## **MERCER**

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March 20, 2006

Mr. Peter C. Proestakes
Project Manager
Financial Accounting Standards Board
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Letter of Comment No: 12 File Reference: 1025-PNU

## Subject:

## Phase 1 of Project for Postretirement Benefit Obligations, Including Pensions

Dear Mr. Proestakes:

Mercer Human Resource Consulting is pleased to provide input on Phase 1 of the project for Postretirement Benefit Obligations, including pensions. As the largest global actuarial firm, we are significant providers, consumers and interpreters of the information in the pension and postretirement plans footnote. We support the Board's continuing efforts to provide financial statement users with meaningful, reliable, relevant and useful information.

Much of the impetus for changes in the balance sheet recognition of unfunded liabilities for pension and other postretirement benefits is that many financial analysts are already adjusting the published balance sheet based on the information disclosed in the footnotes to the 10-K.

We would like to make the Board aware of at least one industry where the proposed phase 1 changes – supposedly affecting the balance sheet only - would result in a real decrease in revenue and earnings for many companies in that industry. This effect involves the utility industry, especially gas and electric utilities.

Rates that utilities can charge their customers are typically subject to regulation. The regulatory body may be the local Public Utility Commission (PUC), or it may be a group with broader authority, such as the Federal Energy Regulatory Commission, referred to as the FERC, which has regulatory authority when wholesale power is sold in more than one state. Most utilities are subject to the state PUC and/or the FERC.

The approach that a PUC may take in setting rates will vary from state to state, but it is typical for a PUC to set rates at a level estimated to allow the utility to earn a specific percentage return on equity. As an example, once an agreement is reached on units of power to be sold and allowable expenses, the rates would be set to provide, for example, a 10% return on equity.

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Because the FASB proposal to recognize the FAS 87 unfunded Projected Benefit Obligation (PBO) and the FAS 106 unfunded Accumulated Postretirement Benefit Obligation (APBO) could result in a reduction in equity for most utilities, revenue and earnings will be reduced for most utilities as well.

As an example, consider a modest sized utility with revenue of \$10 billion and income from continuing operations before income taxes and extraordinary items of \$400 million, and shareholder equity of \$4 billion. For this utility, the regulatory agency sets utility rates to allow for a 10% return on equity. In this case, the Phase 1 proposal would require a charge to equity of \$500 million. Following the regulatory agency's practice, this will reduce the utility's revenue and before tax earnings by \$50 million. This is a 12.5% reduction in earnings.

While it may be possible for many utilities to record a regulatory asset to offset the impact of this reduction in equity, it can be seen from a review of 10-Ks that it is common practice for PUCs to ignore the equity that results from regulatory assets when calculating the allowable return on equity.

While the reaction of the FASB might be that utilities should just convince the PUCs to ignore this adjustment to the balance sheet, it would be very difficult, if not impossible, to accomplish. PUCs are politically sensitive groups that try to balance the pressures from rate-payers with the financial needs of the utility.

We very much appreciate the opportunity to provide comments and look forward to a continuing dialogue on the issues.

Sincerely,

F. Pierce Noble, FSA, MAAA, EA

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