Accounting for Public Utilities

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Session Agenda

Ratemaking Dilemma and Accounting Implications

Plant Abandonment

Regulatory Assets and Probable

FERC Accounting Considerations
Ratemaking Dilemma and Accounting Implications
The Math Does Not Lie

Certain economics of the electric industry can be evaluated with a simple mathematical equation

\[
\text{Cost per kWh sold ($/kWh)} = \frac{\text{Cost of electricity sold ($)}}{\text{Number of kilowatt hours (kWh) consumed}}
\]
The Math Does Not Lie

The numerator is going up and the denominator may well be going down, over time, for the first time in the history of the U.S. electric industry – and this suggests a dilemma.

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<th>The Math at Work</th>
<th>The Dilemma</th>
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<td><strong>The numerator – capital costs</strong></td>
<td><strong>The numerator – operations costs</strong></td>
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Since variables affecting results will vary from company to company, every company must do its own math.
Overview of Accounting Implications

Some decisions in a rate order require careful consideration, such as:

- Cost deferrals for major newly completed plant
- Disallowances for recently completed plant or caps for plants under construction
- Depreciation adjustments
- Full rate of return allowed on cost deferrals
Phase-In Plan Considerations

Current efforts of companies and regulators to moderate or nullify rate increases

Rate programs and strategies designed to minimize rate shock in early years of in-service

These efforts are coincident with or proximate to the in-service date and rate treatment for major, newly-completed plant
Accounting for Disallowances of Plant Costs

Disallowance examples

Direct disallowance

Cost cap (applied pre-completion)
• Measure the undiscounted disallowance
• Discount the disallowance
• Continue AFUDC until plant is completed

Explicit, but indirect disallowance
• Estimate future cash flows disallowed and appropriate discount rate (e.g., allowed cost of capital)
Plant Abandonment
Abandonment – When and How

SFAS 90/ASC 980-360 addresses the accounting for abandonments

When probable asset will be abandoned, remove from CWIP or plant in service

Renewed focus today – coal plants retired early rather than deal with environmental retrofit and new gas-fired generation as a replacement
– Fact that this applies to operating plants and assets is often overlooked
Abandonment – Application to Operating Plants and Assets

Question Arises—When a company decides that an asset will be retired, is that an abandonment or simply a revised estimate of the original service life? Considerations include:

• Change in estimated life due to which circumstances
• How will you recover your unrecovered basis?
• Is something actually probable until a regulatory commission grants approval?
Abandonment – Mechanics

Need to assess the environment and the probability of abandonment

Reclassification from plant in service

Discounting if less than full return of and on
  • Amortized and accreted during recovery period
Regulatory Assets and Probable
ASC 980-340-25-1 states that the “rate action of a regulator can provide reasonable assurance of the existence of an asset.” All or part of an incurred cost that would otherwise be charged to expense should be capitalized as a regulatory asset if:

(a.) It is probable that future revenues in an amount approximately equal to the capitalized cost will result from inclusion of that cost in allowable costs for ratemaking purposes

(b.) The regulator intends to provide for the recovery of that specific incurred cost rather than to provide for expected levels of similar future costs
Incurred cost

An incurred cost is defined in ASC 980 as “a cost arising from cash paid out or obligation to pay for an acquired asset or service, a loss from any cause that has been sustained and must be paid for.”

Equity return (or an allowance for earnings on shareholders’ investment), however, is not an incurred cost that would otherwise be charged to expense.

Exceptions include

- AFUDC equity
- Alternative revenue programs
Probable

Probable is defined in ASC 450, *Contingencies*, as “likely to occur,” which is a high threshold to meet.

Probable is a matter of professional judgment.

If a recorded regulatory asset no longer meets the above criteria, the cost should then be charged to earnings.

Thus, probability assessment is continuous and must be met at each balance sheet date in order for a regulatory asset to remain recorded.
Evidence of Probable

SEC staff have unofficially suggested that evidence to support future recovery and corroborate management’s representation includes:

• Rate orders from the regulator specifically authorizing recovery of the costs in rates
• Previous rate orders from the regulator allowing recovery for substantially similar costs
• Written approval from the regulator approving future recovery in rates and
• Analysis of recoverability from internal or external legal counsel

The SEC has increasingly scrutinized documentation of the basis for recording regulatory assets.
FERC Accounting Considerations
FERC to US GAAP Accounting Differences

Examples of common differences

• Consolidation of Subsidiaries

• Current and long term classification for certain accounts such as debt, deferred income taxes, regulatory assets and regulatory liabilities
FERC to US GAAP Accounting Differences

Common differences (*cont.*)

- Accumulated cost of removal is included in accumulated depreciation for FERC reporting (classified as a regulatory liability in SEC reporting)
- Revenues and expenses from nonutility activities are classified in the “below the line” accounts under FERC reporting (typically classified within operations under GAAP)
- FERC allows reporting as regulatory assets incurred costs that can be reasonably expected to be recovered (under GAAP, amounts must be probable of recovery)
Common differences (*cont.*)

- Income tax differences – Balance Sheet
  - FERC reporting
    - Deferred income tax assets (account 190) and deferred income tax liabilities (accounts 281, 282 and 283) are presented gross
  - US GAAP reporting
    - Current deferred tax assets and liabilities are netted to a single current asset or liability
    - Long term deferred tax assets and liabilities are netted to a single long term asset or liability
Common differences *(cont.)*

- Income tax differences – Income statement
  - For FERC reporting, income tax expense amounts are classified in a variety of above the line and below the line accounts
  - Below the line income tax expense or benefit applies to the various pre tax revenue and expense amounts that are classified below the line
  - Best practice for companies - prepare a separate effective tax rate analysis for the above the line and below the line accounts
FERC to US GAAP Accounting Differences

Common differences (*cont.*)

- Uncertain tax positions
  - FERC Docket A107-2-000 (May 25, 2007) sets forth guidance
  - Certain classifications that are required or permitted under GAAP for uncertain tax positions (ASC 740-45) are not permitted under FERC reporting
FERC to US GAAP Accounting Differences

Common differences *(cont.)*

- Uncertain tax positions
  - Uncertain tax positions related to temporary differences must continue to be classified within the deferred tax accounts under FERC reporting (the liability for uncertain tax benefits under GAAP may not be combined with the deferred tax accounts)
  - Interest must be charged to account 431 and penalties must be charged to account 426.3 (under GAAP, an acceptable policy is to include interest and penalties in income tax expense)
Questions