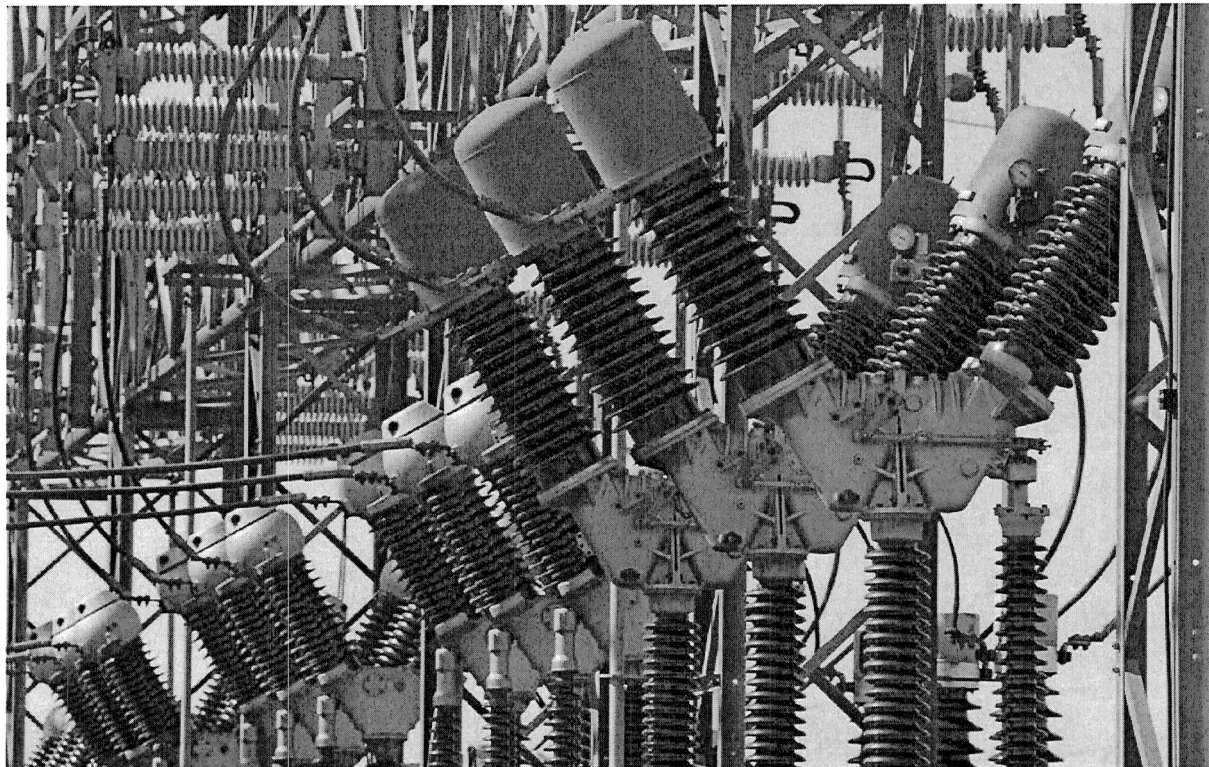


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Nonlegal Cost of Removal

Estimated cost of removal is generally recognized as an element of depreciation expense for regulatory purposes. However, on the basis of SEC guidance, costs of removal that are not a legal requirement are considered a regulatory liability under U.S. GAAP because this expense is recognized sooner than would be required or permitted under general U.S. GAAP. As a result, if the regulator orders or agrees to an adjustment of this regulatory liability, there are no U.S. GAAP restrictions that would prohibit the reversal of previously recorded accumulated cost of removal. Accordingly, a negative cost of removal amortization is appropriate, and the reversal should match the rate treatment.

Negative "True" Depreciation

Because of life extensions and other factors, some utilities have concluded that depreciable lives of some assets should be extended and, in some cases, have determined that current accumulated depreciation reserves exceed the theoretical reserve levels that would be required. The theoretical depreciation reserve requirement is generally determined in connection with the performance of a depreciation study. The theoretical excess reserve may be (1) related to a change in the estimated depreciable lives, (2) from accruals of estimated removal costs (see discussion above), or (3) both. In some cases, utilities or their regulators have proposed negative depreciation or amortization to eliminate the theoretically excess "true" depreciation reserves.

