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Guide to Accounting for Utilities and Power Companies

2013

Attachment C

Figure 18-2
Accounting for Impairments of Utility Plant

	Initial Measurement	Subsequent Measurement
Abandonments (UP 18.7.1)	• Loss on abandonment is measured based on difference between carrying value and present value of future cash flows (ASC 980-360-35) • Any amounts to be recovered are recorded as a regulatory asset	• Record subsequent changes in recovery amounts as an adjustment to the regulatory asset
Disallowances of recently completed plant (UP 18.7.2)	• ASC 980-360-35 requires loss recognition of any disallowance as a reduction of the utility plant balance	• Record subsequent regulatory recoveries as utility plant
Other utility plant impairments (UP 18.7.3)	• ASC 360 two-step impairment model requires assessment upon a triggering event; any impairment is measured based on fair value • Any impairment is a reduction to the utility plant balance	• ASC 360 does not allow subsequent increases in plant • Record regulatory recoveries, if any, as a regulatory asset

Considerations in applying these models are discussed in the following sections. See UP 17.6.3 for further information on utility plant impairment when a regulated utility is discontinuing the application of ASC 980.

18.7.1 Abandonments

A regulated utility may abandon construction of utility plant or plant in service due to various factors, including increasing costs of completing construction, expected declines in demand, or increased operating costs due to regulatory or other changes (e.g., changes in emission laws). ASC 980-360-35-1 through 35-8 provide guidance on accounting for abandonments by regulated utilities.

> **ASC 980-360-35-1**
>
> **When it becomes probable (likely to occur) that an operating asset or an asset under construction will be abandoned, the cost of that asset shall be removed from construction work-in-process or plant-in-service.**

A loss on abandonment should be recognized when it becomes probable that all or part of the cost of the asset will be disallowed from recovery in future rates and such amount is reasonably estimable. The amount, if any, that the regulated utility expects to recover should be recorded as a new regulatory asset.

The new regulatory asset is determined based on the present value of the future revenues for the allowed recovery of abandoned plant. The discount rate used to calculate the present value of future revenues should be the regulated utility's incremental borrowing rate. Regulated utilities should also consider the recovery of any asset retirement obligation in connection with the abandoned plant. Figure 18-3 highlights the concepts for calculating the value of the regulatory asset for an abandoned plant that will be recovered in rates.

Figure 18-3
Abandoned Plant Recovery

	Full Return Likely to Be Provided	**Partial or No Return Likely to Be Provided**
New asset to be recognized	Carrying basis of the abandoned plant less the amount of any cost disallowance	Present value of the future revenues expected to be provided to recover the allowable cost of the abandoned plant
Period between date asset recognized and date recovery begins	Asset is increased for carrying charges; calculated using allowed overall cost of capital in the jurisdiction where recovery will be provided	Carrying charge calculated using rate used for the present value calculation
Amortization pattern (during recovery period)	The same manner as that used for ratemaking purposes	In a manner that will produce a constant return consistent with the rate used for the present-value calculation

The guidance results in the regulated utility recording a loss in the income statement for any amounts that ultimately are not recovered through future rates, including:

- Any portion of the cost of the abandoned utility plant that is disallowed
- Any disallowance of return (i.e., a partial or no return)

The new asset and any loss to be recognized should be recorded when the loss is probable and the amount is reasonably estimable. Prior to receipt of a regulatory order, determining whether to apply the abandonment accounting model may be a matter of judgment. In most cases, the abandonment model will be applied at the time the initial rate order is received. However, the lack of a regulatory order would not preclude accounting for the abandonment if the loss is probable and reasonably estimable. Factors to consider include the nature of the abandonment, as well as the regulated utility's historical experience and past practice, and the current policies of the regulator with respect to abandonments.

If the criteria for loss recognition (i.e., the loss is probable and reasonably estimable) are not met before or at the time of a rate order, because the regulator does not finalize the amount and timing of the future revenues to be provided, the loss should not be recognized at that time. The loss should be recognized once the future cash flows are probable and reasonably estimable. See the response to Question 18-8 for information on the income statement classification of the loss.

If new information becomes available that indicates that the estimates used to record the new asset have changed, the regulated utility should adjust the amount of the asset recorded. However, no adjustment should be made changes in the regulated utility's incremental borrowing rate. Any subsequent change to the estimate of the abandonment loss should be recorded as a gain or loss in the income statement.

Question 18-4: Does the abandonment accounting model apply to all utility plant, including plant in service, or only to construction in progress and newly completed plant?

PwC Interpretive Response

ASC 980-360-35-1 states that the abandonments guidance applies to "an operating asset or an asset under construction." In the Basis for Conclusions of FASB Statement No. 90, *Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs an amendment of FASB Statement No. 71* (FAS 90), paragraph 43, the FASB provided the following context:

> Recently, abandonments of plants under construction have become more common, and some utilities have abandoned plants during the later stages of construction. In many cases, the cost of abandoned plants is much greater than in the past.

This paragraph suggests that the guidance was primarily intended to address issues associated with plants under construction; however, the final guidance specifically scopes in "operating assets." Therefore, we believe the guidance on abandonments should be applied to all abandoned plants, not just those that are newly completed or for which construction is in progress.

Question 18-5: What is the impact on the accounting for an abandonment if the plant will continue to operate for some period after the criteria for recognition has been met?

