licensees.

Since the cost of fly ash disposal is not within the items listed for inclusion in Account 151, the Company did not have a basis for including the cost as a component of fuel cost in determining FAC billings.

It was recommended that the Company:

(1) revise its procedures to exclude the cost of fly ash disposal in determining fuel cost for wholesale FAC billings; and

(2) recompute wholesale FAC billings by eliminating the cost of fly ash from the fuel component and make appropriate refunds, with interest computed in accordance with Section 35.19(a) of the Commission's regulations, to wholesale customers for any overbillings.
CHAPTER 10

FUEL/MATERIALS AND SUPPLIES

FUEL

Items Properly Classified in Fuel Stock Account

The Company charged freight costs for moving fuel oil in storage and storage tank rentals to a subaccount of Account 151, Fuel Stock. These costs eventually passed through the FERC fuel adjustment clause as part of the cost of fuel.

The Uniform System of Accounts provides (1) Account 152, Fuel Stock Expenses Undistributed, for recording cost of moving fuel in storage if such expenses are sufficiently significant in amount to warrant being treated as part of the cost of fuel inventory rather than being charged direct to expense as incurred and (2) Account 507, Rents, for recording of storage tank rentals. In addition, Section 35.14, paragraph 7, of the Commission's Regulations states that "the cost of fossil fuel shall include no items other than those listed in Account 151..." for passage through the fuel adjustment clause. Since the above expenditures were not properly includable in Account 151, they were also improperly included in the FERC fuel adjustment clause.

The Company was required to determine the total cost of the above items improperly recovered from wholesale customers and make the appropriate adjustments to its wholesale fuel adjustment clause calculations. The Company classified the above type of expenditures as prescribed by the Uniform System of Accounts. The Company in April of 1982, made the necessary correcting entry, resulting in a credit to the fuel component of FERC fuel adjustment clause.

Mining Costs Applicable to Future Coal Production

Account 151, Fuel Stock, included certain prepaid coal mining costs which were deferred for subsequent allocation to cost of future coal production.

The Uniform System of Accounts, Account 151, states this account shall include the book cost of fuel on hand.

Since the above prepaid coal mining costs were not associated with fuel inventory on hand but represented costs related to future coal production, the Company was required to reclassify the applicable amounts from Account 151 to Account 165, Prepayments. Also, in the future, the Company was required to record expenditures of the above nature as prescribed by the Uniform System of Accounts. The prepaid coal mining costs which were deferred by the Company in Account 151 did not enter into the fuel cost adjustment calculations.
Fuel Handling Charges in Fuel Adjustment Clause

The Company entered into an agreement with a vendor for the storage of fuel in the vendor's tank farm. Fuel stored in the vendor tank is subsequently transferred to the Company's generating station through a pipeline owned by the Company. The vendor charges the Company for (1) an energy fee, (2) a storage fee, and (3) a handling fee.

The Company charged the fees to Account 151, Fuel Stock and ultimately passed the costs through the wholesale fuel adjustment clause. The Company agreed to refund the amounts via a credit to Account 151 over a period equal to the period for which the costs were improperly included in Account 151.

The wholesale fuel adjustment clause is for fuel and fuel only and should not include handling and other related expenses.

The Company was required to charge these expenses to Account 152, Fuel Stock Expenses Undistributed, in the future.

Fuel Handling Charges in Fuel Adjustment Clause

A vendor operates the Company's Tank Farm. The vendor charges the Company for pumping, chemical and tank labor.

The Company charged the costs of pumping, chemical and tank labor to Account 421, Miscellaneous Nonoperating Income. This was done to preclude charging of the expenses to the customers via the fuel adjustment clause.

The costs paid to the vendor to operate the tank farm should be charged to Account 152, Fuel Stock Expenses Undistributed, and not to Account 421.

In the future, the Company was required to charge these costs to Account 152.
Fuel

Transfer of Oil From One Station to Another

The Company owns an 80% interest in a power plant and two other participants own the remaining 20% interest. During 1982, the Company transferred 31,588 barrels of oil from its plant to the shared plant. The oil was recorded in Account 151, Fuel Stock, at the estimated replacement cost and a gain of $146,276 was recognized for the difference between the fuel oil cost and the estimated replacement cost. Twenty percent of the gain was credited to Account 456, Other Electric Revenues and eighty percent credited to Account 501, Fuel. In addition, the cost to transfer the fuel was recorded in Account 151.

The text of Account 151, states, "this account shall include the book cost of fuel on hand." The Uniform System of Accounts contemplates that inventories be recorded at cost. The valuation of inventories at a replacement cost higher than actual cost is not a generally accepted accounting principle. Further, the text of Account 501 provides for the use of this account for fuel handling costs such as the moving of fuel in storage and transferring fuel from one station to another.

In the future, the Company was required to record its fuel inventory at cost and to expense fuel handling costs. There is no FERC fuel adjustment clause in effect.

Expenses of the Fuel Operations Department

The Company included in Account 151, Fuel Stock, expenses of the fuel operations department. The expenses include charges for labor and labor loadings for the fuel operations department personnel, telex services for monitoring coal trains, the allocation of floor space utilized by the fuel operations department, and certain other department related charges.

The text of Account 501, Fuel, provides for the recording of charges related to the procuring and monitoring of fuel in this account.

In the future, the Company was required to charge the cost of procuring and monitoring fuel directly to Account 501.
FUEL/MATERIALS AND SUPPLIES

Fuel

Improper Charges Included in Account 151

The Company included in Account 151, Fuel Stock, handling costs for moving coal from the stockpile to the coal pit. The Uniform System of Accounts provides for handling charges to be recorded in Account 152, Fuel Stock Expenses Undistributed, or charged directly to Account 501, Fuel.

The Company was required to revise its accounting procedures to properly record handling costs incurred with moving coal from the stockpile to the coal pit in conformance with the Uniform System of Accounts in the future.

The Company agreed to record such handling costs in Account 501, Fuel. Impacts on fuel adjustment clause computations were minimal.

Accounting for the Gain on the Sales of Fuel Oil

The Company recorded gains on the sale of fuel oil in Account 421, Miscellaneous Nonoperating Income.

The text of Account 456, Other Electric Revenues, Item No. 3, of the Uniform System of Accounts, states, "Profit or loss on sale of material and supplies not ordinarily purchased for resale and not handled through the merchandising and jobbing accounts."

In the future the Company was required to record gains on the sale of fuel oil in Account 456. If such gains are material, the Company should request the Commission's direction in accounting for the gains.

Dust Suppressant Improperly Recorded in Account 151, Fuel Stock

The Company recorded the cost of a fuel additive (Liquid Flocculant) which is used as a dust suppressant in Account 151, Fuel Stock.

Under the requirements of the Uniform System of Accounts, the cost of Liquid Flocculant should be recorded in Account 154, Plant Materials and Operating Supplies.

The Commission addressed the accounting and rate treatment for costs of this nature in a Declaratory Order issued in Docket No. EL81-2-000, dated February 26, 1981, in which it required the exclusion of the cost of materials used in the anti-pollution process from all fuel clause adjustment computations. The Commission also ordered that the proper account for the costs of these materials was Account 154, Plant Materials and Operating Supplies.

The Company was required to comply with the Commission's regulations and record dust suppressants in Account 154 in the future.
FUEL/MATERIALS AND SUPPLIES

Fuel

Accounting for Fuel Costs

Soda ash inventory was included in Account 151, Fuel Stock, and charged, when used, to Account 501, Fuel, and the wholesale fuel adjustment clause (F.A.C.). The Commission's Declaratory Order in Docket No. EL81-2-000, dated February 26, 1981, ordered, (1) the exclusion of pollution control materials from fuel cost adjustment computation, and (2) the proper account for these materials was Account 154, Plant Materials and Operating Supplies.

The Company was required to (1) reclassify the soda ash inventory from Account 151 to Account 154, (2) charge Account 501 with the cost of soda ash used, and (3) exclude soda ash from the F.A.C.

Accounting for Gain on Sales of Fuel Stock

The Company sold 4,153,345 gallons of fuel oil inventory at a price above the inventory price. The profit of $167,920 was recorded in Account 421, Miscellaneous Nonoperating Income.

Sales of fuel stock are an incidental part of the overall fuel procurement operation, the total cost of which is borne by the ratepayers.

The Company was required to (1) record an entry to reclassify the profit on the sale of the fuel oil to Account 151, Fuel Stock and (2) include future gains resulting from sales of fuel stock in Account 151.

Classification of OSHA Activities Costs

The Company recorded in Account 501, Fuel, the cost of OSHA activities. Listed below are examples of those costs:

1. Materials and labor to reinsulate steam lines.
2. Evaluation of airborne fiber concentration around Boiler No. 4.
3. Cost of providing disposal facilities for asbestos removed from the turbines during an outage.
4. Cost of nondestructive examination of all turbine and boiler room crane hooks and slings.
5. Industrial hygiene survey of asbestos exposure.

In the future, the Company was required to discontinue the practice of recording the cost of OSHA activities in Account 501 and record such costs in the appropriate steam production operation or maintenance expense account prescribed by the Uniform System of Accounts.
FUEL/MATERIALS AND SUPPLIES

Fuel

Accounting for Salaries and Expenses of the Fuel Accounting and Fuel Supply Departments

The Company followed the practice of charging the salaries and expenses of the Fuel Accounting and Fuel Supply Departments to Account 151, Fuel Stock. Because of their inclusion in Account 151, such costs were used in fuel adjustment clause (FAC) calculations for wholesale customers.

As Account 151, Fuel Stock, does not permit the kind of expenditures described above to be recorded therein, these costs should have been recorded directly in Account 501, Fuel, or in Account 152, Fuel Stock Expenses Undistributed, in accordance with the requirements of the Uniform System of Accounts and excluded from the wholesale fuel adjustment computation.

The Company was required to 1) charge the salaries and expenses of the Fuel Accounting and Fuel Supply Departments directly to Account 501 or 152 in the future, and 2) recalculate the costs collected through the wholesale FAC as a result of including the improper expense and refund the amounts collected with interest.

Accounting For Fuel Additives

The Company followed the procedure of recording the cost of fuel additives in Account 151, Fuel Stock.

The Company mixes an additive called CH22 S10A to the No. 6 fuel oil. The purpose of the additive was to aid in controlling the boiler temperature.

The instructions to Account 151 do not provide for the inclusion of fuel additives.

The proper accounting for fuel additives was addressed by the Commission in Docket EL81-2-000, issued February 26, 1981, in the case of Electric Cooperatives of Kansas. In its order the Commission ruled that fuel additives were properly recorded in Account 154, Plant Materials and Operating Supplies.

The Company was required to revise its procedures to ensure that fuel additives are recorded in Account 154.
Fuel

Accounting Procedures for Coal Inventory

The Company had a stated policy of adjusting its coal inventories when the results of physical inventories showed variances in excess of plus or minus five percent of the carrying amounts.

The Company began a procedure whereby it made an adjustment to its inventory records and reduced the quantity of coal deliveries each month by two percent. This procedure overstated the weighted average cost of coal consumed and understated the book inventory cost.

The Uniform System of Accounts contemplates that a company reflect the results of physical inventories of coal and other fuel in its accounts on a timely basis by charging operating expense in the period that any physical counts show differences from recorded inventory amounts. Furthermore, the Company's stated policy of adjusting its coal inventories to expense when the results of physical inventories showed variances in excess of plus or minus five percent is a generally accepted practice within the utility industry.

The Company entered into various settlements with its wholesale customers that calculate the wholesale revenue requirements based upon the same cost-of-service (rate base, operating expenses, rate of return, etc.) approved by the Commission for retail customers. Also, tariff billings under the wholesale fuel adjustment clause (FAC) are based upon the cost factors and formulas used in the retail fuel adjustment clause. The Commission had not taken formal issue with the Company's billings under the retail FAC. The Company agreed to make refunds to wholesale customers in the event the Commission orders refunds to the retail customers.

It was recommended that the Company revise existing procedures to ensure that coal inventory adjustments are made by charges to fuel expense in the periods that the results of physical inventories indicates known and measurable differences.
Fuel Additives

Accounting and Tariff Billings for the Cost of Fuel Additives

The Company used certain additives in the process of generating electricity. It inventoried the cost of the additives in Account 151, Fuel Stock, and included the fuel additive costs in calculating the average inventory cost of No. 6 Fuel Oil. Also, the Company expensed the cost of the fuel additives as it burned the No. 6 Fuel Oil by charges to Account 501, Fuel Expense.

The following summarizes the various types of additives used during the period 1984 to 1988 and the related costs:

- 7250S - An oil based additive put into fuel oil to control slagging on the interior of the boilers.
- F5362 - An oil based additive used on a trial basis for prevention of slagging.
- 8960 - An additive used at the tank farm to emulsify asphaltines only as needed.
- 8263 - A water based additive to prevent slagging on the interiors of the boilers.

The Company included the cost of additives expensed during the period 1984 to 1988 as a component of fuel costs for calculating FAC billings to wholesale customers. However, it deducted the cost of the additives from current fuel cost when it calculated retail fuel cost adjustment billings.

Section 35.14 of the Commission's Regulations under the Federal Power Act addresses the requirements for fuel adjustment clauses.

Section 35.14(a)(6) states in part:

The cost of fossil fuel shall include no items other than those listed in Account 151 of the Commission's Uniform System of Accounts for Public Utilities and Licensees.

The Commission addressed the proper accounting and tariff billings for the cost of fuel additives in Docket No. EL81-2-000, issued February 26, 1981, in the case of Electric Cooperatives of Kansas. At issue in the case was whether Central Telephone and Utilities Corporation (CTU) and Kansas Power & Light Company had properly classified the inventory cost of limestone in Account 151 and when it used the materials as a component of fuel costs for billings under its fuel adjustment clause. CTU argued that the limestone costs were "directly assignable to the cost of fuel" as provided in the instructions to Account 151.

The Commission stated that the proper account to classify the inventory costs of limestone was Account 154, Plant Materials and Operating Supplies, and collected from wholesale customers through base rates rather than the FAC billings.
FUEL/MATERIALS AND SUPPLIES

Fuel Additives

Accounting and Tariff Billings for the Cost of Fuel Additives (Continued)

It was recommended that the Company:

(1) revise procedures to ensure that the inventory cost of fuel additives is recorded in Account 154 consistent with the requirements of the Uniform System of Accounts;

(2) revise procedures to ensure that the cost of fuel additives are not included as a component of fuel expenses for FAC billings to wholesale customers when expensed;

(3) recalculate FAC billings to wholesale customers during the period that fuel additives were included in such billings and make appropriate refunds, with interest computed according to Section 35.19(a) of the Commission’s regulations, for any overcollected amounts.

Accounting For Limestone and Other Chemical Inventories

The Company recorded the inventory cost of limestone and other chemicals used for pollution control facilities in Account 151, Fuel Stock. As these materials were burned, the Company charged Account 501, Fuel.

The Company did not include the cost of these additives in determining the cost of fuel for billing under the wholesale fuel adjustment clause (FAC).

The Commission addressed the accounting for costs of this nature in a Declaratory Order issued in Docket No. EL81-2-000, dated February 26, 1981, in which it determined that the proper account for the costs of these materials was Account 154, Plant Materials and Operating Supplies.

The Company should have classified the inventory cost of limestone and other chemicals in Account 154.

It was recommended that the Company:

(1) revise procedures to ensure that the inventory cost of limestone and other chemicals are included in Account 154; and

(2) record an entry to reclassify the inventory cost of limestone and other chemicals from Account 151 to Account 154 as of December 31, 1987.
Fuel Additives

Accounting and Tariff Billing for the Cost of a Fuel Oil Additive

The Company burned residual No. 6 oil at its power plants. It used an additive when burning the oil for protection against corrosion and buildup of unburned residuals in the boilers, and to facilitate the removal of fly ash from the stack. The use of the additive varied with the quality and concentration of impurities in the residual No. 6 oil.

The Company classified the cost of the fuel oil additive in Account 151, Fuel Stock. It expensed the cost of the additive to Account 501, Fuel, when it burned the fuel. Also, it included the cost of the fuel additive in FAC billings to wholesale customers.

The Commission addressed the accounting for costs of this nature in a Declaratory Order issued in Docket No. EL81-2-000, Electric Cooperatives of Kansas, 14 FERC ¶ 61,176, dated February 26, 1981. The Commission stated:

Upon consideration of the arguments in the pleadings, the Commission has concluded that inclusion of the cost of limestone in the fuel adjustment clause computations violates section 35.14 of the regulations and is therefore impermissible... .

Section 35.14(a)(6) of the Commission’s Regulations under the Federal Power Act states in part:

The cost of fossil fuel shall include no items other than those listed in Account 151 of the Commission’s Uniform System of Accounts for Public Utilities and Licensees.

Since the additive was not a fossil fuel inclusive in Account 151, the Company should not have included the cost as a component of fuel expense in FAC billings to wholesale customers.

It was recommended that the Company:

(1) revise procedures to ensure that the cost of the fuel oil additive is included in Account 154 and charged to Account 501, as the fuel oil additive are used in operations;

(2) record an entry to reclassify the inventory costs of the fuel oil additive to the proper account; and

(3) recompute monthly FAC billings to wholesale customers from 1984 to present by eliminating the cost of the additive from the current month’s cost of fuel and make appropriate refunds, with interest computed according to Section 35.19a of the Commission’s regulations, for any overcollected amounts.
Fuel Additives

Accounting and Fuel Adjustment Clause Billings for the Cost of Anti-Pollution Fuel Additives

The Company mixed the additive, catane, with oil prior to burning it in the gas turbines. The primary purpose for using the smoke suppressing additive was to enhance anti-pollution control.

During the years 1986 through 1989, the Company charged the cost of the catane to Account 151. The Company included the cost of the catane as a component of fuel cost for its fuel adjustment clause billings to wholesale customers.

The instructions to Account 151 do not provide for the recording of fuel additive materials, such as catane.

Section 35.14(a)(6) of the Commission's FAC Regulations states in part:

The cost of fossil fuel shall include no items other than those listed in Account 151 of the Commission's Uniform System of Accounts for Public Utilities and Licensees.

Therefore, the cost of catane was an improper item for inclusion in the fuel adjustment clause.

An issue concerning exclusion of the cost of additives was addressed in the Commission's Declaratory Order in Docket No. EL81-2-000 (Kansas City Power and Light), dated February 26, 1981. The Commission ordered (1) the exclusion of limestone costs used in the anti-pollution process from all future fuel cost adjustment computations, and (2) the proper account for limestone cost incurred for use in pollution control facilities was Account 154, Plant Materials and Operating Supplies.

It was recommended that the Company:

(1) revise procedure to ensure that it classifies the cost of catane in Account 154, Plant Materials and Supplies, and

(2) revise procedures to exclude the cost of catane as a component of fuel cost in wholesale FAC billings.
Material and Supplies

Accounting for Obsolete Materials and Supplies

When the Company determined that an item of inventory included in Account 154, Plant Materials and Operating Supplies, was obsolete it removed the related costs of the item from Account 154 and concurrently debited Account 108, Accumulated Provision for Depreciation of Electric Utility Plant.

The obsolete materials and supplies originally came from the following three sources:
1. Operating materials and supplies never used.
2. Salvage from retirements of utility plant.
3. Scrap from construction work in progress.

The staff was of the opinion that the Company's accounting for obsolete material was contrary to paragraph A(3) of the instructions to Account 154 which requires that any difference between the amount at which items are included in the account and the amount realized upon disposition, as far as practicable, shall be adjusted to the account credited when the items were charged to the account.

In the future, the Company will account for obsolete materials and supplies in the following manner:
1. Expense all obsolete items never used in construction.
2. Expense all obsolete items returned from construction work in progress.
3. Charge Account 108 for obsolete items previously included in plant in service.

Costs of Reconditioning Materials Returned to Stock

The Company recorded the costs of materials returned to stock from electric plant in service to Account 154.5, Salvage Materials (a subaccount of Account 154, Plant Materials and Operating Supplies). Costs incurred to recondition salvage materials were charged to Account 154.1, Regular Materials and Supplies, a subaccount of Account 154.

The Uniform System of Accounts Instruction A(1) of Account 154 states, "The costs of repairing such items (reusable materials) shall be charged to the maintenance account appropriate for the previous use."

In the future, the Company was required to revise its procedures for accounting for reconditioning costs to comply with the cited requirement of the Uniform System of Accounts.
Material and Supplies

Accounting for Salvage Materials

The Company charged the costs of materials returned to stock from the generating station No. 2 project to the Company’s subaccount of Account 154, Salvage Materials. The $114,097 credit balance in Account 154 at December 31, 1980 reflected the excess of cash proceeds over the cost of such materials.

Account 154 Instruction A(3) states, "The difference between the amounts realized for scrap and nonusable materials sold and the net amount at which the materials were carried in this account, as far as practicable, shall be adjusted to the accounts credited when the materials were charged to this account."

The Company was required to record an entry to transfer the credit balance from Account 154 to Account 107, Construction Work in Progress - Electric, and record future salvage material transactions in accordance with the Uniform System of Accounts.

Clearing of Stores Expense

The rates used by the Company for clearing Account 163, Stores Expense Undistributed, resulted in a credit balance at December 31, 1981.

The Uniform System of Accounts, Account 163, Paragraph B, states the balance in the account at the close of the year shall not exceed the amount of stores expense reasonably attributable to the inventory of materials and supplies. This would indicate that a proper loading rate should result in a year-end balance that is reasonably related to the materials and supplies on hand at year-end.

The Company was required to review its procedures in order to establish loading rates which will result in a year-end balance in Account 163 that is reasonably related to the material and supplies on hand.

Physical Inventory of Materials and Supplies

The staff noted that the company had not performed a physical inventory of all storeroom locations at least every two years.

The text of Account 163, Stores Expense Undistributed, requires that physical inventories of each class of materials and supplies be taken at least every two years.

In the future, the company was required to perform a physical inventory of its materials and supplies at least every two years.
Material and Supplies

Costs Improperly Included in Account 163, Stores Expense Undistributed

Account 163, Stores Expense Undistributed, was charged with purchases of office supplies and stationery. Such items are used by all departments of the Company and were issued on an as-needed basis.

Account 163 should include only the cost of labor, supervision and expenses incurred in the operation of general stores.

The Company was required to revise its procedures to provide that only those costs that are directly related to stores expense be charged to Account 163, Stores Expense Undistributed.

Loading Rates Used to Clear Account 163, Stores Expense Undistributed

The Company recomputed the stores expense loading rate every few months. The stores expense loading rate fluctuated during the audit period from 3% to 10%.

Instruction B of Account 163 states, "This account shall be cleared by adding to the cost of materials and supplies issued, a suitable loading charge which will distribute the expense equitably over stores issues." The large fluctuation in the Company's stores expense loading rates does not equitably allocate stores expense to individual issuances of materials and supplies.