Under U.S. GAAP, generally only prospective changes in depreciation are permitted and not reversals of previously recorded "true" or regular U.S. GAAP depreciation. As a result, adjustments of depreciation expense to address theoretical excess depreciation reserves (excluding any cost of removal) should not result in net depreciation expense being less than zero for any class of assets as defined by the applicable depreciation study for any particular period. This would permit the assumed depreciable life of a class of assets to be reduced to zero for a period until the theoretical excess was eliminated, but it would not result in the actual reversal of previously recorded depreciation.

Furthermore, a utility's placement of any major, newly completed plant into service at the same time it intends to record less depreciation or amortization than it would record under general U.S. GAAP to adjust excess depreciation reserves may conflict with the guidance in ASC 980-340 (as discussed below) because negative depreciation is not a rate-making method that has been routinely used by any regulator before 1982.

Phase-In Plans

ASC 980-340 defines a phase-in plan as any method of recognition of allowable costs in rates that (1) "was adopted by the regulator in connection with a major, newly completed plant of the regulated entity or of one of its suppliers or a major plant scheduled for completion in the near future," (2) "defers the rates intended to recover allowable costs beyond the period in which those allowable costs would be charged to expense under [U.S. GAAP] applicable to entities in general," and (3) "defers the rates intended to recover allowable costs beyond the period in which those rates would have been ordered under the rate-making methods routinely used prior to 1982 by that regulator for similar allowable costs of that regulated entity."

ASC 980-340 also prohibits the capitalization of the allowable costs that are deferred for future recovery by the regulator under a phase-in plan. A regulatory order that modifies the recording of depreciation or other allowable costs to normalize the return on equity for customer rates associated with a newly completed major capital project (including a capital lease) may meet the definition of a phase-in plan.

* Abandonment Accounting, Including Impairment Considerations

ASC 980-360 provides guidance on two topics related to rate-regulated utilities: accounting for abandonments and disallowances of recently completed plants. The provisions in ASC 980-360 on plant abandonment apply to an operating plant or a plant under construction. When it becomes probable that an operating or under-construction plant will be abandoned, the associated cost should be removed from plant-in-service or construction work in progress, respectively.

Impairment Considerations

ASC 360-10-35 addresses financial accounting and reporting for the impairment or disposal of long-lived assets. This standard applies to all entities, including rate-regulated utilities. Specifically, ASC 360-10-35 states that a long-lived asset (asset group) is tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. ASC 360-10-35 notes the following as an example of such events or changes in circumstances: a current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life. The term “more likely than not” refers to a level of likelihood that is more than 50 percent.

For long-lived assets to be held and used, ASC 360-10-35 requires the recognition of an impairment loss only if the carrying amount of a long-lived asset is not recoverable from its undiscounted cash flows. It states that an impairment loss is measured as the difference between the carrying amount and fair value of the asset.

In applying ASC 360-10-35, an entity must determine the asset grouping for long-lived assets. ASC 360-10-35-23 states that “for purposes of recognition and measurement of an impairment loss, a long-lived asset or assets shall be grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities.” For plants, the asset grouping should take into account all relevant facts and circumstances. In some cases, cash flows are identifiable at the individual plant level. In other cases, a group of plants (and related customer contracts) may constitute an asset group. For many rate-regulated utilities, the entire generating fleet as well as purchased power is used to meet the utility’s obligation to serve, and the revenues from regulated customers cannot be identified to any subset of assets. Accordingly, many utilities have concluded that the lowest level of identifiable cash flows is related to the entire regulated generating fleet or a larger group of regulated assets. Support for grouping assets in a rate-regulated environment is discussed further below.