PwC Interpretive Response

As a result of ongoing changes in environmental regulations, many regulated utilities are contemplating abandoning plants that were expected to be in service for much longer periods. The Basis for Conclusions of FAS 90, paragraph 44, states, in part:

> The Board . . . has concluded that an abandonment changes the nature of the asset. A plant under construction is expected to produce utility services that have value. An abandoned plant can produce no services. Any value that results from the abandoned plant is limited to the revenues that will be furnished through the sales of services provided by other plants.

This paragraph highlights the difference between a utility plant asset, which is providing revenue through operations, and cost recovery associated with an abandoned plant. Consistent with this concept, we believe it would be acceptable to reclassify to a regulatory asset only that portion of the recovery expected to occur after the plant is abandoned. The reclassification and any related loss should be recorded at the time the abandonment becomes probable, consistent with guidance in ASC 980-360-35 discussed above. The balance still classified in utility plant should be recognized over the period remaining until the plant is abandoned. Therefore, in such situations, an adjustment to the estimated life of the asset and, accordingly, the rate of depreciation, is likely appropriate to recover the asset while it is still providing service.

18.7.1.1 Income Tax Considerations

Although the net loss on an abandonment is determined by discounting future after-tax revenues, the presentation of the loss on a net-of-tax basis is not allowed in accordance with ASC 980-740-25-1(a). As a result, the net loss on abandonment is grossed up for presentation purposes. Reporting entities should refer to the guidance in ASC 980-360-35-9 through 35-11 and ASC 980-360-55-2 through 55-13 (Example 1) when evaluating the income tax effects.

18.7.2 Disallowance of Recently Completed Plant

Some regulators require construction or management audits to assess whether expenditures incurred in construction projects have been prudent and should be included in rate base. As a result of these audits or based on other factors, regulators may partially or totally disallow capitalized construction costs from rate base, cost-of-service recovery, or both. ASC 980-360-35 provides guidance on the accounting for disallowances of recently completed plants and requires loss recognition of any disallowed amounts on a dollar for dollar basis. This model is different from the impairment model under ASC 360, which requires a recoverability test and then measures impairments by comparing the carrying value of the utility plant to its fair value. Due to the differences in loss recognition under the two models, the determination of when the guidance in ASC 980-360-35 applies is important.

In accordance with ASC 980-360-35-12, when a regulated utility concludes it is probable that part of the cost of a recently completed plant will be disallowed for ratemaking purposes and a reasonable estimate of the amount of the disallowance can be made, such amount should be recorded as a loss. In addition, a regulated utility may become aware of a disallowance prior to construction being completed, in which case a loss should be recognized at that time if the disallowance is probable. ASC 980-360-35-12 also requires recognition of a loss if part of the cost of a recently completed plant is explicitly but indirectly disallowed. An indirect disallowance occurs when, for example, no return or a reduced return on investment is permitted on all or a portion of the new plant for an extended period of time.

To determine the loss resulting from an indirect disallowance, the present value of the future revenue stream allowed by the regulator should first be calculated by discounting the expected future revenues using the last allowed rate of return. This amount should be compared with the recorded plant amount and the difference recorded as a loss. The remaining asset should be depreciated consistent with the ratemaking approach and in a manner that would produce a constant return on the undepreciated asset equal to the discount rate. Any subsequent changes in regulatory recovery are recorded as an adjustment to the utility plant balance.

Question 18-6: What is meant by "recently completed plant"?

PwC Interpretive Response

We have interpreted "recently completed plant" as utility plant, or an addition to utility plant, that has been placed in service but that has not been through an initial rate case. We do not believe the length of time between completion of the plant (or addition) and finalization of the rate case is a factor in the interpretation of what should be included within recently completed plant. The determination is based on whether the plant has previously been through a rate case after being placed in service, regardless of the length of time after completion of construction.

Question 18-7: Should the accounting for disallowances of costs of recently completed plants also be applied to cost disallowances not related to a recently completed plant?

PwC Interpretive Response

No. Prior to the codification, in the Basis for Conclusions of FAS 90, paragraph 63, the FASB considered requiring application of the loss recognition accounting to all cost disallowances by a regulator, whether related to recently completed plant or other situations. The FASB decided to limit the amendments to the specific issues that caused it to add the project to its agenda. See UP 18.7.3 for a discussion of other impairments of utility plant.

Question 18-8: Is it appropriate to record a disallowance or loss on abandonment as an extraordinary item?

PwC Interpretive Response

No. SAB Topic 10.E, *Classification Of Charges For Abandonments and Disallowances*, provides guidance on the income statement classification of losses attributable to abandoned utility plant or utility plant cost disallowances. Specifically, the guidance states that the SEC staff does not believe that such charges meet the requirements to be classified as an extraordinary item as stipulated in ASC 225. Accordingly, such amounts should be recorded within continuing operations in the statement of net income and should be separately presented. In addition, the loss should not be recorded net of taxes because such presentation would imply the losses are similar to extraordinary items.

Question 18-9: In what situations would a disallowance of part of the cost of a recently completed plant indicate that a regulated utility should consider discontinuing the application of ASC 980?

PwC Interpretive Response

The fact that a regulator is unwilling to approve rates based on the current cost of service may call into question the basic premise of ASC 980. Specifically, ASC 980-360-35-13 and 35-14 indicate that when a regulator orders a disallowance without a specific finding as to excess capacity or timing of construction, the rate order raises questions as to whether the regulated utility is being regulated based on its own cost of service.

In our view, a plant disallowance is ordinarily an unusual, nonrecurring event and is only one factor to be considered in the continued application of ASC 980. Reporting entities faced with a disallowance of recently completed plant or other