In the future, the Company was required to determine a stores loading rate which remains relatively constant throughout the year so as to equitably allocate stores expense to stores issues.

Accounting for Limestone Used in Pollution Control Facilities

The Company recorded the cost of limestone used in pollution control facilities in Account 151, Fuel Stock. During 1982, $799,135 of limestone was charged to Account 501, Fuel Expense. None of these costs were included in the wholesale fuel adjustment clause.

The Commission's Declaratory Order dated February 26, 1981, stated that the proper account for limestone cost incurred for use in pollution control facilities was Account 154, Plant Materials and Operating Supplies.

The Company was required to include in Account 154, the inventoried cost of limestone used in pollution control facilities.
FUEL/MATERIALS AND SUPPLIES

Material and Supplies

Inequitable Stores Loading Procedures

The Company's stores expenses were allocated to materials and supplies based on a loading rate estimated at the beginning of each year. The rate was applied for the months January through November, with the remaining stores balance being allocated in December. During the audit period, the allocation rates in the month of December varied significantly from the rates used during the months January through November.

The Uniform System of Accounts requires that Account 163, Stores Expense Undistributed, be cleared by adding to the cost of materials and supplies a suitable loading charge which will distribute the expense equitably over stores issues.

The Company was required to implement procedures to more equitably distribute stores expense.

Improper Accounting for Sales Taxes and Freight

The Company recorded all sales taxes and freight expenses applicable to materials and supplies in Account 163, Stores Expense Undistributed.

The text of Account 154, Plant Materials and Operating Supplies, states, "This account shall include excise taxes, freight, switching or other transportation charges when practicable as part of the cost of particular materials to which they relate."

In the future, the Company was required to record the sales tax and freight expenses in Account 154, when practicable.

Accounting for Stores Expense

Staff's review of Account 163, Stores Expense Undistributed, disclosed that the Company recorded discounts, freight and taxes related to plant materials and operating supplies in Account 163.

The instructions to Account 154, Plant Materials and Operating Supplies, allow only expenses which cannot be directly assigned to particular purchases to be charged to Account 163.

The Company was required to revise its materials and supplies accounting procedures to comply with the instructions to Account 154.
Material and Supplies

Accounting for Salvaged Material Returned to Inventory

Staff's review of the Company's accounting for materials and operating supplies disclosed that the Company returned all materials salvaged from retirements to stock at the system average price.

The text of Account 154, Plant Materials and Operating Supplies, requires that "reusable materials consisting of large individual items shall be included in this account at original cost, estimated if not known" while "reusable materials consisting of relatively small items, the identity of which (from the date of original installation to the final abandonment or sale thereof) cannot be ascertained without undue refinement in accounting, shall be included in this account at current prices new for such items."

The Company was required to price reusable materials returned to stock in accordance with the requirements of Account 154 of the Uniform System of Accounts.

Accounting for Reconditioning Cost of Materials and Supplies Returned to Stock

The Company charged the cost of reconditioning materials returned to stock from construction, retirement, and maintenance activities to Account 108, Accumulated Provision for Depreciation of Utility Plant. Correspondingly, it credited the inventory cost of these materials to Account 108.

Operating Expense Instruction No. 2, Maintenance, and Instruction A (1) and (2) to Account 154, Plant Materials and Operating Supplies, require that the cost of repairing reusable items returned to stock be charged to the appropriate maintenance accounts.

The company was required to revise procedures effective to comply with the Uniform System of Accounts requirements for recording reconditioning costs of materials returned to stock.
Material and Supplies

Accounting for Materials and Supplies

Under the procedures existing prior to 1989 the Company charged some materials and supplies directly to expense prior to the time they were used in utility operations.

As a result of inventory, the Company identified thousands of unused (low cost) parts that it had previously expensed. Also, it identified some spare parts that were in excess of needs because of duplicate purchases, obsolescence, or the interchangeable spare parts held for other units.

Upon completion of the physical inventory, the Company decided to correct the accounting related to the cost of any remaining useful inventory items. The Company added the original cost of items to Account 154, Plant Materials and Operating Supplies, and credited either Account 101, Electric Plant in Service, or the various maintenance expense accounts.

Also, as a result of the inventory the Company identified materials and supplies that were no longer useable. The Company charged to expense and credited its inventory account for these items.

Under the general requirements of the Uniform System of Accounts, a company should charge the cost of purchases of materials held in inventory for use in the utility business for construction, operation, and maintenance to Account 154. A Company should credit Account 154 and charge the appropriate construction or expense account when the company uses the item.

In the past the Commission has recognized certain exceptions to the general requirements of the Uniform System of Accounts for materials and supplies. The exceptions include:

1. A company may expense the cost of minor value materials, supplies, and spare parts when purchased. Minor value materials, supplies and spare parts may be charged to expense when purchased when the improved financial reporting that would result from an inventory method of accounting is not justified by the cost of implementing and maintaining the inventory system. Incidental materials and supplies are minor items of an insignificant nature. They usually are readily available and are generally inexpensive. Examples include lubricants, small fittings, and nuts and bolts.

2. A company may charge to utility plant accounts the cost of "emergency" spare parts in accordance with Accounting Interpretation No. 50 issued by the National Association of Regulatory Utility Commissioners (NARUC).

3. A company would be expected to give appropriate accounting recognition to the economic effects of any specific rate actions by regulatory commissions that provide for rate recovery of the cost of materials and supplies and spare parts in different time periods than provided by the instructions to the Uniform System of Accounts.
Material and Supplies

Accounting for Materials and Supplies (Continued)

The Company's procedures prior to 1989 resulted in assigning the cost of certain materials and supplies to utility plant and operating expense accounts prior to the time it used the materials and supplies in utility operations, which was contrary to the general requirements of Account 154.

However, the Company's pre-1989 method of expensing certain materials and supplies when purchased met the third of the previously listed exceptions to the general requirements of the Uniform System of Accounts. Because the Company's rates were established based upon the expensing when purchased policy, the Company's accounting was an acceptable practice under the requirements of the Uniform System of Accounts. For that reason, the Company should have sought and received prior approval from its regulatory authorities as to the manner in which to implement the changes in accounting procedures. This would have allowed regulatory authorities to appropriately and timely consider the ratemaking ramifications of the change and the extent to which to synchronize the accounting and ratemaking.

On the other hand, the Company's procedures of not expensing the cost of useless or obsolete materials and supplies was not consistent with the requirements of the Uniform System of Accounts, and had the effect of overstating its inventory and net income for previous periods.

Staff recommended that the Company strengthen existing accounting procedures to ensure that:

(1) materials and supplies issues are charged to utility plant and operating expenses during the period of use consistent with the requirements of the Uniform System of Accounts; and

(2) physical inventories of materials and supplies are performed on a regular basis and the cost of useless or obsolete materials and supplies noted as a result of such inspections are expensed on a timely basis.
FUEL/MATERIALS AND SUPPLIES

Spare Equipment

Accounting for Spare Equipment

The Company did not maintain adequate accounting records or perform appropriate periodic physical inventories necessary to support the capitalization of the cost of spare equipment at its power plants as electric in service.

The Company followed the procedure of classifying the initial purchase of spare equipment at its power plants in Account 101, Electric Plant in Service.

Under the Uniform System of Accounts, as a general rule a company should classify the cost of all materials and supplies, including spare equipment, in Account 154, Plant Materials and Operating Supplies.

A utility is permitted to include in Account 101 the cost of materials and supplies that it holds as "emergency" spare equipment. Interpretation No. 50 of the Uniform System of Accounts issued by the National Association of Regulatory Utility Commissioners (NARUC) further defines the criteria for the "emergency" spares as that "associated with specific plant in service...and are not subject to use as normal periodic replacement."

The Division of Audits was unable to determine whether any of the amounts included in the plant accounts as spare equipment met the exception to the general inventory rule because the Company did not maintain adequate accounting records indicating the items of materials and supplies capitalized as components of plant cost.

General Instruction 2A of the Uniform System of Accounts provides that:

Each utility shall keep its books of account, and all other books, records and memoranda which support the entries in such books of account so as to be able to furnish readily full information as to any item included in any account. Each entry shall be supported by such detailed information as will permit ready identification, analysis, and verification of all facts relevant thereto.

Furthermore, the Company did not perform periodic physical inventories to determine the extent to which the inventories of spare equipment were subsequently used, lost or otherwise disposed of.

With respect to physical inventories, Instruction C to text of Account 154 requires that inventories of materials, supplies, fuel, etc. shall be taken at least annually.

The practice of capitalizing emergency spare parts under the provisions of NARUC No. 50 did not relieve the Company from its obligation to perform periodic inventories of all materials and supplies. Periodic physical inventories of all materials and supplies are required under the Commission's accounting regulations and from the broader perspective of adequate controls and protection of assets.
Spare Equipment

Accounting for Spare Equipment (Continued)

The Company was required to (1) revise accounting procedures to ensure that all spare parts are recorded in Account 154, unless the parts qualify for inclusion in Account 101 under the exception provided for "emergency" spare parts; (2) revise accounting procedures for maintaining inventory records and conducting physical inventories of materials and supplies to ensure that those procedures are consistent with the requirements of the Uniform System of Accounts; (3) take a physical inventory of all spare equipment on hand at generating stations and determine the accounts to which the related costs were charged; (4) for any items identified in the physical inventory for which the related costs are included in Account 101, determine whether such items qualify as "emergency spares"; (5) for any items classified in Account 101 that do not qualify as emergency spares, record an entry reclassifying the cost of those items from plant in service to Account 154.

The Company will file a report of its progress in implementing these recommendations with the Office of the Chief Accountant by June 30, 1990.

Accounting for Spare Equipment

The common plant of Units Nos. 1 and 2 included the capitalized cost of spare parts which consisted of items kept on hand at the plant site for emergency as well as for normal maintenance purposes.

The Uniform System of Accounts provides that Account 154, Plant Materials and Operating Supplies, include the cost of materials purchased for construction, operation and maintenance purposes. In addition, NARUC Interpretation No. 50 sets forth the proper accounting for spare parts or auxiliary equipment as between plant and inventory accounts.

The Company was required to prepare a detailed inventory analysis of all items classified as spare parts in the cost of common plant so as to determine the cost of spare parts on hand for emergency purposes and that which should be more properly classified in Account 154. The Company was also required, after completing its analysis, to record the appropriate entry to transfer the cost of spare parts or auxiliary equipment which are subject to use as normal periodic replacements from Account 101, Electric Plant in Service, to Account 154, and accordingly submit a copy of such journal entry to the Commission.
FUEL/MATERIALS AND SUPPLIES

Spare Equipment

Accounting For Spare Equipment

The Company did not properly classify the cost of certain spare equipment at its power plants as electric plant in service.

The Company followed the procedure of classifying the initial purchase of spare equipment at its power plants in Account 101, Electric Plant in Service.

Under the general requirements of the Uniform System of Accounts, a company should classify all materials and supplies, including spare equipment, in Account 154, Plant Materials and Operating Supplies.

The only exception to the general requirement with respect to the classification of materials and supplies relates to "emergency" spare parts. A company is permitted to include in Account 101 the cost of materials and supplies that it purchased as "emergency" spare equipment. Interpretation No. 50 of the Uniform System of Accounts issued by the National Association of Regulatory Utility Commissioners (NARUC) further defines the criteria for the "emergency" spares as that "associated with specific plant in service...and are not subject to use as normal periodic replacement".

The Company had not developed any criteria for determining which items included in the plant accounts as spare equipment met the "emergency" exception to the general inventory rule.

The Company was required to:

1. establish definitive criteria to clearly define "emergency spares" that may be capitalized in Account 101 under the requirements of the Uniform System of Accounts and NARUC Interpretation No. 50.

2. for any items classified in Account 101 that do not qualify as emergency spares, record an entry reclassifying the cost of those items from plant in to Account 154.

Accounting for Power Plant Materials, Supplies and Spare Parts

Prior to 1983, the Company accounted for certain power plant materials, supplies, and spare parts as follows:

(1) It recorded in Account 101, Electric Plant in Service, the cost of materials, supplies, and spare parts purchased during the initial construction of new generating plants but kept on hand for use in future utility operation, maintenance, and construction activity. It depreciated the amounts recorded in Account 101 by charging in Account 403, Depreciation Expense, and crediting Account 108, Accumulated Provision for Depreciation of Electric Utility Plant.
Spare Equipment

Accounting for Power Plant Materials, Supplies and Spare Parts (Continued)

(2) After commencement of commercial operations, it charged to expense the cost of all materials, supplies, and spare parts at the time it purchased the items. Included were the costs of incidental materials and supplies of a relatively insignificant nature, maintenance spare parts that were subject to periodic replacement, and minor item emergency spare parts.

After 1983 the Company made the following changes:

(1) In 1983, the Company implemented a 7 year conversion plan to change its accounting for maintenance spare parts subject to periodic replacement. Under the plan, the Company determined the amount of spare parts on hand at each of its generating plants, assigned a value to them, and recorded an inventory value in the accounts by debiting Account 154, Plant Materials and Operating Supplies, and crediting utility operation and maintenance expense or utility plant. Thereafter, it recorded the cost of maintenance spare parts subject to periodic replacement in Account 154 when purchased, and charged the cost to expense when used.

It changed the accounting for maintenance spare parts at each individual plant as it completed inventory valuations and put in place inventory control procedures.

The Public Service Commission (PSC) and the FERC used the accounting practices adopted for financial reporting purposes prior to 1983 in establishing rate levels during that period.

The Company reflected the 1983 change in accounting practices for maintenance spare parts for the first time in a 1985 rate filing before the FERC. The Company included about $20,000,000 of power plant spare parts inventory previously established under its conversion plan in rate base, and reduced expenses in the test period by about $6 million for the inventories that were scheduled to be established under the Company's accounting conversion plan. The rates ultimately approved in that proceeding resulted from a negotiated settlement and those rates remain in effect at this writing.

The Company first reflected the 1983 change in accounting practices for maintenance spare parts in retail rates before the PSC in 1987. It included about $50 million of spare parts inventory in rate base and reduced test period expenses by approximately $11 million in that proceeding. These rates were superseded by rates placed into effect in 1990.

(2) In January 1988, the Company changed its policy and began recording purchases of replacements for "emergency spare parts" in Account 154. However, later in 1988 it reverted to the previous practice of expensing or capitalizing replacements of "emergency spare parts" when purchased, depending on whether the part was a minor item of property (expense) or a retirement unit (capital).
Spare Equipment

Accounting for Power Plant Materials, Supplies and Spare Parts (Continued)

The Uniform System of Accounts requires a utility to charge an inventory account (Account 154, Plant Materials and Operating Supplies) for the cost of all materials, supplies and spare parts purchased and held for future use for construction, operation or maintenance purposes. When the utility uses the materials, supplies, and spare parts for construction, operation or maintenance purposes, it should credit Account 154 and debit the appropriate expense or plant account in accordance with a generally accepted inventory costing method that is consistently applied.

In the past the Commission has recognized certain exceptions to the general requirements of the Uniform System of Accounts for materials and supplies. The exceptions include:

1. A company may expense the cost of minor value materials, supplies, and spare parts when purchased. Minor value materials, supplies and spare parts may be charged to expense when purchased when the improved financial reporting that would result from an inventory method of accounting is not justified by the cost of implementing and maintaining the inventory system. Incidental materials and supplies are minor items of an insignificant nature. They usually are readily available and are generally inexpensive. Examples include lubricants, small fittings, and nuts and bolts.

2. A company may charge to utility plant accounts the cost of "emergency" spare parts in accordance with Accounting Interpretation No. 50 issued by the National Association of Regulatory Utility Commissioners (NARUC).

3. A company would be expected to give appropriate accounting recognition to the economic effects of any specific rate actions by regulatory commissions that provide for rate recovery of the cost of materials and supplies and spare parts in different time periods than provided by the instructions to the Uniform System of Accounts.

The Uniform System of Accounts generally precludes a company from reaccounting for amounts previously charged to expense accounts. Electric Plant Instruction No. 1 of the Uniform System of Accounts states in part:

B. . . . Adjustments shall not be made to record in utility plant accounts amounts previously charged to operating expenses or to income deductions in accordance with the uniform system of accounts in effect at the time or in accordance with the discretion of management as exercised under a uniform system of accounts, or under accounting practices previously followed.

In the review of the Company's accounting practices for materials and supplies at power plants we noted the following:

1. All materials and supplies acquired prior to the commercial in-service date of generating plants should not be capitalized as a component of construction cost. Only the cost of items constituting "emergency spare parts" should be capitalized as
Accounting for Power Plant Materials, Supplies and Spare Parts (Continued)

a component of plant costs. All other material and supplies acquired during the initial construction of a generating plant and not used in construction should be recorded in Account 154 or expensed when purchased consistent with the Uniform System of Accounts requirements set forth above.

Upon review, Staff concluded that the Company's accounting policies for distinguishing between emergency spare parts and maintenance spare parts are in accordance with the exceptions recognized by the Commission to the general requirements of the Uniform System of Accounts. However, during the review of the 1990 plant warehouse records of retirement unit "emergency spare parts" the Company brought to Staff's attention that certain individual maintenance spare parts (which qualified as retirement units) were mistakenly included as retirement units on the "emergency spare parts" lists.

2. The Company's pre-1983 method of expensing power plant maintenance materials and supplies, and incidental materials and supplies when purchased met the third of the previously listed exceptions to the general requirements of the Uniform System of Accounts. The Company had consistently followed the practice of expensing the items when purchased in previous periods. Because the Company's rates were established based upon the expensing when purchased policy, Staff concluded that the Company's accounting was an acceptable practice under the requirements of the Uniform System of Accounts.

The results of the Company's policy of expensing the items when purchased was included in each cost of service the Company filed with the PSC and the FERC. The regulatory commission(s) approved rate levels that included the expensed amounts. Therefore, the regulatory commissions had already provided the Company with an opportunity to recover from customers the cost of materials and supplies that were later restored to inventory.

3. The Company should not have changed its accounting practices for maintenance spare parts in 1983 and for replacements of "emergency" spare parts in 1988 without the advance approval of regulatory authorities. The Company's conversion plan for maintenance spare parts resulted in significant retrospective changes to account balances previously used in establishing rates. For that reason, the Company should have sought and received prior approval from its regulatory authorities as to the manner in which this change should be implemented. This would have allowed regulatory authorities to appropriately and timely consider the ratemaking ramifications of the changes and the extent to which the accounting and ratemaking should be synchronized.

The Chief Accountant has authorized utilities to change accounting principles for recording inventories and to establish values for any existing inventory items. In each of the cases the companies established an asset in Account 154 and a ratemaking liability in Account 253, Other Deferred Credits. Under the Chief Accountant's directions, the utilities did not include the entire effect of the accounting change in net income in the period of the change.
Spare Equipment

Accounting for Power Plant Materials, Supplies and Spare Parts (Continued)

In most cases the Chief Accountant's decisions resulted from actions of regulatory commissions that had approved the utilities disposition of both the asset and the regulatory liability included in Account 253. The Chief Accountant required the utilities to amortize the balances recorded in Accounts 253 by crediting Account 406, Amortization of Electric Plant Acquisition Adjustments, over the period permitted by its regulatory jurisdictions.

Where a utility that proposed a change in accounting principle for inventories had not received advance rate approval for the change, the Chief Accountant's acceptance of the utility's plan to establish an asset and related liability was contingent on rate approval by the Company's regulatory authorities. The Chief Accountant required the utilities to seek the advice of their regulatory commission(s) and to amortize the amounts deferred in Account 253 consistent with rate plans.

Since 1983 the Company filed rates before the PSC and the FERC reflected the costs resulting from its revised accounting practices for power plant materials and supplies. The PSC and the FERC have not disallowed any of the reestablished assets recorded in Account 154 in approving the Company's cost of service. Therefore, we are not making any accounting recommendations for the Company to establish a regulatory liability at this time.

In the event the Company is subsequently disallowed rate recovery of any of the reestablished amounts in Account 154, it should record the necessary liability in the accounts to reflect the nonrecovery of any remaining asset recorded in Account 154.

Staff recommended that the Company:

1. revise its accounting practices for power plant materials and supplies to ensure that it obtains prior approval from regulatory authorities when contemplating changes in accounting practices of this nature in the future;

2. review all spare parts and equipment for which the related costs are included in Account 101 and redetermine whether such items qualify as "emergency" spare parts under the Company's practices of following the definition provided in NARUC Interpretation No. 50; and

3. record a correcting entry reclassifying to Account 154 the cost of any items classified in Account 101 that do not qualify as emergency spare parts.

The Company shall file with the Office of Chief Accountant a copy of any correcting entries reclassifying costs of recorded spare parts.
FUEL/MATERIALS AND SUPPLIES

Spare Equipment

Accounting for the Cost of Spare Parts and Equipment

The Company followed the policy of classifying the cost of spare parts and equipment in Account 107, Construction Work in Progress-Gas. When the work orders were closed, the Company reclassified the cost from Account 107 to Account 101, Gas Plant in Service.

Under the general requirements of the Uniform System of Accounts a Company should classify the cost of the entire inventory of materials and supplies, including spare equipment, in Account 154, Plant Materials and Operating Supplies.

The only exception to the general requirement with respect to the classification of materials and supplies relates to "emergency" spare parts. A utility is permitted to include in Account 101 the cost of materials and supplies that it holds as "emergency" spare equipment. Interpretation No. 50 of the National Association of Regulatory Utility Commissioners (NARUC) further defines the criteria for the "emergency" spares as that "associated with specific plant in service . . . and are not subject to use as normal periodic replacement."

Staff recommended that the Company:

(1) revise account procedures to ensure that all future purchases of spare parts are recorded in Account 154, unless the parts qualify for inclusion in Account 101 under the exception provided for "emergency" spare parts;

(2) review all spare parts and equipment for which the related costs are included in Account 101 and determine whether such items qualify as "emergency" under the definition provided in NARUC Interpretation No. 50. If the review indicates that the Company has incorrectly capitalized the cost of items as "emergency" spare parts, it should record a correcting entry reclassifying the items to Account 154; and

(3) record correcting entry to reclassify spare parts from the plant accounts to the stock account.
Accounting for the Cost of Spare Parts and Equipment

The Company followed the practice of purchasing spare parts during the construction of the Station based on the manufacturers recommended spare parts listing. The Company purchased additional spare parts after the units were constructed based on what the plant engineers determined was needed as spare parts for each unit. It recorded the cost of the parts in Account 154, Plant Material and Operating Supplies.

During April 1984 the Company began capitalizing in Account 101 the cost of spare parts that met the Company's new emergency spare parts guidelines. Also, the Company adopted a policy on May 18, 1984, of capitalizing one extra spare part where more than one emergency spare part was on hand.

Furthermore, the Company disposed of a number of the remaining excess spare parts recorded in Account 154. In 1989 the Company disposed of some spares through a trading arrangement for exchange of services or for other parts with one of the original vendors.