In its May 29, 1998, letter to representatives of various major accounting firms, the SEC staff stated the following, which continues to provide relevant guidance on applying ASC 360-10-35:

When performing an impairment calculation in accordance with FASB Statement No. 121 [which has been superseded], we would expect plant assets to be grouped at the lowest level of identifiable cash flows that are largely independent of the cash flows of other plant assets. We presume that generally would be on an individual plant basis, however, we understand that there may be circumstances where aggregation on some other level would be appropriate. We do not believe that an entity may solely rely on the manner in which those assets are intended to be managed in order to make the aggregation decision.

Once the utility industry started its now delayed shift from a focus on cost recovery (i.e., regulated) to being a low-cost provider (i.e., deregulated), decisions were increasingly made on an asset- or plant-specific basis by both management and regulators. This change was evident in regulatory jurisdictions that adopted industry restructuring plans and in the financial statements of affected entities that discontinued ASC 980-10 and applied the provisions of ASC 980-20. In practice, such entities generally performed impairment tests pursuant to ASC 360-10-35.

However, for rate-regulated utilities that continue to be subject to traditional, cost-based rate regulation, some grouping of assets is appropriate, even though discrete cash flows could be identified at a lower level of aggregation. The guidance and examples in ASC 360-10-55-35 through 55-36 indicate that long-lived assets could be grouped when there is a service obligation (and pricing of services) on the basis of the operations of the group of assets as a whole.

An electric utility that is subject to traditional, cost-based rate regulation and uses various sources of generation to fulfill its service obligation would illustrate this grouping concept. An electric utility's generating mix could range from high-cost nuclear power plants and peaking units to lower-cost fossil fuel units and inexpensive hydro-electric facilities. Because this collection of plant assets is used together to meet the electric utility's service obligation and produce joint cash flows (generally based on system-wide average costs), such plant assets are interdependent and potentially could be grouped for recognition and measurement of an impairment loss under ASC 360-10-35.

Facts and circumstances should govern the level at which entities perform the ASC 360-10-35 impairment analysis. Among regulatory jurisdictions, such facts and circumstances will differ depending on the status of industry restructuring toward competition and on an entity's operating characteristics.

*** Abandonment Accounting**

As stated above, ASC 980-360 provides guidance on accounting for abandonments of plants in a rate-regulated environment and states that when it becomes probable that an operating or under-construction plant will be abandoned, the associated cost should be removed from plant-in-service or construction work in progress, respectively. ASC 980-360 further provides that if the regulator is likely to provide a full return on the recoverable costs, a separate asset should be established with a value equal the original carrying value of the abandoned asset less any disallowed costs. If the regulator is likely to provide a partial return or no return, the new asset value should equal the present value of the future revenues expected to be provided to recover the allowable costs of the abandoned plant and any return on investment. The utility's incremental borrowing rate should be used to measure the present value of the new asset. Any disallowance of all or a part of the cost of the abandoned plant should be recognized as a loss when it is both probable and estimable. During the recovery period, the new asset should be amortized to produce zero net income on the basis of the theoretical debt and interest assumed to finance the abandoned plant. ASC 980-360 outlines the specific guidance.

SAB Topic 10.E states that losses recorded pursuant to ASC 980-360 should not be reported as an extraordinary item. In addition, ASC 980-360 also implies that extraordinary item treatment of losses from abandoned plants is precluded. When a utility follows the traditional rate-regulated utility reporting format, the effects of a cost disallowance based on ASC 980-360 should be reported gross, as a component of other income and deductions (below the line) and not shown net of tax.