Under the general requirements of the Uniform System of Accounts, a company should charge the cost of purchases of materials held in inventory for use in the utility business for construction, operation, and maintenance to Account 154. A Company should credit Account 154 and charge the appropriate construction or expense account when the company uses the item.

The Commission recognizes certain exceptions to the general requirements of the Uniform System of Accounts. One of the exceptions relates to "emergency" spare parts. The Commission permits utilities to follow Interpretation No. 50 issued by the National Association of Public Utility Commissioners (NARUC) when they account for "emergency" spare parts. NARUC Interpretation No. 50 permits a company to include in the plant accounts the cost of spare parts or auxiliary equipment that it is required to keep on hand for emergency use. It is not intended, however, that a company classify in such category items of spare parts that are subject to periodic replacement. Companies that capitalize items that qualify as emergency spare parts would account for those items by following the same requirements as those that relate to depreciation, additions and retirements of electric plant in service.

Also, at the time the Company determined that it had excess and/or obsolete materials and supplies, it should have reclassified the cost of the excess or obsolete materials and supplies to Account 186, Miscellaneous Deferred Debits, pending final disposition.

Staff recommended that the Company:

(1) revise accounting procedures to ensure that:

(a) future purchases of spare parts are recorded in Account 154, unless the parts qualify for inclusion in Account 101 under the exception provided for "emergency" spare parts; and

(b) materials and supplies inventory are reviewed on a periodic basis and excess and obsolete items are disposed of on a timely basis;
Spare Equipment

Accounting for the Cost of Spare Parts and Equipment (Continued)

(2) record a correcting entry reclassifying the cost of any items classified in Account 101 that do not qualify as "emergency" spares within the definition provided in NARUC Interpretation No. 50; and

(3) record a correcting entry to remove the cost of any items recorded in Account 154 that were determined to be excess or obsolete.

The Company shall submit a copy of the correcting entries to the Office of Chief Accountant.

Accounting for the Cost of Spare Parts and Equipment

The Company followed the policy of classifying the initial purchase of spare parts and equipment at power plants in Account 101, Electric Plant in Service. In addition, the Company charged operating expense accounts with the cost of certain non-emergency spare parts purchased after the construction phase of a project.

Under the general requirements of the Uniform System of Accounts, a company should classify the cost of the entire inventory of materials and supplies, including spare equipment, in Account 154, Plant Material and Operating Supplies.

The only exception to the general requirement with respect to the classification of materials and supplies relates to "emergency" spare equipment. Interpretation No. 50 of the Uniform System of Accounts issued by the National Association of Regulatory Utility Commissioners (NARUC) further defines the criteria for the "emergency" spares as that "associated with specific plant in service . . . and are not subject to use as normal periodic replacement."

Staff recommended that the Company:

(1) review all spare parts and equipment for which the related costs are included in Account 101 and determine whether such items qualify as "emergency spares", under the definition provided in NARUC Interpretation No. 50;

(2) revise accounting procedures to ensure that all future purchases of spare parts are recorded in Account 154, unless the parts qualify for inclusion in Account 101 under the exception provided for "emergency" spare parts; and

(3) record a correcting entry reclassifying the cost of any items classified in Account 101 that do not qualify as "emergency spares" to Account 154.

The Company should file a copy of the correcting entry with the Office of Chief Accountant.
FUEL/MATERIALS AND SUPPLIES

Spare Equipment

Accounting for the Cost of Spare Parts and Equipment

The Company followed the policy of classifying the initial purchase of spare parts and equipment at power plants in Account 101, Electric Plant in Service.

Under the general requirements of the Uniform System of Accounts, a company should classify the cost of the entire inventory of materials and supplies, including spare equipment in Account 154, Plant Material and Operating Supplies.

The only exception to the general requirement with respect to the classification of materials and supplies relates to "emergency" spare parts. A utility is permitted to include in Account 101 the cost of materials and supplies that it holds as "emergency" spare equipment. Interpretation No. 50 of the Uniform System of Accounts issued by the National Association Regulatory Commissioners (NARUC) further defines the criteria for the "emergency" spares as that "associated with specific plant in service . . . and are not subject to use as a periodic replacement."

Staff recommended that the Company:

(1) review all spare parts and equipment for which the related costs are included in Account 101 and determine whether such items qualify as "emergency spares", such as the definition provided in NARUC Interpretation No. 50;

(2) revise accounting procedures to ensure that all future purchases of spare parts are recorded in Account 154, unless the parts qualify for inclusion in Account 101 under the exception provided for "emergency" spare parts; and

(3) record a correcting entry reclassifying the cost of any items classified in Account 101 that do not qualify as "emergency spares" to Account 154.

The Company shall file a copy of the journal entry with the Office of Chief Accountant.
Spare Equipment

Accounting for the Cost of Spare Parts

The Company recorded the cost of spare parts purchased during the construction phase of a project in Account 101, Electric Plant in Service.

Under the general requirements of the Uniform System of Accounts, a company should charge the cost of purchases of materials held in inventory for use in the utility business for construction, operation, and maintenance to Account 154. A company should credit Account 154 and charge the appropriate construction or expense account when the company uses the item.

The Commission recognizes certain exceptions to the general requirements of the Uniform System of Accounts. One of the exceptions relates to "emergency" spare parts. The Commission permits utilities to follow Interpretation No. 50 issued by the National Association of Public Utility Commissioners (NARUC) when they account for "emergency" spare parts. NARUC Interpretation No. 50 permits a company to include in the plant accounts that cost of spare parts or auxiliary equipment that it is required to keep on hand for emergency use. It is not intended, however, that a company classify in such category items of spare parts that are subject to periodic replacement. Companies that capitalize items that qualify as emergency spare parts would account for those items by following the same requirements as those that relate to depreciation, additions and retirements of electric plant in service.

Staff recommended that the Company:

(1) review all parts and equipment for which the related costs are included in Account 101 and determine whether such items qualify as "emergency spares", under the definition provided in NARUC Interpretation No. 50: and

(2) record a correcting entry reclassifying the cost of any items classified in Account 101 that do not qualify as emergency spares to Account 154. If the Company intends to capitalize non-emergency spare parts that had previously been charged to expense, it should first seek approval of its proposed accounting treatment from the Chief Accountant.
Accounting for Spare Parts, Materials and Supplies at Generating Stations

In 1989 and 1990 the Company made several changes in its accounting for the cost of inventories of power plant materials, supplies and spare parts at (1) its own generating plants and (2) at the power plant.

(1) Prior to 1989, the Company followed the practice of expensing the cost of materials, supplies and spare parts purchased for generating plants. In some cases, the materials, supplies and spare parts were not currently used but were held at the stations for use in future utility operation, maintenance, and construction activity.

In 1990 the Company reaccounted for materials, supplies, and spare parts. It assigned a value to the amount of materials, supplies and spare parts on hand at each of its generating plants, and recorded the inventory value in the accounts by debiting Account 154 and crediting utility operation and maintenance expense or utility plant. The Company then adopted the procedure of assigning the cost of purchased power plant materials, supplies and spare parts to Account 154, Plant Materials and Operating Supplies, and charging such amounts to expense (and other accounts) when used.

(2) The Company accounted for the initial purchase of power plant spare parts and equipment at the plant in Account 101, Electric Plant in Service. Also, the Company charged operating expense accounts with the cost of certain non-emergency spare parts purchased after the construction phase of a project. Staff concluded that the Company should have recorded the cost of such parts and equipment in Account 154.

Staff recommended and the Company agreed to review all power plant spare parts for which the related costs are included in Account 101 and determine whether such items qualify as "emergency spares", under the definition provided in NARUC Interpretation No. 50. Also, Staff recommended that the Company record a correcting entry reclassifying the cost of any items classified in Account 101 that do not qualify as "emergency spares" to Account 154.

In 1989 and 1990, the Company adopted the procedure of assigning the cost of purchased power plant materials, supplies and equipment to Account 154 and charging such amounts to expense (and other accounts) when used. Also, based upon information provided, the Company assigned a value to the amount of spare parts on hand, and recorded the inventory value in the accounts by debiting Account 154 and crediting utility operation and maintenance expense or utility plant.

The Company included purchased materials, supplies, and spare parts expensed in the applicable test period as a component of the cost of service in rate requests.
Spare Equipment

Accounting for Spare Parts, Materials and Supplies at Generating Stations
(Continued)

The Uniform System of Accounts requires a utility to charge an inventory account (Account 154, Plant Materials and Operating Supplies) for the cost of all materials, supplies and spare parts purchased and held for future use for construction, operation or maintenance purposes. When the utility uses the materials, supplies and spare parts for construction, operation or maintenance purposes, it should credit Account 154 and debit the appropriate expense or plant account in accordance with a generally accepted method of inventory accounting consistently applied.

In the past the Commission has recognized certain exceptions to the general requirements of the Uniform System of Accounts for materials and supplies. The exceptions include:

1. A company may expense the cost of minor value material, supplies and spare parts when purchased.

2. A company may charge to utility plant accounts the cost of "emergency" spare parts in accordance with Accounting Interpretation No. 50 issued by the National Association of Regulatory Utility Commissioners (NARUC).

3. A company would be expected to give appropriate accounting recognition to the economic effects of any specific rate actions by regulatory commissions that provide for rate recovery of the cost of materials, supplies and spare parts in different time periods than provided by the instructions to the Uniform System of Accounts.

Staff concluded that the Company had the following deficiencies in its accounting for materials, supplies and spare parts:

(1) The Company should have obtained approval from regulatory authorities prior to any reaccounting for the inventory cost of power plant materials, supplies, and spare parts at generating stations.

The Company had consistently followed the practice of expensing the items when purchased in previous periods. The Company's method of expensing power plant materials, supplies and spare parts when purchased met one of the exceptions to the general requirements of the Uniform System of Accounts. The Company's practice of expensing the cost of power plant materials, supplies and spare parts was acceptable under the requirements of the Uniform System of Accounts because the Company's rates were established based upon this practice.

The change from expensing to inventorying power plant materials and supplies resulted in an increase in net income for 1990, for which the Company did not receive regulatory approval from the MPSC before making the accounting change. For that reason, the Company should have sought and received prior approval from its regulatory authorities as to the manner in which to implement the change.
Accounting for Spare Parts, Materials and Supplies at Generating Stations (Continued)

During 1991 the Company provided the Public Service Commission (PSC) with information supporting the reaccounting. Subsequently, the PSC informed the Office of Chief Accountant that it did not take issue with the Company's accounting for the establishment of the materials and supplies inventory, as the PSC will have the opportunity to give due consideration to this matter in the future should the need arise. Therefore, the Division of Audits did not recommend any further adjustment to the Company's accounts.

(2) It was appropriate for the Company to reclassify the power plant spare parts from Account 101, Electric Plant in Service, to Account 154.

The inventory taken in 1990 indicated that it had incorrectly included spare parts that did not meet the criteria for classification as an "emergency spare" in Account 101.
CHAPTER 11

OTHER LIABILITIES

OPERATING RESERVES

Im proper Accrual of the Injuries and Damages Reserve Related to Construction Work in Progress

The Company had accrued a reserve for injuries and damages incurred during construction. This reserve was accrued by debiting Account 107, Construction Work in Progress, and crediting Account 262. The accrued amount charged to Account 107 was allocated to the work orders based upon the current month's construction charges. Any injuries and damages resulting from construction were charged to Account 262 as incurred.

The effect of the Company's accounting was to charge work orders with the cost of injuries and damages which may not relate to those work orders.

The Financial Accounting Standards Board's Statement No. 5 established two criteria which must be met in order for a contingent liability to be accrued. The Company's construction-related injuries and damages reserve did not meet these criteria. Further, the Company had not been allowed this reserve in a rate filing before either the State Commission or the Federal Energy Regulatory Commission.

The Company was required to (1) discontinue accruals to this reserve, (2) charge any future construction-related injuries and damages to this reserve until it is extinguished, and (3) after extinguishment of the reserve, charge any injuries and damages related to construction to the appropriate work order as incurred.
Operating Reserves

Recording of Book Operating Reserve Accruals

The Company maintained an operating reserve in Account 261, Property Insurance Reserve. This reserve was established for the purpose of limiting the effect that losses from storm damage would have on the income statement. As of December 31, 1980, the balance in this account was $496,582.

The Public Service Commission used the above-mentioned reserve to reduce rate base in the Commission's latest rate order and allowed the Company a level of storm damage expenses as a cost of service item based on historical experience. Book reserve accruals charged to expense, however, were less than the level of storm damage expenses allowed in rates.

In the future, the Company was required to charge book reserve accruals to expense at the same level as storm damage expenses are included in rates. No correcting entry was necessary since the differing rate level was not effective until after the end of the audit period.

Operating Reserves

As of December 31, 1981, the Company had recorded in Account 262, Injuries and Damages Reserve, an amount of $1,280,154. The Company's estimated liability as of that date was $793,895, leaving an excess of reserve over estimated liability of $486,259.

The Company's accounting instructions require that the recording of injuries and damages reserves meet the following two tests:

1. The loss must be probable.
2. The amount of loss must be capable of reasonable estimation.

This instruction adheres to the requirements of FASB Statement No. 5. The Company was required to record an entry to adjust the balance in Account 262, Injuries and Damages, to a level approximating the Company's estimated liability. Company agreed to maintain Account 262 in accordance with the requirements of FASB Statement No. 5 and to ensure that the account reflects estimated liability within a $25,000 tolerance.
OTHER LIABILITIES

Operating Reserves

Accounting Related to Property Damage Reserve

The Company had established a property damage reserve in Account 265, Miscellaneous Operating Reserves, to accrue for the impairment of assets, representing the Company's self insured amount. Maintenance was charged for the estimated repair cost. As repairs to the property began and the extent of the damage became known, the reserve and expenses were adjusted to reflect this current information. The actual repair cost was charged to a job order. After the repairs were completed, the accumulated costs recorded in the job order were cleared against the reserve, with the difference adjusted to expense.

In 1979, the Company made a decision to phase out this reserve. Its practice was to collect repair costs in a job order and write off these costs which represented the Company's self insured portion, to the appropriate maintenance account quarterly.

The balance in Account 265 with regard to this reserve had remained at a constant amount of $1,019,332 for the years 1980 and 1981, even though several job orders which had accrued amounts in the reserve had been closed. The effect of the closing of these job orders directly to the maintenance accounts rather than the reserve was an overstatement of maintenance expense.

The Company was required to (1) clear the repair amounts against the reserve as those jobs orders which have amounts accrued in the reserve are closed and (2) record an adjusting entry to correct the overstatement of maintenance expense which occurred in prior years.

Improper Use of Account 262, Injuries and Damage Reserve

The Company charged Account 262, Injuries and Damages Reserve, with the current salaries and expenses of the Claims Department. The use of operating reserve accounts for clearing of current expenses is not allowed by the Uniform System of Accounts. The text of Account 925, Uniform System of Accounts, states that this account shall include the cost of labor and related supplies and expenses incurred in injuries and damages activities.

The Company was required to charge Account 925, Injuries and Damages, with the current salaries and expenses of the Claims Department.
OTHER LIABILITIES

Operating Reserves

Injuries and Damages Reserve

At December 31, the Company had a balance of $1,000,000 recorded in Account 262, Injuries and Damages Reserve. There was no activity in this account during the audit period, although the Company had expended amounts for injuries and damages.

The Company did not have any written policies and procedures covering the injuries and damages reserve. Based on guidelines contained in Financial Accounting Standards Board Statement No. 5, the staff was unable to determine the existence of any contingent liability which would justify maintaining this reserve on the Company's books of account.

The Company was required to amortize the balance recorded in Account 262, over a 5-year period, to Account 925, Injuries and Damages.

Use of Operating Accruals for Injuries and Damages

The Company established an operating provision to accrue estimated injury and damage expenses. The provision was recorded in Account 925, Injuries and Damages, with a corresponding credit to Account 228.2, Accumulated Provision for Injuries and Damages. The Company was only allowed to collect the actual injury and damage costs incurred in establishing rates.

The Special Instruction to Account 228.1 through 229 states, "No amounts shall be credited to these accounts unless authorized by a regulatory authority or authorities to be collected in a utility's rate level."

The Company was required to (1) adopt procedures to cease reserve accounting for injury and damage expenses related to coal and non-coal employees and (2) record a correcting entry to eliminate the balances in the injuries and damages reserve.
Operating Reserves

Accounting For Operating Provisions and Contingencies

The Company recorded the following operating provisions and contingent expenses in its accounts during the audit period:

a. The Company charged Account 924, Property Insurance, and credited Account 261, Property Insurance Reserve, to record an operating provision for self-insurance for the deductible portion of each outside property damage insurance policy.

b. The Company charged Account 925, Injuries and Damages, and credited Account 262, Injuries and Damages Reserve, to record an operating provision for self-insurance for: (1) worker's compensation, occupational disease, etc. in states where the Company is qualified to self-insure, and (2) the deductible portion of each outside public liability insurance policy.

c. The Company charges Account 926, Employee Pensions and Benefits, and credited Account 263, Pension and Benefits Reserve, to record an operating provision for: (1) the special retirement program, and (2) a nonqualified stock option plan. The special retirement program operating provision was accrued prior to the January 1, 1983 and no additional provisions were recorded during the audit period.

d. The Company charged Account 426.5, Other Deductions, and credited Account 265, Miscellaneous Operating Reserves, for various other miscellaneous contingencies and the write-down of various assets.

The Company's accounting for operating provisions was not in compliance with Commission Order No. 390, issued August 3, 1984 and General Instruction No. 2A of the Uniform System of Accounts.

The Commission made several changes to the requirements of the Uniform System of Accounts covering the use of operating reserves in Order No. 390. One change was to withdraw the operating reserve Accounts 261 through 265 and to establish the following new liability accounts: Accounts 228.1, Accumulated Provision for Property Insurance; 228.2, Accumulated Provision for Injuries and Damages; 228.3, Accumulated Provision for Pensions and Benefits; and 228.4, Accumulated Miscellaneous Operating Provisions.

Another change was to limit the use of the new accounts only to situations when a regulatory authority permits the collection of the above estimated provisions as part of the company's rate levels.

The Company should have ceased using Accounts 261 through 265 at the effective date of the provisions of Order No. 390. The Company did not have a basis to use the new Accounts 228.1 through 228.4 since it did not provide the necessary support to demonstrate that the Commission has approved the use of operating provisions in establishing its rates.
OTHER LIABILITIES

Operating Reserves

Accounting For Operating Provisions and Contingencies (Continued)

The Uniform System of Accounts permits a company to establish liabilities in accordance with the provisions of Financial Accounting Standards Board Statement (SFAS) No. 5, Accounting for Contingencies. A company should record the liabilities in the appropriate operating and nonoperating expense accounts and balance sheet Accounts 242, Miscellaneous Current and Accrued Liabilities or 253, Other Deferred Credits.

The Company was required to (1) revise procedures to classify any future operating provisions that are specifically provided in rate levels to Accounts 228.1, 228.2, 228.3 and 228.4, and (2) record a correcting entry to reclassify and/or reverse the operating contingencies previously established in Accounts 261, 262, 263 and 265 to the proper accounts based upon the guidelines of SFAS No. 5. The Company should record any reversals of the previously established contingencies in the same accounts that the Company recorded the initial charges. The Company shall file a copy of the journal entry with the Office of the Chief Accountant.

Accounting for Anticipated Property Losses

The Company established an operating provision for anticipated property losses during the operation of the pipeline by charges to Account 924, Property Insurance, and credits to Account 228.1, Accumulated Provision for Property Insurance. For tariff billing purposes, the amount charged to Account 924 was included as an operating expense. When claims were settled and payments were made, the Company reduced the amounts established in Account 228.1.

The Company's use of Account 228.1 was not in compliance with Commission Order No. 390, issued August 3, 1984. In Order No. 390, the Commission changed the requirements of the Uniform System of Accounts to limit the use of Account 228.1 to instances when a regulatory authority specifically permits the collection of loss provisions in a company's rate levels.

The Company's cost of service tariff does not specifically permit the use of operating provisions as set forth in Accounts 228.1 through 228.5 of the Uniform System of Accounts. Under the limitations set forth in Order No. 390, therefore, the Company did not have a basis for making property insurance accruals to Account 924 and 228.1 to cover contingent losses and for including such amounts in tariff billings.

The Company was required to (1) revise procedures to limit the use of operating provisions to those items of expense where operating provisions are specifically provided in rate levels, (2) cease making accruals to operating expense accounts covering property insurance, and (3) record a correcting entry to eliminate the operating provision.
Operating Reserves

Accounting for a Liability to Customers

The Company created the Hardship Fund through a Stipulation and Agreement between the Company and the Public Utility Commission. The reserve is entirely funded from interest the Company received from Transmission Corporation.

The Company credits the proceeds to Account 228.4, Accumulated Miscellaneous Operating Provisions. At December 31, 1988, the Company had recorded $2,133,249 in Account 228.4. The monies recorded in Account 228.4 are used to offset payments from customers recorded in Account 142, Customer Accounts Receivable.

Order No. 390 issued August 3, 1984, added new operating reserve accounts to the Uniform System of Accounts. However, the Order provided that the accounts:

...may be credited only where a regulatory authority permits the collection of these amounts in a regulated company's rate levels.

The provision recorded in Account 228.4 does not represent amounts collected in rates but rather a refund from Transmission Corporation that must, in turn, be paid out to the Company's customers through the Hardship Fund. Therefore, the Company should establish a liability in the appropriate account.

It was recommended that the Company:

(1) adopt procedures to ensure that Account 228.4 is used only for recording amounts that are collected in rates; and

(2) record an entry to reclassify the Hardship Fund to Account 253 until a determination can be made as to what portion should be reclassified as a current liability.

Accounting Classification of Liabilities for Environmental Clean-up Costs

During 1988 the Company determined that it would have to perform environmental clean-up work in the following areas: PCB contamination, hazardous waste disposal sites, underground storage tanks, asbestos abatement and waterways contamination. The Company estimated that the total cost of the work would be $3,336,340. In December 1988, the Company accrued a liability for the cost to do the clean-up work. It did so by charging Account 924, Property Insurance, and crediting Account 228.4.
OTHER LIABILITIES

Operating Reserves

Accounting Classification of Liabilities for Environmental Clean-up Costs
(Continued)

The Special Instruction to Accounts 228.1, 228.2, 228.3 and 228.4 state:

No amounts shall be credited to these accounts unless authorized by a regulatory authority or authorities to be collected in a utility's rate level.

The Commission provided the 228 series of accounts for the limited purpose of recording regulatory liabilities stemming from the inclusion in rate levels of provisions for operating expense, and not liabilities otherwise incurred in providing utility service.

The Company did not have a basis to use Account 228.4 since it did not provide the necessary support to show that the FERC and the state regulatory commissions had approved the use of operating provisions in establishing rates.

We concluded that the amounts the Company recorded in Account 228.4 represented a valid liability that should have been recognized in its accounts. However, the Company should have recorded the amounts as current and accrued liabilities in Account 242.

The Company did not have a basis to use Account 924 to classify accruals for the clean-up related to PCB contamination, hazardous waste disposal sites, underground storage tanks, asbestos abatement and waterways contamination.

The Uniform System of Accounts provides various operation and maintenance expense accounts for each functional classification of utility plant (production, transmission, and distribution). The Company should have classified the previously mentioned costs to the appropriate operation and maintenance expense accounts.

It was recommended that the Company:

(1) revise its procedures to ensure operating expenses and related accrued liabilities are classified in the proper accounts consistent with the requirements of the Uniform System of Accounts; and

(2) record an entry to reclassify the amounts recorded in Account 228.4 to Account 242.
Operating Reserves

Accounting Classification of Liabilities

In 1982, the Environmental Protection Agency filed suit against the Company, among others, for the costs it incurred to clean-up an area. The Company owned a coal gasification plant on the site from 1928 to 1964. The operation of the plant resulted in contamination of the surrounding land.

The Company estimated its liability in this suit to be approximately $1,000,000. The Company recorded accruals totaling $1,063,000 in 1987 and 1988 to cover the contingency by charging Account 925, Injuries and Damages, and crediting Account 228.2. The Company had not settled this suit as of December 31, 1989.

The Company did not have a basis to use Account 228.2 since it did not provide the necessary support to show that the FERC and the state regulatory commission had approved the use of operating provisions in establishing rates. Therefore, the Company's accounting classification of the liability for clean-up costs was not consistent with the requirements of the Uniform System of Accounts.

The Uniform System of Accounts permits a company to establish accruals for liabilities that are known and measurable in accordance with generally accepted accounting principles. A company should record any liabilities in the appropriate balance sheet Accounts 242, Miscellaneous Current and Accrued Liabilities, and 253, Other Deferred Credits.

It was recommended that the Company:

1. revise procedures to ensure the liabilities are classified in the proper account consistent with the requirements of the Uniform System of Accounts; and

2. record an entry to reclassify the amounts recorded in Account 228.2 to the appropriate account.

Accounting for Clean-up Costs and General Liabilities

During the audit period the Company recorded the following provisions in Accounts 228.2 and 228.4:

1. The Company recorded a monthly accrual for injuries or damages to cover the liability for amounts that are not covered by insurance by debiting Account 925, Injuries and Damages, and crediting Account 228.2. It charged the actual cost incurred each month for injuries and damages to Account 228.2.

The Public Utilities Commission allowed the Company to recover actual cash expenditures for injuries and damages in rate levels.
Operating Reserves

Accounting for Clean-up Costs and General Liabilities (Continued)

(2) In 1989 the Company made an accrual to record the $3.5 million estimated clean-up costs for a Superfund site by debiting Account 925 and crediting Account 228.2. It did not seek approval of its regulatory commissions to include the clean-up costs in rates and its existing rates did not have any provision for the costs.

(3) The Company established a liability for employees that qualify for disability payments under its long-term disability program. At the same time it recorded a regulatory created asset to recognize the collection of the liability in rates charged to customers. The Company recorded the liability and related asset by charging Account 186, Miscellaneous Deferred Debits, and crediting Account 228.4.

The PUC allowed the Company the actual cash disability payments in establishing rate levels.

The Company's accounting for the liabilities and the related ratemaking assets was contrary to the following Commission requirements.

The Special Instructions to Accounts 228.1 through 228.4 state:

No amounts shall be credited to these accounts unless authorized by a regulatory authority or authorities to be collected in a utility's rate levels.

Under the above requirements, the Company did not have a basis to use Accounts 228.2 and 228.4 for the previously mentioned transactions.

Based upon the circumstances present in this case, the Company should have recorded the previously mentioned liabilities in balance sheet Account 242, Miscellaneous Current and Accrued Liabilities, or Account 253, Other Deferred Credits, instead of using Accounts 228.2 and 228.4.

The Company should use income accounts to reflect the liability and related ratemaking assets related to the disability program.

The Company should expense the entire liability under its long-term disability programs at the time the amounts become capable of being measured under the requirements of the Uniform System of Accounts and generally accepted accounting principles. It should not wait until such amounts are paid to plan participants to charge Account 926.

The Commission has approved special accounting to accommodate ratemaking actions of public utility commissions when such actions created regulatory assets that the jurisdictional company would recover in future rates.
Operating Reserves

Accounting for Clean-up Costs and General Liabilities (Continued)

Since it had reasonable assurance of recovering the liability under the disability program in future rates, the Company should establish a regulatory created asset in an amount equal to its disability liability by charging Account 186 and crediting Account 406, Amortization of Electric Plant Acquisition Adjustments.

It was recommended that the Company:

(1) revise procedures to only use Accounts 228.1, 228.2, 228.3, and 228.4 in the future to classify operating provisions that are specifically provided in rate levels; and

(2) record an entry to reclassify the Superfund site clean-up costs and the long-term disability payments as a liability to the proper accounts.
OTHER LIABILITIES

Rate Refunds

Accounting for Gas Supplier Refunds

Staff’s examination disclosed that the Company recorded gas supplier refunds in Account 253, Other Deferred Credits, pending pass through of those amounts to Gas Interstate Company’s customers via the purchased gas adjustment clause. In its Purchased Gas Adjustment Clause (PGAC) filings, the Company properly reflected the refunds as a reduction of gas cost when received, and carrying charges were computed on unrecovered purchase gas cost, net of supplier refunds.

Part 154.38 of the Commission’s Regulations under the Natural Gas Act provides that refunds received from gas suppliers be recorded in Account 191, Unrecovered Purchased Gas Costs.

Reserve for Revenues Subject to Refund

The Company established a contingency for revenues subject to refund for the pricing of gas. This contingency reserve was recorded in Account 232, Accounts Payable, and at year-end the ultimate disposition of this amount was unknown.

The Uniform System of Account provides the use of Account 253, Other Deferred Credits, for items which cannot be cleared or disposed of until additional information is received. Further, Financial Accounting Standards Board Statement No. 5 states, that a contingency is an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss that will ultimately be resolved when one or more events occur or fail to occur.

The Company was required to reclassify the reserve for revenues subject to refund from a current liability to a deferred credit, transfer the reserve from Account 232 to Account 253, and in the future, record such amounts in Account 253 when the ultimate disposition is unknown.
OTHER LIABILITIES

Rate Refunds

Accounting for Rate Refunds

The Company credited amounts to be refunded for retail revenues in excess of
the allowed rate of return to Account 242, Miscellaneous Current and Accrued
Liabilities, with a concurrent debit recorded in Account 557, Other Expenses.

The Uniform System of Accounts, Account 229, Accumulated Provision for Rate
Refunds, states, "This account shall be credited with amounts charged to
Account 449.1, Provision for Rate Refunds, to provide for estimated refunds
where the utility is collecting amounts in rates subject to refund." In
addition, "When refund of any amount recorded in the account is ordered by
regulatory authority, such amount shall be charged hereto an credited to
Account 242, Miscellaneous Current and Accrued Liabilities."

The amounts recorded in Account 242 at December 31, 1984 were known and
measurable. In addition, the staff noted that the Public Service Commission
had established a policy of issuing orders detailing the amounts to be refunded
shortly after the close of each calendar quarter. Therefore, the staff did not
object to the use of Account 242 to classify the liability for the refund.

The Company was required to revise its procedures so as to charge the estimated
refunds to Account 449.1

Accounting for Rate Refunds and Wholesale Rate True-Ups

The Company established a reserve for an estimated retail rate refund in
Account 253, Other Deferred Credits, with an offsetting debit to Account 426.5,
Other Deductions. The Company also recorded an estimated rate true-up
associated with cost-of-service billings to Gas & Electric Company in Accounts
253 and 426.5.

Effective January 1, 1984, the Commission established Account 449.1, Provision
for Rate Refunds, and Account 229, Accumulated Provision for Rate Refunds, in
the Uniform System of Accounts for the purpose of accounting for estimated rate
refunds. The instruction of Account 449.1 states in part,

A. This account shall be charged with provisions for the
estimated pre-tax effects on net income of the portions of
amounts being collected subject to refund which are estimated
to be required to be refunded. Such provisions shall be
credited to Account 229, Accumulated Provisions for Rate
Refunds.

The Company was required to revise procedures to ensure that Accounts 449.1
and 229 are used for recording provisions for rate refunds and rate true-ups.
OTHER LIABILITIES

Rate Refunds

Accounting for Provisions for Rate Refunds

The Company recorded provisions for rate refunds by: (1) debiting Accounts 483, Sales for Resale; 489, Revenues From Transportation of Gas of Others; 491, Revenue From Natural Gas Processed by Others; and 495, Other Gas Revenue; and (2) crediting Accounts 232, Accounts Payable; and 253, Other Deferred Credits. The rate of refund provisions related to Docket RP85-122, NGPA pricing of Company production, gas search program and various other rate matters. The total provisions recorded in the above accounts as of December 31, 1986 amounted to $160,033,421.

The instructions to Account 496, Provision for Rate Refunds, state, in part:

This account shall be charged with provisions for the estimated pretax effects on net income of the portions of amounts being collected subject to refund which are estimated to be required to be refunded. Such provisions shall be credited to Account 229, Accumulated Provision for Rate Refunds.

The Company should have recorded the provisions for rate refunds by charges to Accounts 496 and credits to 229.

The Company was required to (1) revise procedures to account for provisions for rate refunds in accordance with the Uniform System of Accounts, and (2) record an entry to reclassify the provisions for rate refunds as of December 31, 1986 in Account 229, Accumulated Provision for Rate Refunds.
OTHER LIABILITIES

Other

Accounting for Customer Deposits

The Company's procedure was to request a customer deposit on new service. Once the service was discontinued, the amount of the deposit was applied towards the final billing and the amount remaining was forwarded to the customer. If for any reason the customer could not be located, the customer's deposit was credited to Account 253, Other Deferred Credits, until the legal liability has lapsed. Once the legal liability has expired, the Company's practice was to credit the deposit to various accounts such as, Account 142, Customer Accounts Receivable, Account 144, Accumulated Provision for Uncollectible Accounts - Credit, Account 232, Accounts Payable, Account 235, Customer Deposits, Account 241, Tax Collections Payable, Account 253, Other Deferred Credits, and Account 456, Other Electric Revenues.

NARUC Interpretation No. 51 provides that all unclaimed deposits are to be transferred to Account 144, Accumulated Provision for Uncollectible Accounts, after legal liability has lapsed.

The Company was required to maintain all customer deposits in Account 235 until returned or until the legal liability has lapsed, and then transfer such deposits to Account 144, Accumulated Provision for Uncollectible Accounts - Credit, in accordance with NARUC Interpretation No. 51.

Incorrect Accounting for Unclaimed, Uncashed Checks

The Company transferred all unclaimed and uncashed checks for overpayments on service accounts and other miscellaneous payments to Account 421, Miscellaneous Nonoperating Income. These checks remained in Account 421 until the payee was located or the money was turned over to the state.

The text of Account 242, Uniform System of Accounts, states that this account shall include the amount of all other current and accrued liabilities not provided for elsewhere.

In that a liability still existed for these unclaimed checks and no income had been earned, the Company was required to account for unclaimed and uncashed checks as miscellaneous liabilities in Account 242, Miscellaneous Current and Accrued Liabilities.
OTHER LIABILITIES

Other

Accounting for Compensated Absences

The Company charged amounts paid for vacation, holiday, sick leave and other compensated absences to expense at the time the employee was absent from work (i.e., the Company did not accrue a liability for compensated absences). When an employee was absent, a charge was made to the employee's "normal work order," and billed to the operating companies according to the allocation method used for that work order. However, according to Company personnel, about half of all employees charge a portion of their time to a cost center other than their "normal work order" during a typical pay period.

Generally Accepted Accounting Principles require that a liability should be accrued when it is probable that an obligation has been incurred and the amount of such obligation can be estimated. Furthermore, costs should be charged to the proper cost centers to assure proper billing to the operating utility companies.

The Company was required to revise its accounting procedures with respect to compensated absences so as to recognize a liability for the amount estimated to be paid in the current period and to provide for the proper assignment of compensated absences to the appropriate cost centers.

Improper Accounting for Dividends Declared

The Company recorded the accrual of preferred stock dividends in Account 237, Interest Accrued, before the dividends were declared by the Board of Directors. The accruals remained in Account 237 until the dividends were paid.

The Company was required to refrain from recording a liability for preferred stock dividends prior to the declaration and record the liability for dividends declared in Account 238, Dividends Declared, upon official declaration.

The Company proposed to use Account 242, Miscellaneous Current and Accrued Liabilities. It accrued preferred dividends monthly so as to properly reflect earnings available for common.
Accounting for Unclaimed Checks and Dividends

The Company recorded in Accounts 242, Miscellaneous Current and Accrued Liabilities, unclaimed dividends and checks resulting from a utility customer's discontinuance of electric service and unlocated stockholders.

The Uniform System of Accounts contemplates that Account 253, Other Deferred Credits, should be used to record unclaimed dividends and checks.

The Company was required to: (1) revise its procedures for reclassifying unclaimed dividends and checks and (2) record an entry to reclassify unclaimed dividends and checks improperly classified as of December 31, 1984 to Account 253, Other Deferred Credits.
CHAPTER 12

LONG-TERM DEBT/STOCKHOLDERS' EQUITY

LONG-TERM DEBT

Accounting for Reacquired Bonds

The Company amortized debt discount, expense and premium balances on a straight line basis but did not adjust these balances in the periods when debt was retired prematurely. Adjustments for premature retirements were made every four or five years. Gains applicable to the reacquisition of debt without refunding were recognized as income currently by crediting Account 428, Amortization of Debt Discount and Expense. The Public Service Commission had not disallowed the rate principle of amortization.

The text of General Instruction No. 17B states that "... the difference between the amount paid upon reacquisition and the face value; plus any unamortized premium less any related unamortized debt expense and reacquisition costs; or less any unamortized discount, related debt expense and reacquisition costs applicable to the debt redeemed, retired or cancelled, shall be included in Account 189, Unamortized Loss on Reacquired Debt, or Account 257, Unamortized Gain on Reacquired Debt, as appropriate. The utility shall amortize the recorded amounts equally on a monthly basis over the remaining life of the respective security issues. The amounts so amortized shall be charged to account 428.1, Amortization of Loss on Reacquired Debt, or credited to Account 429.1, Amortization of Gain on Reacquired Debt-Credit, as appropriate."

The Company was required to adjust the balances in debt discount, expense and premium accounts in the period bonds are reacquired and any gain or loss resulting from bond reacquisitions be deferred and amortized as required by General Instruction No. 17, in the future, unless such amortization is specifically disallowed by the Public Service Commission.
LONG-TERM DEBT/STOCKHOLDERS' EQUITY

Long-Term Debt

Discount on Long-Term Debt

The Company recorded in Account 224, Other Long-Term Debt, the liability for funds borrowed through the issuance of commercial paper under the trust agreement and the bank credit agreement. The Company borrowed less than the face value of the commercial paper but was liable for the face value of the commercial paper at maturity. The difference between the face value of the commercial paper and the cash received by the Company was recorded in Account 165, Prepayments, and was amortized over the life of the respective issue to Account 427, Interest on Long-Term Debt.

The text of Account 226, Unamortized Discount on Long-Term Debt-Debit, states, "this account shall include the excess of the face value of long-term debt securities over the cash value of consideration received, therefor, related to the issue or assumption of all types and classes of debt." Amounts recorded in this account should be amortized to Account 428, Amortization of Debt Discount and Expense.

The Company was required to record an entry to reclassify the excess of the face value of long-term debt securities over the cash value of consideration received to Account 226, Unamortized Discount on Long Term Debt, and in the future, amortize such amount to Account 428.

Improper Accounting for Gains/Losses on Bond Reacquisition

The Company failed to recognize the bond expense, discount and/or premium as part of the gain and losses on reacquired debt securities. The Company did not adjust its bond expense, discount and/or premium until the end of the year for reacquired debt and then Account 428, Amortization of Debt Discount and Expense or 429, Amortization of Premium on Debt-Credit, was used.

The bond expense, discount and/or premium should have been used to reduce the gains or losses on reacquired debt as stated by General Instruction No. 17J, Alternate Method, Uniform System of Accounts. The difference between the amount paid upon reacquisition of any long-term debt and the face value, adjusted for unamortized discount, expense or premium applicable to the debt redeemed, shall be recognized currently in income and recorded in Account 421, Miscellaneous Nonoperating Income, or Account 426.5, Other Deductions.

In the future, the Company was required to amortize the bond expense, discount and/or premium on reacquired debt to Account 421, Miscellaneous Nonoperating Income, or Account 426.5, as appropriate.
LONG-TERM DEBT/STOCKHOLDERS' EQUITY

Long-Term Debt

Accounting for the Loss on the Reacquisition of Debt

The Company recorded a portion of the loss it incurred on the reacquisition on debt to Account 186, Miscellaneous Deferred Debits, instead of Account 189, Unamortized Loss on Reacquired Debt. Also, the Company amortized the loss to Account 426.5, Other Deductions, instead of Account 428.1, Amortization of Loss on Reacquired Debt.

The Company redeemed at a premium all of its December 7, 1989, Debentures in September 1986 and the remainder in December 1988. The Company incurred an $8.3 million loss on the redemption. It improperly recorded $5.4 million of the loss in Account 186 instead of Account 189. The Company also improperly amortized approximately $91,000 of the loss from Account 186 to Account 426.5.

The Uniform System of Accounts requires that losses incurred to reacquire long-term debt should be recorded in Account 189, and amortized to Account 428.1.

The Company was required to (1) revise procedures to ensure that losses incurred on the reacquisition of debt are recorded in accordance with the instructions of the Uniform System of Accounts, (2) record a correcting entry to properly record the loss incurred on the reacquisition of long-term debt to Account 189.

Classification of Restricted Funds Held by a Trustee

The Company followed the practice of offsetting restricted bond funds held by a trustee against the liability for the bonds payable that was recorded in Accounts 221, Bonds, and 224, Other Long-Term Debt. The funds held by the trustee were to be used for specific construction projects.

The text of Account 221 states, in part, "This account shall include a separate subdivision for each class and series of bonds the face value of the actually issued and unmatured bonds which have not been retired or cancelled..." The test of Account 128, Other Special Funds, states, in part, "This account shall include the amount of cash...which have segregated in special funds for insurance, employee pensions, savings, relief, hospital, and other purposes not provided for elsewhere."

The Company was required to (1) revise procedures to account for activity related to funds held by trustee in Account 128, and (2) record an entry to reclassify funds held by the trustee from Accounts 221 and 224 to Account 128.
Approval of Short-Term Debt

Jurisdiction Over Short-Term Debt Issuances

Under the terms of the State Public Utility Code, the Public Utility Commission has jurisdiction over the long term debt issuances of the Company, while no mention is made of short term debt. In these circumstances, Section 204 of the Federal Power Act is applicable, placing the regulation of short term debt issuances under FERC jurisdiction.

Section 204 requires the Company to seek Commission authorization for issuances of short term debt when such issuances would cause the total amount of short term debt outstanding to exceed 5% of the par value of the outstanding securities of the Company. The Company has not complied with this requirement during the audit period.

The Company was required to obtain Commission authorization for future issuance of short term debt in accordance with the requirements of the Federal Power Act.

Issuance of Securities Within the Purview of Section 204 of the Federal Power Act

During the years 1977 through 1980, the Company, in several instances, issued short-term notes in excess of 5% of the par value of the other securities of the Company. The Company did not file an application with either FERC or the Public Service Commission for authorization of these issuances. During these identified years, the Company held an exemption from the provisions of The Public Utility Holding Company Act administered by The Securities and Exchange Commission.

Section 204 of the Federal Power Act requires that a public utility must file an application for issuance of short-term notes in excess of 5% of the par value of other securities of the Company unless the State Commission has approved such short-term debt.

The Company was required to file an application with FERC for authorization of all short-term notes in excess of 5% of the par value of other securities in the future, and for all such debt still outstanding relating to prior periods.
Approval of Short-Term Debt

Short-Term Debt Issuances

The State Public Utility Commission has jurisdiction over the long-term debt of the Company - but has not exercised jurisdiction over short-term debt issues. In these circumstances, Section 204 of the Federal Power Act is applicable, placing regulation of short-term debt under FERC jurisdiction.

Section 204 requires the Company to apply for Commission authorization for issuances of short-term debt when such issuances would cause the total amount of short-term debt outstanding to exceed 5% of the par value of the total outstanding securities of the Company. The Company did not comply with this requirement during the audit period.

The Company was required to comply with the requirements of Section 204 of the Federal Power Act for future issuances of short-term debt.

Approval of Issuance of Short-Term Debt in Excess of Section 204(e) Limitation Not Requested

Section 204(e) of the Federal Power Act requires Commission authorization for the issue, or renewal of, or assumption of liability on, a note or draft maturing not more than one year after the date of such issue, renewal or assumption of liability and aggregating more than five per centum of the value of the other securities of the public utility then outstanding.

The staff noted the Company exceeded the limitation set out in Section 204(e) during the audit period and did not file with the Commission for authorization. At December 31, 1984, the Company balance of short-term debt had exceeded the five per cent limitation.

The Company was required to (1) revise its procedures to file with the Commission for authorization when the limitation set out in Section 204(e) is exceeded and (2) make a filing with the Commission to obtain specific authorization for debt currently outstanding.
LONG-TERM DEBT/STOCKHOLDERS' EQUITY

Other

Incorrect Accounting for Capital Stock Expense

The company charged all underwriting commissions related to its 1980 issuance of preferred stock to Account 214, Capital Stock Expense. The Company isolated the underwriting commission costs on the sales and amortized them over a three-year period to Account 425, Miscellaneous Amortization, while expensing all other issuance costs in the year incurred to Account 425.

The text of Account 214 states, "The utility may amortize the balance in this account by systematic charges to Account 425, Miscellaneous Amortization, or it may write off capital stock expense in whole or in part by charges to Account 439, Adjustments to Retained Earnings." Therefore, the accounting for underwriting commissions was in compliance with the text but the accounting for the remaining costs was not.

In the future, the Company was required to account for all capital stock issuance expenses in accordance with the text of the Uniform System of Accounts.

Inadequate Segregation of Account 207, Premium on Capital Stock

The Company's books and records regarding Account 207, Premium on Capital Stock, had not been subdivided for each class and series of stock contained therein. The text of Account 207, Uniform System of Accounts, states that this account shall contain a separate subdivision for each class and series of stock.

The Company was required to establish a separate subdivision for each future class and series of stock contained in Account 207.
Accounting for Fees Related to Letters of Credit

The Company's accounting for fees related to Letters of Credit was not in accordance with the requirement of the Uniform System of Accounts.