Matters Related to Abandonment Accounting

The discussion above describes the overall accounting model for plant abandonments in a regulated environment; however, a careful assessment of a utility's facts and circumstances is required in the determination of what constitutes abandonment of a plant and the likelihood that abandonment will occur. While ASC 980-360 provides no explicit guidance on what constitutes an abandonment of an operating asset, typically a plant that will be retired in the near future and much earlier than its previously expected retirement date is subject to the ASC 980-360 disallowance test. Alternatively, if a plant is to be retired, but not in the "near future" and not "much earlier than its previously expected retirement date," then use of abandonment accounting in accordance with ASC 980-360 may not be appropriate. Instead, the appropriate accounting may be to modify the remaining depreciable life of the plant in accordance with ASC 360-10-35. Under this accounting, depreciation would be accelerated to fully depreciate the plant to the abandonment date (early retirement date). Determining what constitutes an abandonment is a matter of judgment. Below are factors to consider in evaluating whether a plant is being abandoned:

- Change in remaining depreciable life of the operating asset is modified outside the utility's normal depreciation study.
- Any accelerated depreciation due to a change in depreciable life is not reflected in rates currently or expected to be reflected in rates in the near future.
- The plant is to be retired sooner than its remaining useful life and in the near future.
- Reduction in estimated remaining depreciable life is reduced by more than 50 percent.

Other matters that should be considered related to a probable abandonment of a plant would be the abandonment's impact on related items such as materials and supplies and asset retirement obligations directly associated with the plant.

Disallowances of Recently Completed Plant

As noted above, ASC 980-360 provides guidance on accounting for both abandonments and disallowances of recently completed plants. If a rate-regulated utility has an unregulated affiliate with costs recorded for a recently completed plant, such costs should be evaluated for impairment under ASC 360-10-35. If the affiliate transfers the recently completed plant costs to the rate-regulated utility, and such costs are then subject to the provisions of ASC 980-10, an impairment determination should be made under ASC 980-360 when the transfer is recorded.

There is no specific guidance in ASC 980-360 or ASC 360-10-35 defining a "recently completed plant" nor is there specific guidance in ASC 980-340 defining a "newly completed plant." It is reasonable to conclude that both terms should have the same definition. However, in practice these terms have been effectively defined on the basis of facts and circumstances, so some diversity has resulted. The starting point for determining what constitutes a recently or newly completed plant, for both a self-constructed and acquired plant, is typically the time from the completion in-service date until the plant owner files its initial rate request for inclusion of the plant in allowable costs. If that period approximates 12 months or less, it would also be reasonable to conclude that the plant is recently or newly completed under ASC 980-360 and ASC 980-340.

Disallowances

ASC 980-360 stipulates that, when a direct disallowance of the cost of a recently completed plant becomes probable and estimable, the estimated amount of the probable disallowance must be deducted from the reported cost of the plant and recognized as a loss. Future depreciation charges should be based on the written-down asset basis.

Disallowances of costs for plants that are not recently completed are recognized in accordance with U.S. GAAP as applied by enterprises in general. An explicit, but indirect, disallowance occurs when no return or a reduced return is permitted on all or a portion of the new plant. In the case of indirect disallowances, if the regulator does not specify the amount of the disallowance, the amount must be calculated on the basis of estimated future cash flows. To determine the loss resulting from an indirect disallowance, entities should estimate and discount the future revenue stream/cash flows allowed by the regulator by using a rate consistent with that used to estimate the future cash flows. This amount should be compared to the recorded plant amount, and the difference recorded as a charge to current earnings. Under this discounting approach, the remaining asset should be depreciated in a manner consistent with the rate-making and in a manner that would produce a constant return on the undepreciated asset that is equal to the discount rate.

Impact of Subsequent Events Related to Regulatory Matters

Developments often occur in regulatory proceedings after the balance sheet date but before financial statements are issued. The discussion below (1) outlines the accounting framework companies should use in considering the impact of subsequent events in general and (2) presents some examples in which the framework is applied to situations faced by P&U companies.

ASC 855 prescribes the accounting for events and transactions that occur after the balance sheet date but before financial statements are issued. Under ASC 855, there are two types of subsequent events. Type 1 subsequent events provide additional evidence about conditions that existed as of the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Type 1 subsequent events are recognized in the financial statements. Type 2 subsequent events are those that provide evidence about conditions that did not exist as of the date of the balance sheet but arose after that date. Type 2 subsequent events are not recognized in the financial statements, but material Type 2 events should generally be disclosed in the financial statements.