The Division of Audits concluded that fees related to Letters of Credit support the underlying debt and have the same function and characteristics as interest. Interest is not limited to the nominal rate specified on the debt instrument but should reflect all other costs related to the debt.

The Commission addressed a similar issue in a previous proceeding involving the Company (Docket No. FA86-19-002). In an order issued on September 20, 1989, the Commission rejected the Company's arguments that fees related to Letters of Credit were properly recorded in Account 921. The Commission decided that the fees related to Letters of Credit were a cost of debt and therefore properly classified in Account 427, Interest on Long-Term Debt.

It was recommended that the Company revise procedures to ensure that it charges fees for Letters of Credit and other financing cost to Account 427.

Accounting for Letter of Credit Fees

The Company's accounting for fees related to "Letters of Credit" was not in accordance with the requirements of the Uniform System of Accounts.

The Company incurred letter of credit fees in the operation of its "money pool". The Company recorded the fees in Account 930.2, Miscellaneous General Expenses.

Under the requirements of the Uniform System of Accounts, interest expense related to associated company debt is properly chargeable to Account 430, Interest on Debt to Associated Companies.

The fees related to the Company's money pool should be treated as interest because the letters of credit are necessary to support the money pool. Therefore, the fees are considered as a cost of borrowing from an associated company and are not in the nature of a miscellaneous general expense but interest on debt.

It was recommended that the Company:

(1) revise procedures to ensure it charges fees for Letters of Credit and other financing costs related to money pool borrowings to Account 430; and

(2) record memorandum entries to reclassify the letter of credit fees incurred to the proper interest expense account.
Accounting for Financing Placement Fees

The Company improperly accounted for fees paid to place short-term debt.

In 1986, the Company paid Morgan Stanley a one (1) percent fee for the private placement of $158 million of 270-day notes. The Company characterized this fee as a processing fee and charged the amount to Account 930.2, Miscellaneous General Expenses.

We concluded that the fee paid to Morgan Stanley for placing the short-term debt qualified under the Uniform System of Accounts as a "debt expense". The Uniform System of Accounts requires that debt expense be charged to interest expense.

The instruction to Account 431, Other Interest Expense, states:

This account shall include all interest charges not provided for elsewhere.

Items
1. Interest on notes payable on demand or maturing one year or less from date and on open accounts, ...

The Company should have charged the private placement fee to Account 431, Other Interest Expense, along with the actual interest accruals related to the debt issue.

It was recommended that the Company:

(1) revise procedures to ensure that it records all debt expense in accordance with the requirements of the Uniform System of Accounts; and

(2) recalculate, and refund with interest, amounts overbilled to customers as a result of the improper accounting procedure.
LONG-TERM DEBT/STOCKHOLDERS' EQUITY

Other

Accounting and Tariff Billings for Bank Fees

During the period July 1985 through February 1986 the Company improperly classified about $7.5 million of bank fees in Account 921, Office Supplies and Expenses, an administrative and general operating expense account. Amounts properly includible in Account 921 are permitted in cost of service tariff billings. However, DOA considered the costs to be a cost of issuing debt and therefore, treated as an increment to the cost of debt interest. Under the tariff, only debt costs is includible in tariff billings.

The construction of the project placed a heavy financial burden on the Company. The Company was required to use Letters of Credit from banks as a condition for issuance of Series A, B and C tax-exempt pollution control bonds. The Letters of Credit required payment of bank fees every three months. In addition, fees were paid to banks for release from escrow of proceeds from the Series C bonds. Fees were also paid to banks for restructuring certain debt consisting of foreign and domestic loans.

The instructions to Account 427 specifically provide for including interest on outstanding long-term debt issues but do not provide any item list or other descriptions of what constitutes interest. However, it is well known that interest cost is not limited to the nominal rate specified on debt instruments. The Line of Credit fees are just as much a cost for long-term borrowing as the nominal rates of interest payable to debt holders.

The instructions to Account 181 specifically provide for including therein expenses related to the issuance or assumption of debt securities. The release and restructuring fees were related to SERI's debt.

General Instruction No. 6, Item Lists, of the Uniform System of Accounts makes it clear that the lists are intended to be representative and not complete, and that classification of a listed item to an account is warranted only when consistent with the instructions to that account.

Recommendations: The Company (1) adopt procedures effective January 1, 1987, to classify fees for maintaining Letters of Credit to Account 427, Interest on Long-Term Debt, (2) establish in Account 181, Unamortized Debt Discount and Expense, an amount representing the unamortized portion of escrow release and restructuring fees through January 1, 1987, and thereafter amortize the fees monthly over the remaining life of the related debt issues by charges to Account 428, Amortization of Debt Discount and Expense; and (3) recalculate and refund prior tariff billings based on a restatement of accounts as they would have been if the recommended procedures had been followed from inception of the fees.
CHAPTER 13

FINANCINGS - REACQUIRED STOCK

Accounting for Premiums and Issuance Expenses Related to Redeeming Preferred Stock

The Company improperly accounted for the premiums incurred in redeeming preferred stock and any related unamortized preferred stock issuance expense.

In May 1986, the Company redeemed all outstanding shares of its 10.10 percent preferred stock at a price of $106.74 per share. It recorded the premium on the redemption to Account 186, Miscellaneous Deferred Debits. Also, the Company transferred the remaining amount of original stock issuance expenses to Account 186. It was amortizing the $3,056,729 recorded in Account 186 to Account 425, Miscellaneous Amortization, over 10 years.

The instruction to Account 217, Reacquired Capital Stock, of the Uniform System of Accounts state in part:

When reacquired capital stock is retired or canceled, the difference between its cost, including commissions and expenses paid in connection with the reacquisition, and its par or stated value plus any premium and less any discount and expenses applicable to the shares retired, shall be debited or credited as appropriate, to Account 210, Gain on Resale or Cancellation of Reacquired Capital Stock, provided, however, that debits shall be charged to Account 439, Adjustment to Retained Earnings, to the extent that they exceed the balance in Account 210.

Furthermore, the instructions to Account 439, Adjustments to Retained Earnings, state in part:

B. Adjustments, charges, or credits due to losses on reacquisition, resale or retirement of the Company's own capital stock shall be included in this account.

The Company's accounting for preferred stock redemptions in Account 186 was contrary to the requirements of the Uniform System of Accounts. Because there was no balance in Account 210, Gain on Resale or Cancellation of Required Capital Stock, the Company should have charged the premium and expenses associated with the redeemed stock to Account 439. The Company should not have recorded the effect of the redemptions in Account 186. Also, the Company should have charged the issuance expenses related to the refunded preferred stock to Account 439 and not to Account 186.
Accounting for Premiums and Issuance Expenses Related to Redeeming Preferred Stock (Continued)

The Company was required to (1) revise procedures to account for redemptions of capital stock in accordance with the requirements of the Uniform System of Accounts, (2) record a correcting entry to correct the accounting for the redemption of preferred stock by charging Account 439 and crediting Account 186.

Accounting for Premiums and Issuance Expenses Related to Redeeming Preferred Stock

The Company initially recorded the premiums in Account 439, Adjustments to Retained Earnings. Subsequently, the company sought and received approval from the state Commission to recover the expenses of redeeming the preferred stock from the retail ratepayers. It then credited Account 439 and debited Account 186, Miscellaneous Deferred Debits, to remove the effects of the preferred stock redemptions from the common equity accounts related to the jurisdiction of the state regulatory commissions.

The Company began amortizing the jurisdictional portion of the expenses of redeeming the preferred stock from Account 186 to Account 425, Miscellaneous Amortization.

The Company’s accounting for the expenses of redeeming preferred stock was contrary to the following requirements of the Uniform System of Accounts.

The Company should have not recorded the additional entries to reverse the preferred stock premium amounts from Account 439 and included the amounts in Account 186 and amortized them to Account 425.

The Commission specifically rejected a proposal to change the accounting for preferred stock redemptions in Order No. 390, issued August 3, 1984.

Under the requirements of the Uniform System of accounts, it is improper for a company to record income or expense for a capital stock transaction. A company must reflect the effects of capital stock transactions in the capital stock accounts. Therefore, the Company’s procedure of deferring the preferred stock redemption premiums and expenses as an asset in Account 186, with a subsequent amortization to income, was contrary to the requirements of the Uniform System of Accounts.

The rules in the Uniform System of Accounts are based on the generally accepted accounting principle that gains and losses resulting from transaction between classes of equity holders should not be considered as income or a cost entering into the determination of net income or earnings of a corporate entity from its own business activities. Since there is no cost to be recognized by the Company, there is no cost eligible to be deferred in the accounts for future recovery in rates.
Accounting for Premiums and Issuance Expenses Related to Redeeming Preferred Stock (Continued)

In an unregulated business, reacquisitions of higher cost preferred stock would be expected to result in higher future earnings available to common shareholders because of lower preferred stock dividend requirements. The Company's accounting is inconsistent with sound accounting and reporting practices of all industries. It avoids timely recognition of a reduction in common shareholders' equity and records in advance anticipated future earnings on common equity. Failure to recognize the premiums and expenses on reacquisition of stock as current reduction of stockholders' equity and the capitalization of future earnings are both unsound accounting practices.

Moreover, the Company's accounting is not necessary for ratemaking purposes. The Company can use memorandum records to account for the stock redemption premiums and expenses that it may expect to include in requested rate levels before the state regulatory commissions.

It was recommended that the Company:

(1) revise procedures to account for redemptions of capital stock in accordance with the requirements of the Uniform System of Accounts; and

(2) record an entry to reclassify the preferred stock redemption costs to Account 439.

Accounting for Premiums and Issuance Expenses Related to Redeeming Preferred Stock

The Company redeemed preferred stock. The Company recorded the premium on the redemptions in Account 186, Miscellaneous Deferred Debits. Also, the Company transferred the remainder of the original stock issuance expenses to Account 186. It is amortizing the remains recorded in Account 186, to Account 425, Miscellaneous Amortization.

In a letter to the FERC's Chief Accountant, the Company requested an exception to the accounting requirements for reacquired capital stock. The Company sought to record the loss on the reacquisition of preferred stock in Account 186 and to amortize the loss over a 33-year period to Account 425. By letter issued on September 18, 1987, the Chief Accountant denied the Company's request. The Chief Accountant informed the Company that he did not object to the use of a memorandum account to track the rate treatment of the amortization.

The Company should not have recorded the additional entries transferring the preferred stock premium amounts from Account 439 to Account 186 and began amortizing them to income by charges to Account 425.
Accounting for Premiums and Issuance Expenses Related to Redeeming Preferred Stock (Continued)

The Commission specifically rejected a proposal to change the accounting for preferred stock redemptions in Order No. 390, issued August 3, 1984.

Under the requirements of the Uniform System of Accounts, it is improper for a company to record income or expense on its own capital stock transactions. A company must reflect the effects of capital stock transactions in the capital stock accounts. Therefore, the Company's procedure of deferring the preferred stock redemption premiums and expenses as an asset in Account 186, with a subsequent amortization to income, was contrary to the requirements of the Uniform System of Accounts.

It was recommended that the Company:

1. revise procedures to account for redemptions of capital stock in accordance with the requirements of the Uniform System of Accounts; and

2. record a correcting entry to reclassify the preferred stock redemption costs to Account 439.

Accounting for Premiums and Issuance Expenses Related to Redeeming Preferred Stock

The Company redeemed three issues of preferred stock. In accounting for each redemption, the Company deferred the call premiums and reacquisition expenses by debiting Account 189, Unamortized Loss on Reacquired Debt. Also, the Company reclassified the unamortized issuance expenses related to the original sale that were recorded in Account 214, Capital Stock Expense, to Account 189.

The Company amortized the Capital Stock Expense to Account 428.1, Amortization of Loss on Reacquired Debt. The Company began to amortize the premiums paid to redeem the 11.25 percent and the 11.75 percent series and the related capital stock expense, over a 30 year (or 360 month) period, the life of its Series I Bonds. On May 1, 1987, the Company changed the amortization period for the 11.25 percent and 11.75 percent series to 15 years (or 180 months) to reflect the rate treatment approved by the Public Utility Commission in Docket No. 87-81.

Beginning January 1, 1989, the Company began to amortize the call premiums and the related expenses of the 12.75 percent series over a nine year (or 108 month) period which related to rate recovery approved in MPUC Docket NC. 87-136.

The Company's accounting for premiums paid on the preferred stock redemptions, capital stock issuance expenses and reacquisition expenses in Account 189 was contrary to the requirements of the Uniform System of Accounts.
Accounting for Premiums and Issuance Expenses Related to Redeeming Preferred Stock (Continued)

The Company should have recorded the redemption premiums, reacquisition expenses and the balance in Account 214 related to the redeemed stock to Account 439. In addition, the Company should not have amortized capital stock expenses to Account 428.1, since there is no provision in the Uniform System of Accounts to do so.

The Commission specifically rejected a proposal to change the accounting for preferred stock in Order No. 390, issued August 3, 1984. In Order No. 390, the Commission stated:

One commentator recommends that the Commission prescribe that gains or losses resulting from the reacquisition of cumulative preferred stock be amortized to income. Although cumulative preferred stock has some of the characteristics of debt, essentially it is still capital stock. Therefore, cumulative preferred stock should be treated as capital stock and any gains or losses from its reacquisition and resale or cancellation may not be flowed through the income statement.

Under the requirements of the Uniform System of Accounts, it is improper for a company to recognize a "gain" or a "loss" in income on a capital stock transaction. The effects of capital stock transactions can only be reflected in the capital stock accounts. Because net income should not reflect the effects of capital stock transactions, the Company's procedure of deferring the premiums on reacquired preferred stock and the unamortized issuance expenses in Account 189, with subsequent amortization to income, was contrary to the Commission's requirements.

The rules in the Uniform System of Accounts are based on the generally accepted accounting principle that gains and losses resulting from transaction between classes of equity holders should not be considered as income or a cost entering into the determination of net income or earnings of a corporate entity from its own business activities. Since there is no cost to be recognized by the Company, there is no cost eligible to be deferred in the accounts for future recovery in rates.

In an unregulated business, reacquisitions of higher cost preferred stock would be expected to result in higher future earnings available to common shareholders because of lower preferred stock dividend requirements. The Company's accounting is inconsistent with sound accounting and reporting practices of all industries. It avoids timely recognition of a reduction in common shareholders' equity and records in advance anticipated future earnings on common equity. Failure to recognize the premiums and expenses on reacquisition of stock as a current reduction of stockholders' equity and the capitalization of future earnings are both unsound accounting practices.
Accounting for Premiums and Issuance Expenses Related to Redeeming Preferred Stock (Continued)

Moreover, the Company's accounting is not necessary for ratemaking purposes. The Company can use memorandum records to account for the stock redemption premiums and expenses that it has included in requested rate levels before the Public Service Commission.

In summary, when the stock was redeemed, the Company should have recorded the premiums paid and related reacquisition expenses in Account 439. Also, it should not have amortized the balance recorded in Account 214 to income but reclassified the full unamortized amount related to the original sale of the stock to Account 439 when the stock was redeemed.

It was recommended that the Company:

(1) revise its procedures to account for redemptions of capital stock in accordance with the requirements of the Uniform System of Accounts; and

(2) record issuance expenses in Account 214 and reclassify the full unamortized amount to Account 439 when stock is redeemed; and

(3) record an entry to charge off the loss on reacquired preferred stock improperly recorded in Account 189 to Account 210 and Account 439.

Accounting for Issuance Expense on Reacquired Preferred Stock

The Company accounted for the original issuance expense related to the reacquired and retired preferred by debiting Account 217, Reacquired Capital Stock, and crediting Account 214, Capital Stock Expense. The Company then transferred the amounts from Account 217 to Account 210, Gain on Resale or Cancellation of Reacquired Capital Stock. At December 31, 1989, the Company had included in Account 210 preferred stock issuance expenses related to reacquired and retired preferred stock.

The Company should have written-off the capital stock issuance expense applicable to shares of preferred stock retired to Account 210 directly from Account 214 and charged the debit balances in Account 210 and Account 439.

It was recommended that the Company:

(1) revise its procedures to comply with the requirements of the Uniform System of Accounts related to capital stock issuance expenses; and

(2) record an entry to write-off the debit balances in Account 210 associated with preferred stock retired to Account 211, Miscellaneous Paid-In Capital.
Accounting for Premiums and Issuance Expenses Related to Redeeming Preferred Stock

The Company recorded the unamortized related stock expense and the resulting loss of reacquisition of the preferred stock in Account 210, resulting in a debit balance in Account 210. It had subsequent redemptions, resulting in minor gains and losses charged or credited to Account 210.

In decisions issued in 1986 and 1988, the state Commission permitted the Company to amortize gains and losses from redeeming preferred stock over a 10-year period in determining the cost of capital for rate purposes.

The Company's accounting for the expenses of redeeming preferred stock was contrary to the following requirements of the Uniform System of Accounts.

The instructions to Account 217, Reacquired Capital Stock, state in part:

B. When reacquired capital stock is retired or cancelled, the difference between its cost, including commissions and expenses paid in connection with the reacquisition, and its par or stated value plus any premium and less any discount and expenses applicable to the shares retired, shall be debited or credited as appropriate, to Account 210, Gain on Resale or Cancellation of Reacquired Capital Stock, provided, however, that debits shall be charged to Account 439, Adjustments to Retained Earnings, to the extent that they exceed the balance in Account 210.

Furthermore, the instructions to Account 439, Adjustments to Retained Earnings, state in part:

B. Adjustments, charges, or credits due to losses on reacquisition, resale or retirement of the Company's own capital stock shall be included in this account.

Under the Commission's accounting requirements, the Company should have recorded the premium to redeem its preferred stock in Account 439 when a debit balance resulted in Account 210.

It is recommended that the Company:

(1) revise procedures to account for redemptions of Capital Stock in accordance with the requirement of the Uniform System of Accounts; and

(2) record an entry to reclassify the debit balance in Account 210 to Account 439.
Accounting for Preferred Stock Redemptions

Between 1986 and 1988 the Company reacquired and cancelled, at a premium, all of its outstanding shares of its 13.25 percent, 13.60 percent, and 15.48 percent preferred stock.

In August and September 1986, the Company paid a total premium of $1,809,180 to redeem 138,000 shares of 15.48 percent series preferred stock. In August through November 1986, the Company paid a total premium of $432,544 to redeem 37,876 shares of preferred stock. In February 1988, the Company paid a premium of $1,555,500 to redeem 150,000 shares of 13.25 percent series preferred stock.

The Company accounted for the redemptions of preferred stock as follows:

1. upon reacquisition and cancellation, the Company properly charged Account 204, Preferred Stock Issued, for the par or stated value of the stock;

2. recorded the redemption premiums first in Account 181, Unamortized Debt Expense; however, it then transferred the redemption premiums from Account 181 to Account 186, Miscellaneous Deferred Debits;

3. recorded the redemption premiums directly to Account 186, Miscellaneous Deferred Debits;

4. reclassified the original issuance costs recorded in Account 214, Capital Stock Expense, to Account 186.

5. reclassified the original issuance premiums recorded in Account 207, Premium on Capital Stock, to Account 186.

6. amortized the amounts recorded in Account 186 to Account 425, Miscellaneous Amortization, over either 15-year or 17-year periods.

The Company's accounting for preferred stock redemptions in Account 186 was contrary to the requirements of the Uniform System of Accounts.

The Company should have accounted for preferred stock redemptions as follows:

1. It should have credited Account 217, Reacquired Capital Stock, for the par or stated value of the redeemed stock and debited Account 217 with the amount paid to reacquire the stock.

2. It should have transferred the original issuance costs recorded in Account 214 and the original issuance premiums recorded in 207 related to the reacquired stock to Account 210, Gain on Resale or Cancellation of Reacquired Capital Stock.
Accounting for Preferred Stock Redemptions (Cont.)

(3) It should have debited or credited Account 210, as appropriate, for the difference between the amount paid to reacquire the stock and its par or stated value, plus any premiums, and less any expenses applicable to the shares retired, or

(4) If the amounts exceeded the balance recorded in Account 210, it should have charged the remaining amounts to Account 439, Adjustments to Retained Earnings.

It was recommended that the Company:

(1) revise its procedures to account for redemptions of capital stock in accordance with the requirements of the Uniform System of Accounts; and

(2) record a correcting entry to properly classify the capital stock redemption premiums to Account 439, Adjustments to Retained Earnings.

Accounting for the Original Issuance Costs Related to the 9.00 Percent Series Preferred Stock

The Company recorded $201,900 in underwriting fees for the issuance of 9.00 series preferred stock in Account 214. In September 198, the Company reclassified the underwriting fees from Account 214 to Account 186. The Company began amortizing the costs from Account 186 to Account 425 over a 15-year period.

The instructions to Account 214 state in part:

A. This account shall include in a separate subdivision for each class and series of stock all commissions and expenses incurred in connection with the original issuance and sale of capital stock...

The Company should not have reclassified the underwriting fees from Account 214 to Account 186, and should not have amortized any portion of the cost from Account 186 to Account 425.

It was recommended that the Company:

(1) revise its procedures to ensure that the original issuance cost of capital stock is recorded in Account 214; and

(2) record a correcting entry to reclassify the issuance costs from Account 186 to Account 214, and to reverse the amount amortized to Account 425.
Accounting for Expenses Related to Refinancing

The Company incorrectly classified certain expenses related to the refinancing of its First Mortgage Bond Series 1 and 2.

The Company incurred an additional payment for failing to give bondholders 30 days notice that it was reacquiring First Mortgage Bond Series 1 and 2 as part of a refinancing.

The Company recorded the additional payment in Account 930.2, Miscellaneous General Expenses.

The payment resulted from the refinancing of the Company debt. Under these circumstances, the Company should have classified the payment as a component of unamortized debt costs applicable to the refinancing. It should have amortized the costs to expense over the life of the replacement debt.

The Uniform System of Accounts provides Account 181, Unamortized Debt Expense, for the expenses related to the issuance or assumption of debt, with amortization of the expenses to Account 428, Amortization of Debt Discount and Expense.

It was recommended that the Company:

1. revise it procedures to charge similar payments in the future to the appropriate account;

2. record a correcting entry to properly account for this financing cost; and

3. recalculate billings using the correct accounting for the additional payment, and refund with interest, any overbilled amounts.

Accounting for Premiums and Administrative Fees Related to Redeeming Preferred Stock

The Company accounted for the redemption of preferred stock as follows. It debited Account 204, Preferred Stock, for the redemption price of the stock, which included the premiums. The Company made another entry removing the premiums from Account 204 and transferring them to Account 186, Miscellaneous Deferred Debits.

During 1986 and 1987, the Company accumulated administrative charges related to the redemption in Account 186.

In a letter dated November 7, 1986, the Company asked the Public Service Commission for approval of its proposed accounting treatment of the premium paid to reacquire preferred stock. On February 3, 1987, the PSC provided the following response to the Company:
Accounting for Premiums and Administrative Fees Related to Redeeming Preferred Stock (Continued)

The appropriate forum for consideration of this request is a rate case. Therefore, at this time the Commission will not authorize the Company to undertake any specific accounting treatment of the premium. The Company should decide itself which method to use, based on generally accepted accounting principles and in consideration of the methodologies approved by this Commission. If the Company wishes to include these costs in a rate cost, it should file such case at its earliest convenience.

The Company made a retail rate filing covering its gas operations during 1988 in which it requested recovery of the preferred stock premiums. On August 11, 1988, the Company received the approval of PSC to include the state jurisdictional portion of the premiums deferred in Account 186 as a component of rate base for retail gas service, along with an annual amortization in the cost-of-service.

The Company made a retail rate filing covering its electric operations during 1989 in which it requested recovery of the preferred stock premiums. The Company received the approval of PCS to include as a component of rate base a portion of the amount it deferred in Account 186 as a regulatory asset, along with an annual amortization in the cost-of-service for retail electric customers. However, in the same rate order the PSC disallowed recovery of the Company's investment in certain plant facilities. After the PSC's action, the Company charged a portion of the deferred amount in Account 186 to retained earnings, representing the amount associated with the facilities no longer subject to PSC rate jurisdiction.

The Company did not seek specific FERC rate approval to recover any of the premiums and expenses deferred in Account 186 in sales under wholesale rate tariffs.

The Company's procedure of including premiums and administrative fees paid to reacquire the preferred stock in Account 186 was contrary to the requirements of the Uniform System of Accounts.

The instructions to Account 217, Reacquired Capital Stock, of the Uniform System of Accounts, state in part:

B. When reacquired capital stock is retire or cancelled, the difference between its cost, including commissions and expenses paid in connection with the reacquisition, and its par or stated value plus any premium and less any discount and expenses applicable to the shares retired, shall be debited or credited as appropriate, to Account 210, Gain on Resale or Cancellation of Reacquired Capital Stock, provided, however that debits shall be charged to Account 439, Adjustments to Retained Earnings, to the extent that they exceed the balance in Account 210.
Accounting for Premiums and Administrative Fees Related to Redeeming Preferred Stock (Continued)

Because there was no balance in Account 210, Gain on Resale or Cancellation of Reacquired Capital Stock, the Company should have charged the premium and expenses associated with the redeemed stock first to Account 210, and then to Account 439.

Under the requirements of the Uniform System of Accounts, it is improper for a company to recognize a "gain" or a "loss" in income on a capital stock transaction. The effects of capital stock transactions can only be reflected in the capital stock accounts. Because net income should not reflect the effects of capital stock transactions, the Company's procedure of deferring the premiums on reacquired preferred stock in Account 186, with subsequent amortization to income, was contrary to the Commission's requirements.

The requirements contained in the Uniform System of Accounts are based on the generally accepted accounting principle that gains and losses resulting from transaction between classes of equity holders should not be considered as income or a cost entering into the determination of net income or earnings of a corporate entity from its won business activities. Since there is no cost to be recognized by the Company, there is no cost eligible to be deferred in the accounts for future recovery in rates.

In an unregulated business, reacquisitions of higher cost preferred stock would be expected to result in higher future earnings available to common shareholders because of lower preferred stock dividend requirements. The Company's accounting is inconsistent with sound accounting and reporting practices of all industries. It avoids timely recognition of a reduction in common shareholders' equity and records in advance anticipated future earnings on common equity. Failure to recognize the premiums and expenses on reacquisition of stock as a current reduction of stockholders' equity and the capitalization of future earnings are both unsound accounting practices.

Moreover, the Company's accounting was not necessary for ratemaking purposes. The Company can use memorandum records to account for the stock redemption premiums and expenses that it has included in requested rate levels before the Public Service Commission.

In summary, when the stock was redeemed, the Company should have recorded the premiums paid and related reacquisition expenses in Account 439. Also, it should have amortized the balance recorded in Account 214 to income but reclassified the full unamortized amount related to the original sale of the stock to Account 439 when the stock was redeemed.

It was recommended that the Company:

(1) revise its procedures to account for redemptions of capital stock in accordance with the requirements of the Uniform System of Accounts; and

(2) record an entry to reclassify the premiums and the administrative redemption fees paid upon reacquisition of preferred stock to Account 211, Miscellaneous Paid-In Capital.

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Accounting for Premiums and Issuance Expenses Related to Redeeming Preferred Stock

Between the years 1985 and 1988 the Company redeemed three issues of preferred stock.

- On October 31, 1985, the Company redeemed 400,000 outstanding shares of preferred stock that had a par value of $100 per share and a coupon rate of 9.72 percent. It paid $106.48 per share to redeem the stock.

- In April 1987, the Company sold 400,000 shares of 6.95 percent preferred stock at the par value of $100 per share. The net proceeds of the offering were used, together with internal funds, to redeem all 200,000 shares of 8.84 percent preferred stock on April 1, 1987, at the redemption price of $103.72 per share and all 300,000 shares of 8.16 percent preferred stock on May 1, 1987, at the redemption price of $104.21.

- During 1988, the Company redeemed all of the 395,000 shares of its 9.6 percent preferred stock. It redeemed 160,000 shares at the sinking fund redemption price of $100 and the remaining 235,000 shares at prices ranging from $103.60 to $105.

In accounting for each redemption the Company deferred the premiums paid on the redemptions by debiting Account 186, Miscellaneous Deferred Debits. Also, the Company transferred the unamortized amounts related to the original preferred stock issues that were recorded in Account 214, Capital Stock Expense, to Account 186.

In November 1985, the Company began amortizing both the premium and the remaining issuance expenses related to the redeemed 9.72 percent preferred stock recorded in Account 186 to Account 425, Miscellaneous Amortization, over a period of 33-years. In May 1987, it began amortizing the premium and remaining issuance expenses related to redeeming the 8.84 percent and 8.16 percent issues over a 38-year period. The amortization periods were based on the sinking fund redemption periods for the related issue of the preferred stock.

The instructions to Account 217, Reacquired Capital Stock, of the Uniform System of Accounts state in part:

B. When reacquired capital stock is retired or canceled, the difference between its cost, including commissions and expenses paid in connection with the reacquisition, and its par or stated value plus any premium and less any discount and expenses applicable to the shares retired, shall be debited or credited as appropriate, to Account 210, Gain on Resale or Cancellation of Reacquired Capital Stock, provided, however, that debits shall be charged to Account 439, Adjustment to Retained Earnings, to the extent that they exceed the balance in Account 210.
Accounting for Premiums and Issuance Expenses Related to Redeeming Preferred Stock  (Continued)

Furthermore, the instructions to Account 439, Adjustments to Retained Earnings, state in part:

B. Adjustments, charges, or credits due to losses on reacquisition, resale or retirement of the Company's own capital stock shall be included in this account.

The Company's accounting for preferred stock redemptions in Account 186 was contrary to the requirements of the Uniform System of Accounts. Because there was no balance in Account 210, Gain on Resale or Cancellation of Reacquired Capital Stock, the Company should have charged the premium and expenses associated with the redeemed stock to Account 439. The Company should not have recorded the additional entry reversing the effect of the redemptions from Account 439 to Account 186. Also, the Company should have charged the issuance expenses related to the refunded preferred stock to Account 439 and not to Account 186.

Under the requirements of the Uniform System of Accounts, it is improper for a company to recognize a "gain" or a "loss" in income on a capital stock transaction. The effects of capital stock transactions can only be reflected in the capital stock accounts. Because net income should not reflect the effects of capital stock transactions, the Company's procedures of deferring the premiums on reacquired preferred stock and the unamortized issuance expenses in Account 186, with a subsequent amortization to income, was contrary to the Commission's requirements.

In summary, the Company should have recorded the premiums and related issuance expenses in Account 439. Also, it should have charged the unamortized original issuance expenses related to the refunded issue of preferred stock to Account 439, and not to Account 186.

The Company may use a memorandum account to track amounts for any rate allowances that it may receive for the premiums and unamortized issuance expenses of redeemed preferred stock.

The Company was required to revise procedures to account for redemptions of capital stock in accordance with the requirements of the Uniform Systems of Accounts.
CHAPTER 14

LITIGATION/PENALTIES

Improper Accounting for Penalties

During the audit period the following penalties were assessed against the Company:

<table>
<thead>
<tr>
<th>Type of Penalty</th>
<th>Account Charged</th>
</tr>
</thead>
<tbody>
<tr>
<td>Underpayment of 1977 estimated taxes</td>
<td>Account 431, Other Interest Expense</td>
</tr>
<tr>
<td>Highway Use Tax Audit</td>
<td>Account 431, Other Interest Expense</td>
</tr>
<tr>
<td>OSHA (Safety)</td>
<td>Account 107, Construction Work in Progress</td>
</tr>
</tbody>
</table>

All amounts were minor. Per the text of Account 426.3, Penalties: "This account shall include payments by the Company for penalties or fines for violations of any regulatory status by the Company or its officials."

The Company was required to record all penalties assessed it in Account 426.3

Accounting for Fines and OSHA Citations

The Company paid citations of $1,840 to the U.S. Occupational Safety and Health Administration for violations of the OSHA Act of 1970. Of this amount $1,120 was recorded improperly in Account 923, Outside Services Employed.

In addition, the Company paid water pollution fines to the state totaling $15,630. Account 107, Construction Work in Progress – Gas, was identified as being charged with $2,940 of these fines.

The text of Account 426.3, Penalties, states, "This account shall include payments by the company for penalties or fines for violation of any regulatory statutes by the company or its officials."

In the future, the Company was required to record in Account 426.3, Penalties, all payments made for fines, penalties, citations, etc. The staff also recommended that the Company record the appropriate correcting entry to the plant accounts.
LITIGATION/PENALTIES

Accounting for Expenses Related to Unsuccessful Litigation

The Company incurred salaries and expenses and legal fees in connection with unsuccessful litigation and accounted for these expenditures in utility operation accounts. Penalties incurred in 1980 for environmental violations were properly accounted for in Account 426.3, Penalties; however, expenditures for negotiations related to the settlement were accounted for in utility operational accounts.

Accounting Release AR-12 affirms that charges to utility operations should be just and reasonable. AR-12 does this by specifying that all readily identifiable and quantifiable expenditures made by a utility resulting from employment practices that were found to be discriminatory by decree or settlement are not just and reasonable. Staff believes that expenditures to defend against alleged violations of environmental protection rules, health and safety laws, anti-trust laws and expenditures in certain other instances, when they result in unsuccessful litigation are not just and reasonable when considered in parallel with the interpretation of just and reasonable in AR-12.

The Company in the future was required to allocate salaries and expenses and legal fees when they are incurred in connection with certain unsuccessful litigation to Account 426.5, Other Deductions.

Accounting for Anti-Trust Settlement

An anti-trust settlement agreement was reached between the City and the Company. As a result, the Company paid $500,000 and promised free future engineering services to the City. The $500,000 payment was charged to Account 930.2, Miscellaneous General Expenses.

The Uniform System of Accounts provides for nonoperating expense items of this nature to be charged to Account 426.5, Other Deductions. The payment was excluded from cost of service in a recent rate case before the Public Utilities Commission.

In the future, items of this nature should be charged to Account 426.5. The cost of engineering services to be provided to the city as a result of the settlement should also be charged to Account 426.5.
Improper Accounting for Expenditures Resulting from Discriminatory Employment Practices

The Company was named as defendant in two actions for alleged violations of Federal statutes, on the basis of alleged patterns and practices of discrimination by the Company.

The Company accrued a total of $5,350,000 in anticipation of approval of various consent orders before the Court. In addition, it had incurred a total of $1,143,071 of legal costs, and had paid a $30,000 out of court settlement in 1978. All of these costs had been charged to utility operating expenses.

The Company's accounting was not in accordance with the Federal Energy Regulatory Commission Accounting Release No. 12, which states that expenditures resulting from employment practices that were found to be discriminatory by a judicial or administrative decree or that were the result of a compromise settlement or consent decree should not be considered as just and reasonable charges to utility operations and should be classified to the appropriate nonoperating expense account.

The Company changed its procedure so that all costs related to discriminatory employment practices incurred in the future be properly classified to the appropriate nonoperating expense accounts, and that Form 1 pages be refiled showing the properly classified cost previously charged to operations.

Classification of Employee Payroll Expenses

Under applicable election laws and regulations, the Company paid for the establishment, administration and solicitation of employee membership in State and Federal Political Action Committees (PAC). The Company was reimbursed a portion of these expenses by the PAC and charged the unreimbursed expenses to Account 426.4, Expenditures of Certain Civic, Political and Related Activities.

The amounts charged to Account 426.4 did not include payroll or payroll related expenses, although the employees were engaged in PAC activities during working hours.

The Company was required to adopt procedures to ensure that payroll and related charges of employee conducting PAC related activities are recorded in Account 426.4.
CHAPTER 15

NONOPERATING REVENUES AND EXPENSES

TIMBER SALES

Accounting for Timber Sales

The Company improperly deferred revenues and expenses related to timber sales in Account 107, Construction Work in Progress-Electric. The net amounts of timber revenues and expenses were not cleared to the appropriate income accounts on a timely basis.

The Company's timber operations do not constitute electric plant in process of construction and therefore, the inclusion of the costs related thereto in Account 107 was improper. Rather, the timber activities represent work-in-process of a miscellaneous nature not specifically provided in the Uniform System of Accounts.

The requirements of Electric Plant Instruction No. 7 of the Uniform System of Accounts, requires revenues from the sale of timber be recorded in Account 456, Other Electric Reserves or Account 421, based on the property classification.

Furthermore, the instructions to Account 253, Other Deferred Credits, state,

This account shall include advance billings and receipts and other deferred credit items, not provided for elsewhere, including amounts which cannot be entirely cleared or disposed of until additional information has been received.

The Company should have recorded the net revenues from the sale of timber in Account 456, Other Electric Revenues, or Account 421, based upon the accounting classification of the related property, in the year that such sales took place. The Company may classify the proceeds from the timbering operations in Account 253 pending determination of the proper accounting classification of the related revenues and expenses, provided such determination is made on a timely basis and the Company's net income for the period properly reflects such proceeds.

The Company was required to (1) revise procedures to record revenues and expenses related to the sale of timber in the proper accounting period and accounts consistent with the requirements of the Uniform System of Accounts, and (2) record an entry to properly reflect the revenues and expenses from the sale of timber.
Timber Sales

Accounting for Revenues and Expenses Related to Timber Sales

The Company recorded the revenues from incidental sales of timber logged from nonutility land in Account 421, Miscellaneous Non-Operating Income. The related expenses were recorded in Account 421.1, Gain on Disposition of Property, and the two accounts were netted for FERC Form 2 reporting purposes.

Uniform System of Account instructions for Account 421 provide that all revenue and expense items (except income taxes) properly includible in the income account and not provided for elsewhere should be included in Account 421.

The Company was required to account for revenues and expenses related to incidental timber sales in accordance with Uniform System of Account instructions in the future.

Accounting for the Sale of Timber

During 1983, the Company sold timber from certain land recorded in Account 101, Electric Plant in Service. The proceeds from the sale were recorded in Account 421, Miscellaneous Nonoperating Income.

Electric Plant Instruction No. 7 states in part:

...the net profit (after giving effect to the cost of the natural resources) from the sale of timber or its products or other natural resources shall be credited to the appropriate utility operating income account, when such land has been recorded in Account 105, Electric Plant Held for Future Use or classified as plant in service...

The instructions to Account 456, Other Electric Revenues, state,

This account shall include revenues derived from electric operations not includible in any of the foregoing accounts.

The Company should have recorded the net profit for the above mentioned sales in Account 456.

The Division of Audits recommended that the Company revise procedures to record the sale of timber from land recorded in electric utility property in Account 456.
NONOPERATING REVENUES AND EXPENSES

Other

Classification of Certain Legal Expenses

The Company recorded certain legal expenses related to election and campaign laws, campaign polls and political advertisements in Account 923, Outside Services Employed.

The instructions to Account 426.4 state:

This account shall include expenditures for the purpose of influencing public opinion with respect to the election or appointment of public officials, referenda, legislation, or ordinances (either with respect to the possible adoption of new referenda, legislation or ordinances or repeal or modification of existing referenda, legislation or ordinances) or approval, modification, or revocation of franchises; or for the purpose of influencing the decisions of public officials.

The Company was required to strengthen procedures to ensure that expenses are recorded in Account 426.4.

Accounting for Civic, Service and Social Club Dues

The Company recorded in Account 426.1, Donations, membership dues of employees in various community, civic and service clubs.

The text of NARUC Interpretation No. 49 states that expenditures for gold club dues, social club dues, service club dues (Rotary, Kiwanis, etc.), house charges and items of a similar nature should be charged to Account 426.5, Other Deductions.

The Company was required to charge the above membership dues to Account 426.5 in the future.

Accounting for EEI Dues

All payments for membership in the Edison Electric Institute (EEI) were charged to Account 930.2, Miscellaneous General Expenses. A portion of the dues were used by EEI to pay for advertising and should have been charged to an appropriate advertising expense account. Also, a portion of the dues were used by EEI to pay for lobbying expenses and should have been charged to Account 426.4, Expenditures for Certain Civic, Political and Related Activities.

The portion of the EEI dues which represent advertising and lobbying costs was required to be charged to the appropriate expense accounts.
Nonoperating Revenues and Expenses

Other

Accounting for Industry Association Dues

The Company charged the entire amount of its membership dues to the U.S. Committee on Energy Awareness to Account 930.2, Miscellaneous General Expenses. The amounts paid to the U.S. Committee on Energy Awareness during the period 1983 through 1986 were approximately $12,738,461.

Based on a previous review of the various activities of the U.S. Committee on Energy Awareness, the Division of Audits determined that these activities would support an allocation of the dues to Account 930.2, Miscellaneous General Expenses, and Account 426.4, Expenditures for Certain Civic, Political and Related Activities.

The Company should request the necessary information from the U.S. Committee on Energy Awareness on its activities in order to make the appropriate accounting classification to the above mentioned accounts in accordance with the requirements of the Uniform System of Accounts. Absent receipt of information on the specific activities of this group, the Company should record the entire payment to Account 426.5, Other Deductions.

We recommend that the Company revise procedures to ensure that the proper accounting classifications are made for the dues paid to this and similar organizations and record a memorandum entry correcting the accounting for the payments made to the U.S. Committee on Energy Awareness for the years 1983 to 1986.

Accounting for Legal Fees Incurred in Connection with Environmental Violations

In 1982, the Company incurred environmental penalties imposed by a judgement order as a consequence of station operations. While the penalties were properly accounted for in Account 426.3, Penalties, the related legal expenses were charged to Account 923, Outside Services, and other operating expense accounts.

In the future, the Company was required to allocate legal fees incurred in connection with certain unsuccessful litigation relating to nonoperating expenses to Account 426.5, Other Deductions.
NONOPERATING REVENUES AND EXPENSES

Other

Accounting for Royalty Payments

The Company included in Account 421, Miscellaneous Nonoperating Income, royalty payments received for the system design of the Post Loss of Coolant Accident (LOCA) Hydrogen Oxygen Recombiner System at the Power Plant. The payments were received during the construction period of the Power Plant.

Electric Plant Instruction No. 3(18) states in part, "The earnings and expenses during construction shall constitute a component of construction costs.... The revenues shall also include rentals for lands, buildings, etc., and miscellaneous receipts not includable in other accounts."

The Company was required to (1) revise its procedures to classify future royalty payments of this nature in accordance with instructions of the Uniform System of Accounts.

Accounting for Goodwill and Promotional Advertising

The Company charged certain goodwill and advertising expenses related to the nuclear project to Account 107, Construction Work in Progress - Electric, and accrued AFUDC thereon. In addition, the Company charged Account 107 with costs incurred for certain banquets, dinners, and parties during the course of construction of the nuclear project.

Electric Plant Instruction No. 3 of the Uniform System of Accounts does not provide for the capitalization of goodwill and promotional advertising, or banquets and parties. Goodwill and promotional advertising is properly chargeable to Account 930.1, General Advertising Expenses.

The Commission stated in 1 FPC, page 132, in the Louisville Hydro Electric Company, Project No. 289 that, "The cost of a banquet is not an appropriate or proper part of the cost of a public utility project. To approve such expenditure might open the door to goodwill advertising at the cost of the consuming public." The Commission also stated the following in 1 FPC on page 269 of the Clarion River Power Company, Project No. 309, "Expenditures for social functions celebrating the completion of the project, do not constitute a part of the actual legitimate cost of the construction project."

The Company was required to (1) revise procedures to ensure that goodwill and promotional advertising along with the cost of banquets are charged to the appropriate expense accounts, and (2) record a correcting entry to expense the payments charged to Account 107. In addition, the Company should reverse all AFUDC that was accrued on the amounts improperly recorded in Account 107.
CHAPTER 16

OPERATING REVENUES AND EXPENSES

Improper Classification of Customer Accounts Expenses

The Company recorded in Account 908, Customer Assistance Expenses, the salaries and expenses incurred in the operation of the Residential Electric Customer Conservation Information Program including the printing, postage and all other mailing and handling costs of a direct mail program.

In addition, classified in Account 920, Administrative and General Salaries, were the expenses and salaries of Public Affairs Department employees engaged in consumer information activities. These activities include such items as keeping customers informed on billing practices, fuel cost adjustments, equal monthly payment plan, customer health and safety, efficient use of energy and home insulation.

The text of Account 909, Informational and Instructional Advertising Expenses, states, "this account shall include costs incurred in activities which primarily convey information as to what the utility urges or suggests customers should do in utilizing electric service to protect health and safety, to encourage environmental protection, to utilize their electric equipment safely and economically, or to conserve electric energy."

In the future, the Company was required to charge to Account 909 the costs associated with operating the Residential Electric Conservation Information Program and the salaries and expenses of the Public Affairs Department employees engaged in consumer information activities.

Interest Charges Improperly Classified

Commitment fees paid on various lines of bank credit have been recorded in Account 930.2, Miscellaneous General Expenses.

The Uniform System of Accounts contemplates the use of Account 431, Other Interest Expense, for all interest charges not provided elsewhere.

The Company was required to classify the above type of interest charges in Account 431.
Accounting for Advertising Expenses

The Company charged to Account 909, Informational and Instructional Advertising Expenses, the cost of advertisements to promote the purchase and use of heat pumps and electric baseboard heating.

The instructions of Account 913, Advertising Expenses, require that advertising designed to promote or retain the use of utility service shall be charged to this account.

The Company was required to revise its procedures to classify advertisements designed to promote or retain the use of utility service in Account 913, Advertising Expenses.

Service Corporation Billings

Approximately 60% of the amounts billed from Service Corporation were charged to Account 923, Outside Services Employed.

General Instruction No. 14, Uniform System of Accounts, states that transactions with associated companies shall be recorded in the appropriate accounts for transactions of the same nature.

In the future, the Company was required to classify costs billed by Service Corporation in the appropriate accounts for transactions of the same nature in accordance with General Instruction 14.

Accounting for Expenses of Electric Property Rented to Others

The Company included in Account 454, Rent from Electric Property, the revenues and expenses related to electric property rented to others.

The text of Account 454, states that, "this account shall include rents received for the use by others of land, buildings and other property devoted to electric operations by the utility."

In the future, the Company was required to record the expenses of electric property rented to others in the appropriate operation and maintenance expense accounts.
PROCEEDURES FOR BILLING AFFILIATED COMPANIES

Certain property of the Company was used for the benefit of affiliated companies. The subject property included utility plant property such as EDP equipment; office furniture and fixtures; general office building and improvements; and land. The affiliated companies compensated the Company for the return related to such property. However, they did not compensate the Company for the income taxes related to the return. This procedure resulted in an underrecovery of costs associated with the property.

The Company recovered a return on net utility property and related income taxes from ratepayers in its established rates. The Company recorded the revenues from affiliated companies, which benefited from the use of utility property, in Account 454, Rent from Electric Property, so as to reduce the revenue requirements to be collected from ratepayers.

The Company's procedure resulted in an understatement of utility income by an amount equal to income taxes related to the return on utility property utilized to benefit affiliated companies.

The Company was required to adopt procedures for charging affiliated companies for the return and related income taxes applicable to property used for the benefit of affiliated companies.

ACCOUNTING FOR DISTILLATE SALES

The Company recorded sales of products extracted from natural gas (distillates) in Account 495, Other Gas Revenues.

The Uniform System of Accounts provides that Account 490, Sales of Products Extracted from Natural Gas, include revenues from sales of gasoline, butane, propane, and other products extracted from natural gas.

The Company was required to comply with the instructions of the Uniform System of Accounts in the future.
Accounting for Interest Received in Connection with Refunds Pursuant to FERC Docket

The Company credited the applicable interest it received in connection with a refund of purchased power costs pursuant to the resolution of a FERC Docket to Account 419, Interest and Dividend Income.

The interest should have been credited to Account 555, Purchased Power, to offset related purchased power costs to the extent that purchased power costs had passed through fuel adjustment clause calculations.

In the future, interest received on purchased power refunds previously passed through fuel clause calculations, should be credited to Account 555.

Accounting for the Department of Energy (DOE) Refund

The Company recorded revenues from the sales of propane and butane in Account 490, Sales of Products Extracted from Natural Gas. Beginning in 1980, the Company transferred amounts equivalent to refunds made, from Account 490 to Account 421, Miscellaneous Nonoperating Income. Refunds were made by debiting a previously established reserve for revenues subject to possible refund and crediting Account 131, Cash.

The Uniform System of Accounts provides the use of Account 490, Sales of Products Extracted from Natural Gas, for the recording of butane and propane revenues extracted from natural gas.

In the future, the Company was required to record butane and propane revenues in the Account 490.

Accounting for Carrying Charge Income and Expenses

The Company recorded in Account 514, Maintenance of Miscellaneous Steam Plant, and Account 562, Station Expense, carrying charges on the cost of spare parts and equipment furnished by an affiliate. The affiliate did not sell these spare parts and equipment to the Company since the items can be used in the affiliate's locations other than the plant and related common facilities. The affiliate allocates the costs of the items to the Company and bills a carrying charge based on the affiliate's cost of capital.

The carrying charges and credits are in the nature of interest expense and interest income rather than operating expenses and should be included in Accounts 431, Other Interest Expense, or Account 419, Interest and Dividend Income, as appropriate.
Accounting for Carrying Charge Income and Expenses (Continued)

The instruction to Account 431 of the Uniform System of Accounts states:

This Account shall include all interest not provided for elsewhere.

The instructions to account 419 state in part:

A. This account shall include interest revenues on securities, loans, notes, advances, special deposits, tax refunds and all other interest-bearing assets, . . .

It was recommended that the Company revise its procedures to classify interest income, expenses, and carrying charges in accordance with the requirements of the Uniform System of Accounts.

Accounting for Income From Wells and Farms on Utility Property

The Company recorded income from oil well operations and leased farm land in Account 421, Miscellaneous Nonoperating Income. The land related to the oil wells and leased farms was recorded in Account 101, Electric Plant in Service and included in ratebase.

Electric Plant Instruction No. 7 states in part,

C. The net profit from the sale of timber, cord wood, sand, gravel, other resources or other property acquired with the rights-of-way or other lands shall be credited to the appropriate plant account to which related. Where land is held for a considerable period of time and timber and other natural resources on the land at the time of purchase increases in value, the net profit (after giving effect to the cost of the natural resources) from the sales of timber or its products or other natural resources shall be credited to the appropriate utility operating income account when such land has been recorded in Account 105, Electric Plant Held for Future Use or classified as plant in service....

The Company should have recorded the income in Account 456, Other Electric Revenues.

The Company was required to revise procedures to account for revenues from oil wells and farms on utility property in Account 456.
Accounting Procedures for Allocating Payroll Costs

Natural Gas Company, the operating partner of the partnership, charged payroll costs only to Company projects that have received regulatory approval. Payroll costs were incurred for another extension project but no payroll costs were charged to this project since the Company had not received regulatory approval, certification, or agreement to proceed with the project. The application for the Extension Project was pending before the Commission.

General Instruction No. 9, Distribution of pay and expenses of employees, of the Uniform System of Accounts states,

The charges to gas plant, operating expense and other accounts for services and expenses of employees engaged in activities chargeable to various accounts, such as construction, maintenance, and operation, shall be based upon the actual time engaged in the respective classes of work, or in case that method is impracticable, upon the basis of a study of the time actually engaged during a representative period.

The failure to charge payroll costs to Extension Projects resulted in an incorrect assignment of payroll costs to the Company's other customers.

The Company was required to establish procedures to ensure payroll costs are charged to the Extension Project and other regulated projects as required by General Instruction No. 9 of the Uniform System of Accounts.
CHAPTER 17

ADMINISTRATIVE AND GENERAL EXPENSES

General Engineering Costs Allocated to Construction

Engineering direct labor costs charged to construction were increased by an amount equal to 40% of such costs to cover general engineering supervision, clerical labor, rents, office supplies and expenses. The Company's allocation of general engineering overheads was based on the supervised payroll method.

The supervised payroll method of allocating overheads is contrary to the provisions of Electric Plant Instruction No. 48 and NARUC Interpretation No. 60 which states as far as practicable, the determination of payroll charges includible in construction overheads shall be based on time card distribution. Where this procedure is impractical, special studies shall be made periodically of the time of supervisory employees devoted to construction activities to the end that only such overhead costs as have a definite relation to construction shall be capitalized.

General engineering supervisory salaries chargeable to construction overheads should be based on time card distribution or periodic time studies in accordance with the above cited requirements.

Charges to Account 920, Administrative and General Salaries

The Company recorded in Account 920, Administrative and General Salaries, expenses of employees and other miscellaneous expenses as follows:

(1) Printing of business cards for a division vice-president.
(2) Mileage and meals expense incurred by a division vice-president and engineer.
(3) Telephone service for Company office.

The text of Account 921, Office Supplies and Expenses, states that "This account shall include office supplies and expenses incurred in connection with the general administration of the utility's operations... This includes the expenses of the various administrative and general departments, the salaries and wages of which are includable in Account 920."

In the future, the Company was required to charge Account 921 for the above type expenses.
Accounting for Regulatory Commission Expenses and Other Costs Incurred in Connection with Orders of Regulatory Authorities

The Company had deferred $1,354,722 related to costs incurred in rate cases before various regulatory bodies or in connection with orders issued by these authorities.

Paragraph B of the instructions to Account 928, Regulatory Commission Expenses, permits deferral of regulatory commission expenses when such treatment is directed or approved by the Commission. Although generally regulatory bodies allow or require regulatory commission expenses to be spread over future periods for ratemaking purposes, an explicit directive to this effect was not obtained by the Company.

The Company was required to obtain Commission approval to defer expenses of this nature in the future in accordance with paragraph B of the instructions to Account 928.

Classification of Charges to Account 930.2, Miscellaneous General Expenses

The following costs charged to Account 930.2, Miscellaneous General Expenses, were improperly classified according to the Uniform System of Accounts:

<table>
<thead>
<tr>
<th>Description</th>
<th>Proper Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contribution to the 4-H Foundation</td>
<td>426.1 Donations</td>
</tr>
<tr>
<td>Farm Family Banquet</td>
<td>908 Customer Assistance Expenses</td>
</tr>
<tr>
<td>A portion of the Home Builders Association dues</td>
<td>426.4 Expenditures for Certain Civic, Political and</td>
</tr>
<tr>
<td></td>
<td>Related Activities</td>
</tr>
<tr>
<td>A portion of the contribution to the Atomic Industrial Forum</td>
<td>426.1, Donations</td>
</tr>
</tbody>
</table>

In the future, the Company was required to record items of the above nature as required by the Uniform System of Accounts.
Lack of Support for the Allocation of Consultant's Expenses

The Company retained a consultant whose duties included legislative monitoring and lobbying as well as other functions. All billings received from the consultant were allocated 75% to Account 923 and 25% to Account 426.4, Expenditures for Certain Civic, Political and Related Activities. The Company had not performed a study supporting the allocation between Accounts 923 and 426.4 since the consultant was retained.

In the future, the Company will be required to perform an analysis of the functions of the consultant to support the allocation between Accounts 923 and 426.4.

Lack of Support for Dues and Payments to Edison Electric Institute

The Company is a member of the Edison Electric Institute (EEI) and provides financial support for a number of programs administered through EEI, including the Media Communications program and the Atomic Industrial Forum. The Company records the payments made to EEI for media advertising in Account 930.1, General Advertising Expenses, and for dues and other programs in Account 930.2, Miscellaneous General Expenses.

The Company was unable to provide the staff with sufficient information on the various activities carried out under the various EEI programs to support the accounting classification to Accounts 930.1 and 930.2. With respect to EEI dues, the staff has obtained evidence that some portion of the dues is in support of activities that should be recorded in Account 426.4, Expenditures for Certain Civic, Political and Related Activities, based upon the criteria established by the Commission in Order No. 276 issued December 18, 1963. With respect to the Media Communications, Atomic Industrial Forum and similar programs, staff has obtained sufficient information on previous years' advertisements and activities to make an assessment that a portion of the payments should also have been recorded in Account 426.4.

In the future, the Company was required to obtain from EEI sufficient information on the various activities of these programs to support the accounting classification for the payments to EEI to both operating and nonoperating expense accounts, consistent with the criteria established by the Commission.
Improper Accounting for Employee Benefits and A&G Expenses Applicable to the Below-The-Line Accounts

In the staff's review of the charges to Account 421, Miscellaneous Nonoperating Income, and Account 426.4, Expenditures for Certain Civic, Political and Related Activities, it was noted that the company charged labor and payroll taxes thereto applicable to miscellaneous and political activities. However, the Company did not allocate the employee benefits (Account 926) and other appropriate A&G expenses applicable to the labor transferred to these accounts from other utility expense accounts. This resulted in overstated utility expense and understated, other income and deductions by approximately $40,000 in 1981.

The Company was required to begin allocating employee benefits and A&G expenses applicable to the labor charged to these accounts in 1982.

Classification of Certain Nonoperating Expenditures

The staff review disclosed that the Company charged to Account Nos. 921, Office Supplies and Expenses, and 930.2, Miscellaneous General Expenses, minor amounts of country club dues, country club expenses incurred by a retired officer and sporting event tickets for entertainment of a non-utility nature.

NARUC Interpretation No. 49 and the Uniform System of Accounts provide that such expenditures be classified in Account 426.5, Other Deductions.

The Company in the future was required to ensure all such similar expenditures be recorded in Account 426.5.

Accounting for Insurance for Patrol Planes

Staff review disclosed that the Company accumulated the costs for operation and maintenance of gas pipeline patrol plans in a subaccount of Account 184, Clearing Accounts. The insurance premium for its two aircraft was included in Account 924, Property Insurance.

The instructions to Account 924, Note B, state in part, "The cost of insurance ... for the following classes of property shall be charged as indicated ... (2) Transportation and other general equipment to appropriate clearing accounts that may be maintained...".

The Company was required to revise its accounting procedures for patrol plane insurance to conform with the instructions to Account 924.
Improper Classification of Loan Commitment Fees

The Company charged commitment fees to maintain lines of credits to Account 930.2, Miscellaneous General Expenses. Commitment fees are financing costs and accordingly should be charged to nonoperating accounts.

In the future, the Company was required to charge loan commitment fees to Account 431, Other Interest Expense. The Company disagreed that commitment fees were a financing cost. However, it proposed to record commitment fees in Account 425.5, Other Deductions, beginning in 1983. The staff did not object to the Company's proposal.

Accounting for Supervisor Training and Development Expenditures

The Company recorded in Account 926, Employee Pensions and Benefits, supervisor training and development expenses of a type which directly affected the employees' on-the-job ability and efficiency.

The text of Account 926, Employee Pensions and Benefits, provides for the account to include expenses incurred in medical, educational or recreational activities for the benefit of the employees.

In the future, all supervisor training and development expenses of the type described above should be recorded in the appropriate functional operating expense account prescribed in the Uniform System of Accounts.

Accounting for American Gas Association (AGA) Membership Dues

Staff's audit disclosed that payment for the AGA membership dues and research subscription was divided equally between the Company and its Parent. The Company charged the entire portion of the membership dues to Account 930.2, Miscellaneous General Expenses, although a portion of the dues was related to AGA's communications and television subscription programs.

It was staff's position that the AGA dues and research subscription should be apportioned between the Company and the Parent based on operating income, as this was the factor AGA used to determine the annual billings. Additionally, the portion of AGA dues applicable to the communications programs and television subscription should have been charged to the appropriate advertising accounts, rather than Account 930.2.

In the future, the Company should apportion the AGA dues and research subscription based on operating income and charge the portion related to the communication and television subscription programs to the appropriate advertising expense accounts.
ACCOUNTING FOR WELL STATUS DETERMINATION COSTS

The Company recorded Natural Gas Policy Act well status determination costs in Account 921, Office Supplies and Expenses.

The Uniform System of Accounts provides Account 928, Regulatory Commission Expenses, for the recording of application fees in connection with filings before regulatory commissions.

The Company was required to charge well status determination costs to Account 928 in the future.

IMPROPER ACCOUNTING FOR GAS RESEARCH INSTITUTE

The Company recorded the liability to the Gas Research Institute (GRI) in Account 232, Accounts Payable, with a contra entry to Account 930.2, Miscellaneous General Expenses. Account 188, Research, Development and Demonstration Expenditures, was not utilized.

FERC Accounting Release No. 11 states that a company should record surcharges to finance GRI funding in the appropriate operating revenue account for the class of customer served. Upon the recording of revenue, the company should establish a liability for payment to GRI for surcharge collections. The amount of the liability should be charged first to Account 188, and concurrently expensed to Account 930.2.

In the future, the Company was required to account for collections and payments to GRI as prescribed by FERC Accounting Release No. 11.

ACCOUNT CLASSIFICATION OF MANAGEMENT INCENTIVE BONUS PLAN COST

The Company classified in Account 930.2, Miscellaneous General Expenses, the cost of the Company's management incentive bonus plan. The costs were not included in rates.

The text of Account 426.5, Other Deductions, states, "This account shall include other miscellaneous expenses which are nonoperating in nature, but which are properly deductible before determining total income before interest charges."

In the future, the Company was required to classify the costs of its management incentive bonus plan in Account 426.5 to the extent the costs are not allowed for rate recovery purposes before the Commission.
Industry and Trade Association Dues

The Company recorded in Account 930.2, Miscellaneous General Expenses, all industry and trade association dues for Edison Electric Institute, U.S. Committee for Energy Awareness, West Associates, and Association of Electric Companies. The amounts were included in Account 930.2 without obtaining information about the activities of the organizations necessary to assure classification of the dues to the appropriate account or accounts.

General Instruction No. 2 of the Uniform System of Accounts requires utilities to keep their books of account so as to be able to furnish readily full information as to any item included in any account. Further, each entry should be supported by such detailed information as will permit ready identification, analysis, and verification of all facts relevant thereto. Recorded amounts not supported by full information may not be considered just and reasonable and should be included in Account 426.5, Other Deductions.

The Company was required to obtain sufficient information to support the accounting classification of dues payments to both utility and nonutility operating expense accounts. Account 426.5 should be charged for all expenses for which sufficient evidence is not available to support the just and reasonableness of the expense.

Classification of Officers' Expenses

Company policy provided for reimbursement of Company employees for expenses incurred in charitable and community affairs or citizenship activities. Amounts reimbursed to officers were charged to Account 921, Office Supplies and Expenses.

The Uniform System of Accounts requires that expenses incurred for charitable activities are properly includable in Account 426.1, Donations, whether the expenditures are made directly or are in the form of reimbursements to officers or other employees.

The Company was required to classify future reimbursements for charitable expenses of employees in accordance with the requirements of the Uniform System of Accounts.
Expenses Related to Commercial Paper Sales

The Company records all payroll expense related to the Commercial Paper Sales Operation to Electric Operating Expense Account No. 920, Administrative and General Salaries. All revenues for this service were recorded in a below the line account. A portion of the labor expended was for placing commercial paper for other utility companies for a fee. This segment of the Commercial Paper Sales Operation relates to nonutility operations.

The text of Account 426.5, Other Deductions, states, "This account shall include other miscellaneous expenses which are nonoperating in nature...".

The Company was required to charge all labor charges or other expenses related to the Commercial Paper Sales Operation, which are nonoperating in nature be charged to Account No. 426.5, Other Deductions.

Classification of Fees and Expenses Related to Formal Rate Cases

Staff's examination disclosed that fees and expenses of rate consultants, utilized in rate cases before the Federal Energy Regulatory Commission, were recorded in Account 923, Outside Services Employed.

This accounting was contrary to the Uniform System of Accounts Instructions for Account 928, Regulatory Commission Expenses, which provides, in part:

"This account shall include all expenses (except pay of regular employees only incidentally engaged in such work) properly includible in utility operating expenses, incurred by the utility in connection with formal cases before regulatory commissions..."

The Company was required to account for fees and expenses of rate consultants in accordance with Uniform System of Accounts Instructions in the future.
Accounting for Deferred Compensation Plan

The Company offered a deferred compensation plan to its key executives that provided for the deferral of base and/or incentive bonus. Elections to defer were made annually and were effective for one to eight years.

Prior to 1989, the Company recorded the deferred salary and/or bonus to Account 426.5, Other Deductions, and the interest to Account 431, Other Interest Expense. Beginning in 1989, the Company revised its procedures and recorded the deferred salary and/or bonus to Account 920, Administrative and General Salaries, and the interest to Account 926, Employee Pension and Benefits.

The Company included the interest on the deferred compensation plan in the cost of service in its rate filing. This case resulted in a settlement agreement that disallowed rate recovery of the interest element on the executive compensation plan recorded in Account 926.

The instructions to Account 926 do not permit for the recording of interest.

The Uniform System of Accounts includes several accounts for the recording of interest, including Account 431. The instructions to Account 431 state:

This account shall include all interest charges not provided for elsewhere.

We concluded that the Company should have recorded the interest element on the deferred compensation plan in Account 431.

It was recommended that the Company revise procedures to ensure that the interest on the deferred compensation plan are recorded in Account 431 consistent with the requirements of the Uniform System of Accounts.
CHAPTER 18

ACCOUNTING MISCLASSIFICATIONS

Incorrect Classification of Donations to Volunteer Fire Departments and Rescue Squads

Contributions to various volunteer fire departments and rescue squads throughout the Company's service area were charged to Account 930.2, Miscellaneous General Expenses.

The text of Account 426.1, Donations, states "This account shall include all payments or donations for charitable, social or community welfare purposes."

In the future, the Company was required to record donations to local volunteer fire departments and rescue squads in Account 426.1, Donations.

Miscellaneous Accounting Misclassifications

The Company classified various items to improper accounts. The following summarizes the account used, the proper account recommended and the description of the transaction:

<table>
<thead>
<tr>
<th>Account Used</th>
<th>Proper Account</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>403</td>
<td>405</td>
<td>Amortization of leasehold improvements.</td>
</tr>
<tr>
<td>108</td>
<td>111</td>
<td>Accumulated amortization of leasehold improvements.</td>
</tr>
<tr>
<td>123</td>
<td>123.1</td>
<td>Advance to Subsidiary Company.</td>
</tr>
<tr>
<td>419</td>
<td>CR 101</td>
<td>10% of the nonrefundable portion of a customer advance.</td>
</tr>
<tr>
<td>930.2</td>
<td>Part to 426.4</td>
<td>Dues paid to Council.</td>
</tr>
<tr>
<td>930.2</td>
<td>Part to 426.4</td>
<td>Dues paid to Atomic Industrial Forum</td>
</tr>
<tr>
<td>186</td>
<td>143</td>
<td>Receivable for payment of obligation under leasing agreement.</td>
</tr>
<tr>
<td>923</td>
<td>426.4</td>
<td>Legal fees for representation regarding legislation for the tax treatment of a settlement.</td>
</tr>
</tbody>
</table>

Appropriate corrective action was required to properly classify the above types of transactions in the future.
**Miscellaneous Account Misclassifications**

During the review of Company records, various misclassifications were noted. The following is a listing of examples indicating the nature of the transaction, classification by the Company, and the correct classification as required by the Uniform System of Accounts:

<table>
<thead>
<tr>
<th>Account Used</th>
<th>Proper Account</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>920</td>
<td>926</td>
<td>Expenses of agency used to sell employee homes subsequent to relocation.</td>
</tr>
<tr>
<td>921</td>
<td>930.2</td>
<td>Better Business Bureau membership dues.</td>
</tr>
<tr>
<td>926</td>
<td>925</td>
<td>Cost of hard hat emblems to be used for safety promotion.</td>
</tr>
<tr>
<td>926</td>
<td>921</td>
<td>Membership dues for Company employees in the American Society for Training Development.</td>
</tr>
<tr>
<td>926</td>
<td>925</td>
<td>Cost of a film concerning burns to be used by the Company's Safety Dept.</td>
</tr>
<tr>
<td>417.1</td>
<td>418</td>
<td>Depreciation expense on nonutility property.</td>
</tr>
<tr>
<td>421</td>
<td>456</td>
<td>Revenue from computer time sales.</td>
</tr>
<tr>
<td>421.1</td>
<td>421</td>
<td>Gain on sale of investment.</td>
</tr>
<tr>
<td>355</td>
<td>354</td>
<td>Labor and materials used to install a 500KV tower foundation.</td>
</tr>
<tr>
<td>502</td>
<td>512</td>
<td>Freight on pipe and boiler tubes used to modify steam boilers and air preheaters.</td>
</tr>
<tr>
<td>506</td>
<td>505</td>
<td>Freight on oil/water separator chemicals used for station wastewater treatment.</td>
</tr>
<tr>
<td>910</td>
<td>926</td>
<td>Wiring allowances granted only to employees.</td>
</tr>
<tr>
<td>930.1</td>
<td>930.2</td>
<td>Cost of poinsettias to be used as holiday decorations.</td>
</tr>
<tr>
<td>930.1</td>
<td>909</td>
<td>Cost of national energy watch and winter weatherization ads.</td>
</tr>
<tr>
<td>930.2</td>
<td>926</td>
<td>Cost of tickets for employees to attend the prison rodeo.</td>
</tr>
<tr>
<td>930.2</td>
<td>909</td>
<td>Cost of conservation and/or informational advertising provided by local television.</td>
</tr>
</tbody>
</table>

The Company was required to institute corrective procedures to insure the proper classification of these types of expenditures in the future.
## Miscellaneous Accounting Misclassifications

During the staff's review of Company records, various misclassifications were noted. The following is a listing of examples indicating the nature of the transaction, the Company's classification and the classification recommended by the staff.

<table>
<thead>
<tr>
<th>Account Used</th>
<th>Proposed Account</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>923</td>
<td>928</td>
<td>Cost of official reports from the Reporting Co., Inc., used in FERC Dockets.</td>
</tr>
<tr>
<td>923</td>
<td>928</td>
<td>Various out-of-pocket legal expenses which were related to FERC Dockets.</td>
</tr>
<tr>
<td>926</td>
<td>923</td>
<td>Recruitment fees from Management Recruiters for recruiting personnel.</td>
</tr>
<tr>
<td>926</td>
<td>921 or appropriate expense account</td>
<td>Meals and breaks for Managers of the Division while attending a management meeting.</td>
</tr>
<tr>
<td>926</td>
<td>921</td>
<td>Expenditure for a customer relations program text which is given to all employees who come in contact with customers.</td>
</tr>
<tr>
<td>926</td>
<td>588</td>
<td>Reimbursed costs of lodging to employees of the meter department for work days at a training school for meter recorders.</td>
</tr>
<tr>
<td>926</td>
<td>appropriate expense account</td>
<td>Expenditure to the Downtown Motor Lodge for rooms for employees attending a safety training program.</td>
</tr>
<tr>
<td>926</td>
<td>appropriate expense account</td>
<td>Meals and miscellaneous expenses for the employee safety training program.</td>
</tr>
<tr>
<td>926</td>
<td>920</td>
<td>Salary of the Personnel Director, whose purpose is to assist management with the human resources function.</td>
</tr>
<tr>
<td>921</td>
<td>935</td>
<td>Expenditure for cleaning services for the general office.</td>
</tr>
<tr>
<td>921</td>
<td>935</td>
<td>Expenditure for window-cleaning.</td>
</tr>
<tr>
<td>921</td>
<td>930.2</td>
<td>Dues to the Chamber of Commerce.</td>
</tr>
</tbody>
</table>
Miscellaneous Accounting Misclassifications (Continued)

920   935 The portion of the salary of the building supervisor which related to the maintenance and supervision of general plant.

In the future, the Company was required to account for costs of the above nature in accordance with the Uniform System of Accounts.

Miscellaneous Accounting Misclassifications

During the examination, the staff noted certain accounting misclassifications. The staff listing with recommendations follows:

<table>
<thead>
<tr>
<th>Used</th>
<th>Proper Account</th>
<th>Account Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>921</td>
<td>426.5</td>
<td>Payments in settlement of discrimination suits.</td>
</tr>
<tr>
<td>930.2</td>
<td>426.4</td>
<td>Dues for Atomic Industrial Forum.</td>
</tr>
<tr>
<td>930.2</td>
<td>426.4</td>
<td>Dues for Capital Hill Club.</td>
</tr>
<tr>
<td>930.2</td>
<td>426.4</td>
<td>American Nuclear Energy Council Dues.</td>
</tr>
<tr>
<td>930.2</td>
<td>426.4</td>
<td>Utility State Government Organization Dues.</td>
</tr>
<tr>
<td>921</td>
<td>426.4</td>
<td>Costs of employees attending USGO annual meeting.</td>
</tr>
<tr>
<td>921</td>
<td>426.4</td>
<td>Costs of employees attending EEI governmental affairs conference.</td>
</tr>
<tr>
<td>921</td>
<td>426.4</td>
<td>44th Congressional meeting - County Chamber of Commerce.</td>
</tr>
</tbody>
</table>

Appropriate corrective action was required to properly classify the above type expenses in the future.
## Miscellaneous Accounting Misclassifications

The following account misclassifications were noted by the staff during the audit:

<table>
<thead>
<tr>
<th>Account Used</th>
<th>Proper Account</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>506</td>
<td>930.1</td>
<td>Booklets for promotions and advertisements</td>
</tr>
<tr>
<td>921</td>
<td>931</td>
<td>Computer rental</td>
</tr>
<tr>
<td>921</td>
<td>426.1</td>
<td>Dues to Kiwanis Club for community welfare</td>
</tr>
<tr>
<td>923</td>
<td>431</td>
<td>Issuance fee for notes issued</td>
</tr>
<tr>
<td>930.1</td>
<td>909</td>
<td>Informational and instructional advertising</td>
</tr>
<tr>
<td>930.2</td>
<td>910</td>
<td>Informational program advertising charges</td>
</tr>
<tr>
<td>930.2</td>
<td>908</td>
<td>Payment for classroom posters, Energy and Man’s Environment</td>
</tr>
<tr>
<td>506</td>
<td>426.3</td>
<td>Payments made to OSHA relative to fines or penalties</td>
</tr>
<tr>
<td>930.2</td>
<td>426.4</td>
<td>Local government affairs and EEI dues for lobbying</td>
</tr>
<tr>
<td>921</td>
<td>426.4</td>
<td>Prorate airfare incurred by lobbyist</td>
</tr>
</tbody>
</table>

The Company, in the future, was required to classify the above types of transactions in the respective proper account.
Account Classifications

During the audit period, the Company misclassified a number of expenditures. The following list describes each item, the classification of each item by the Company, and the classification prescribed by the Uniform System of Accounts.

<table>
<thead>
<tr>
<th>Description</th>
<th>Company's Classification</th>
<th>Uniform System of Accounts Classification</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Noncurrent portion of gas take or pay contract cost</td>
<td>Account 186, Miscellaneous Deferred Debits</td>
<td>Account 165, Prepayments</td>
</tr>
<tr>
<td>2. Various prepaid liability insurance</td>
<td>Account 186, Miscellaneous Deferred Debits</td>
<td>Account 165, Prepayments</td>
</tr>
<tr>
<td>3. Pollution control bonds issued, payment of which has been assumed by the Company</td>
<td>Account 224, Other Long-Term Debt</td>
<td>Account 221, Bonds</td>
</tr>
<tr>
<td>4. Deferred income taxes related to the repair allowance, removal expenses, and taxes capitalized</td>
<td>Account 283, Accumulated Deferred Income Taxes - Other</td>
<td>Account 282, Accumulated Deferred Income Taxes - Other</td>
</tr>
<tr>
<td>5. Cost of fuel analysis, purchasing, unloading, and other fuel related services</td>
<td>Account 151, Fuel Stock (Note: The Company's account misclassification had no affect on the wholesale fuel adjustment clause).</td>
<td>Account 152, Fuel Stock Expense Undistributed</td>
</tr>
<tr>
<td>6. Cost of performing economic, physical and environmental studies to select a tract of land for future construction of generating units</td>
<td>Account 107, Construction Work in Progress-Electric</td>
<td>183, Preliminary survey and investigation charges</td>
</tr>
</tbody>
</table>
Account Classifications (Continued)

8. Payments to various civic, social and community welfare groups
   Description: Payments to various civic, social and community welfare groups
   Company's Classification: Account 930.2, Miscellaneous General Expenses
   Uniform System of Accounts Classification: Account 426.1, Donations

9. Fines assessed by OSHA
   Description: Fines assessed by OSHA
   Company's Classification: Various Operating and Maintenance Expense Accounts
   Uniform System of Accounts Classification: Account 426.3, Penalties

10. Salaries & Expenses of company security personnel
    Description: Salaries & Expenses of company security personnel
    Company's Classification: Account 926, Employee Pensions and Benefits
    Uniform System of Accounts Classification: Account 920, Administrative and General Salaries and Account 921, Office Supplies and Expenses

The Company was required to: (1) classify the above listed expenditures in accordance with the Uniform System of Accounts in the future, and (2) correct the account classification of the expenditures as of December 31, 1983.

Classification of Other Expenditures

The Company improperly classified a number of transactions in its accounts. The following is a summary of items misclassified:

<table>
<thead>
<tr>
<th>System Description</th>
<th>Account Utilized</th>
<th>Account Prescribed by the Uniform System of Accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rent received for the use of Company transmission lines.</td>
<td>565</td>
<td>454</td>
</tr>
<tr>
<td>Sale of material and supplies.</td>
<td>451</td>
<td>456</td>
</tr>
<tr>
<td>Reimbursement to employee for costs of selling old home and buying new one.</td>
<td>921</td>
<td>926</td>
</tr>
<tr>
<td>Noncurrent portion of compensation awards not payable within one year.</td>
<td>228.2</td>
<td>253</td>
</tr>
</tbody>
</table>

The Company was required to revise procedures to record the above transactions in conformance with the requirements of the Uniform System of Accounts.
Accounting Classifications

The Company classified certain transactions in the wrong accounts. The following summary indicates (a) the nature of the items misclassified, (b) the account used by the Company, and (c) the proper accounts for such transactions.

<table>
<thead>
<tr>
<th>Description</th>
<th>Account Used</th>
<th>Proper Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tickets for scholarship fund dinner</td>
<td>921</td>
<td>426.1</td>
</tr>
<tr>
<td>Security and Exchange Commission annual filing fees</td>
<td>921</td>
<td>930.2</td>
</tr>
<tr>
<td>Services related to legal cases</td>
<td>921</td>
<td>923</td>
</tr>
<tr>
<td>Moody's Investor Services for commercial paper ratings</td>
<td>921</td>
<td>923</td>
</tr>
<tr>
<td>Fitch Investor Services for commercial paper ratings</td>
<td>921</td>
<td>923</td>
</tr>
<tr>
<td>Moody's Investor Services for investment grade ratings</td>
<td>921</td>
<td>923</td>
</tr>
<tr>
<td>Preparation of material for legal cases</td>
<td>921</td>
<td>923</td>
</tr>
<tr>
<td>Stone and Webster consulting services</td>
<td>921</td>
<td>923</td>
</tr>
</tbody>
</table>

The Company was required to revise procedures to ensure that the identified transactions are classified consistent with the requirements of the Uniform System of Accounts.

Miscellaneous Accounting Classifications

The Company recorded certain transactions in the wrong accounts as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Account Used</th>
<th>Proper Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues for the transmission of electricity of others</td>
<td>454</td>
<td>456</td>
</tr>
<tr>
<td>Amortization of preferred stock expense</td>
<td>439</td>
<td>211</td>
</tr>
<tr>
<td>Cash surrender value of insurance policies</td>
<td>124</td>
<td>174</td>
</tr>
</tbody>
</table>

It was recommended that the Company revise its accounting procedures to record the above items in the proper accounts.
CHAPTER 19

GENERAL COMPLIANCE

Reconciliation of Account Numbers

Company's expense accounts are maintained in such a manner that reconciliation of their account numbers and related expenses with the account numbers prescribed in the Uniform System of Accounts is not readily possible. This inadequacy prevents ready analysis of the prescribed accounts. General Instruction No. 3C of the Uniform System of Accounts requires that each utility using different account numbers than those provided in the Uniform System of Accounts, shall maintain records so as to permit ready analysis by prescribed accounts.

The Company was required to implement accounting procedures to comply with the requirements set forth in General Instruction No. 3C of the Uniform System of Accounts.

Adherence to Prescribed Accounts

The Company divides all the Uniform Systems of Accounts' balance sheet and income accounts into numerous subaccounts in the general and operating ledger. Generally, most of these subaccounts correctly reflect the detail of the prescribed account in accordance with General Instruction No. 2D of the Uniform System of Accounts; however, they are not controlled by the prescribed account numbers as contemplated by General Instruction No. 3C.

In addition, certain accounts not prescribed by the Uniform System of Accounts are maintained and certain accounts are incorrectly maintained which result in numerous reconciliations to reflect the proper expense accounts. General Instruction No. 3C contemplates that the books and records be maintained to permit preparation of financial and operating statements directly from such records at the end of each accounting period.

In the future, the Company was required to maintain their books and records as prescribed by the Uniform System of Accounts.
Supporting Details for Journal Entries

Staff noted various vouchers and journal entries for which documentary support was insufficient or not readily available. The Uniform System of Accounts provides in General Instruction No. 2, that all entries be supported by such detailed information that will permit ready identification, analysis, and verification of all facts relevant thereto.

The Company was required to take action to provide for adequate supporting detail for all journal entries and vouchers so as to comply with the instructions of the Uniform System of Accounts.

Availability of Documents

During the course of the audit, staff encountered certain problems concerning the Records Department. Several times during the audit, the documents staff requested were not readily available because the documents were either removed without being checked out or misplaced due to inadequate filing procedures. In one case, certain accounts payable vouchers could not be readily located in the files. The vouchers were finally located, either elsewhere in the Company or during another search of the files.

Section 125.2, Paragraph (m) of Part 125, Subchapter C of the Federal Power Act states that, "At each office of the public utility or licensee where records are kept or stored, such records as are herein required to be preserved shall be so arranged, filed and currently indexed that they may be readily identified and made available to representatives of the Commission."

The Company was required to adopt procedures to enhance internal controls over the location of records so that they are both readily identified and available for use.
Account Numbering System

The Company used a different account numbering system from the prescribed Uniform System of Accounts, and maintained a list of such account numbers to reconcile to the prescribed accounts. The staff noted instances (primarily with deferred tax accounts) in which the account numbers per the general ledger either were not included in the reconciling list or differed from it. An additional reconciling worksheet had to be obtained from the user department before the reconciliation could be completed.

General Instruction No. 3C states each utility may adopt for its own purposes a different system of account numbers provided that the utility maintain a list of account numbers which it uses and a reconciliation of such account numbers to the prescribed account numbers.

In the future, the Company was required to maintain a more accurate reconciling list of Company account numbers to the prescribed account numbers.

Requirement to File for Interlock Approval Under Section 305(b)

None of the Company's officers and directors had filed with the Commission for approval to hold interlock positions. The staff was unable to determine which other officers and directors may require Commission approval under Section 305(b) of the Federal Power Act. Section 305(b) requires approval for holding officer and director positions which are interlocked between the utility and companies that supply the utility with electric equipment or are authorized to participate in underwriting or marketing public utility securities.

The Company was required to review the current interlocks and notify the directors and officers to file with the Commission for approval to hold interlocking positions, where required under Section 305(b).

Notes to the Financial Statements

The Company has not included any notes to the financial statements in the FERC's Annual Report Form No. 1. Instead, the following statement was provided, "See Notes in Annual Report to Shareowners."

Instruction 1 on Page 122, Notes to Financial Statements, of the Form 1, requires the reporting of important notes regarding the Balance Sheet, Statement of Income, Statement of Retained Earnings, and Statement of Changes in Financial Position.

The Company was required to include notes to its financial statements in accordance with the reporting requirements of Form 1 in the future.
Waiver Required to Adopt Securities and Exchange Commission's (SEC) Prescribed Method of Successful Effort Accounting

Effective June 30, 1986, the Company changed from the full-cost method of accounting to the SEC successful efforts method of accounting for production properties subject to NGPA pricing and subject to Modified Cost of Service (MCOS) rate treatment. The Company did not request a waiver from the Commission to make the change in accounting methods. Previously, for those production properties subject of NGPA pricing, the Company used the SEC’s method of full-cost accounting in accordance with the limited waiver granted by the Chief Accountant per letter dated July 15, 1980, and for those production properties subject to MCOS rate treatment, the Company used FERC's method of full-cost accounting in accordance with the requirements of the Uniform System of Accounts as established under Order No. 440, issued November 5, 1971.

The Uniform System of Accounts and rules and regulations contained are required to be kept and observed by natural gas companies subject to the jurisdiction of the Commission. A waiver of the Commission’s Uniform System of Accounts rules and regulations is required in order to change from the full-cost method to the SEC’s successful efforts method of accounting for production properties.

The Company was required to (1) revise procedures to ensure that the requirements of the Uniform System of Accounts is observed, and (2) make a filing with the Commission to request a waiver of the Uniform System of Accounts rules and regulations in order to change from the full-cost method to SEC's successful efforts method of accounting for production properties.

On May 28, 1987, the Company filed a request for waiver of the Uniform System of Accounts. Such request was approved by letter issued by the Chief Accountant on July 23, 1987.
CHAPTER 20

DISCONTINUANCE OF SFAS-71

Accounting Changes Resulting from Discontinuance of SFAS-71

The Company changed the following accounting policies to reflect the decision to discontinue the application of SFAS-71:

(1) Allowance for Funds Used During Construction

The Company and the other FERC jurisdictional companies developed an overall allowance for funds used during construction (AFUDC) rate using Parents consolidated capital structure and the formula provided in Gas Plant Instruction No. 3(17) of the Uniform System of Accounts.

Beginning in 1985 the Company began calculating an Interest During Construction (IDC) rate based on the criteria set forth by the Financial Accounting Standards Board in Statement of Financial Accounting Standards No. 34.

In 1986, the Company's IDC rate was 75 basis points higher than the AFUDC rate computed under the Commission's regulations. The Company included in its utility plant accounts the excess of that permitted under Gas Plant Instruction No. 3(17).

We concluded that the Company should comply with Gas Plant Instruction No. 3(17) for determining the AFUDC rate and adjust the plant accounts for the AFUDC overcapitalized in 1986.

Also, the Company's discontinuance of SFAS No. 71 had the effect of increasing its net income and retained earnings for the year 1985. We concluded that it would be inappropriate in determining the AFUDC rate for each year to reflect the effect of any increased earnings in the Company's capital structure as a result of discontinuing SFAS No. 71.

(2) Deferred Income Taxes

The Company's accounting for deferred income taxes for periods prior to 1985 reflected the Commission's ratemaking policies. Prior to the discontinuance of SFAS No. 71, the Company had a deficiency in its deferred income tax accounts, reflecting the flow through of certain income tax benefits in previous periods. As a result of a previous rate proceeding, the Commission provided the Company with a make-up period to collect the deferred tax deficiency.
Accounting Changes Resulting from Discontinuance of SFAS-71 (Continued)

In 1985 the Company recorded an entry adjusting its deferred income tax accounts by $8,083,830. It did not include the adjustment to deferred income taxes in computing the formula rate billings to other companies.

General Instruction No. 18, Comprehensive Interperiod Income Tax Allocation, of the Uniform System of Accounts requires a utility to follow comprehensive interperiod tax allocation procedures to the extent that normalized income taxes are provided in rate levels.

It was inappropriate for the Company to record the $8,083,830 of deferred income taxes in its accounts during 1985 since the Company's rates were providing the additional income taxes to makeup the deficiency over a number of years. The Company has a formula rate tariff based upon the accounting requirements of the Uniform System of Accounts. Therefore, it is important that the amounts recorded in its accounts properly reflect the results of the ratemaking process.

(3) Gains on Reacquired Debt

The Company had followed the accounting practice of deferring in its accounts any gains related to reacquiring debt. This accounting practice was consistent with the Commission's ratemaking requirement for amortizing the gains as a reduction of debt expense for cost of service purposes. Upon discontinuance of SFAS No. 71, the Company revised its accounting procedures so as to recognize gains on reacquired debt in current income. Also, the Company included in income the unamortized balance of deferred gains from previous periods. As a result of the accounting change, the Company restated its deferred income tax balances.

The Company recorded an entry in the amount of $1,709,919 by charges to Account 410.2, Provision for Deferred Income Taxes, Other Income and Deductions, and credits to Account 282, Accumulated Deferred Income Taxes - Other Property, to reflect the tax effect of Columbia's change. 1/

We concluded that since the gains on reacquired debt initially were recorded on the Company's books, it was inappropriate for the Company to reflect the related deferred income taxes in its accounts.

Also, we concluded that the Company should have continued reflecting the amortization of the gains on reacquired debt in calculating interest expense for cost of service billings to other company's.

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1/ The amount is part of the previously discussed $8,083,830 deferred income tax adjustment.
Accounting Changes Resulting from Discontinuance of SFAS-71 (Continued)

It was recommended that the Company:

(1) revise its procedures to properly account for allowance for funds used during construction and deferred income taxes in accordance with the requirements of the Uniform System of Accounts;

(2) record an entry to reverse the amount of AFUDC overcapitalized in 1986;

(3) record an entry to reverse to reduce the amount of deferred income taxes recorded in its accounts by the $8,083,830; and

(4) to the extent that any of the accounting changes have impacted on tariff billings, recalculate the tariff billings to reflect the corrections mentioned above and refund any overcollected amounts.
Financial Reporting to the Commission - OFF 71

The Company changed its financial reporting of the results of operations of the Company and several other subsidiaries under FERC jurisdiction in presenting its consolidated financial statements to stockholders and others.

The Company provided the following disclosures as part of the Notes to Financial Statements in its FERC Form filings during the audit period:

1. In 1985 and 1986 the Company reported that it had discontinued application of Statement of Financial Accounting Standards (SFAS) No. 71, Accounting for the Effects of Certain Types of Regulation. Also, it reported 1985 earnings reduced by $8,083,830 as a result of recording an additional liability for deferred income taxes.

2. In 1987 the Company noted its decision in 1985 to discontinue application of SFAS No. 71. Also, it reported preparing the 1987 financial statements based upon the accounting regulations of the FERC's Uniform System of Accounts.

3. In 1988 the Company reported preparing the financial statements and supporting documentation from its books and records that were maintained in accordance with generally accepted accounting principles. Also, it noted the fact that any differences arising from different accounting under the FERC's Uniform System of Accounts and generally accepted accounting principles were included in other income and deductions accounts.

We concluded that certain of the above disclosures were inaccurate, incomplete, and possibly misleading to the readers of the financial statements included in the Form for the following reasons:

1. the accounting changes made by the Company in 1985 were not consistent with the requirements of the Uniform System of Accounts;

2. the Company did not prepare its financial statements reported in the Form for 1985 through 1988 according to the requirements of the Uniform System of Accounts; and

3. the Company's 1988 general disclosure that any differences between the financial statements and the Uniform System of Accounts were included in other income and deductions were incomplete and lack the necessary details for the reader to determine the significance of such differences.

It was recommended that the Company:

1. revise its procedures for future reporting in the FERC Form to ensure that the financial statements are based upon the accounting requirements of the Uniform System of Accounts; and

2. refile the financial statements and supporting information included in Form for the years 1985 through 1988 to correct the accounting deficiencies noted.