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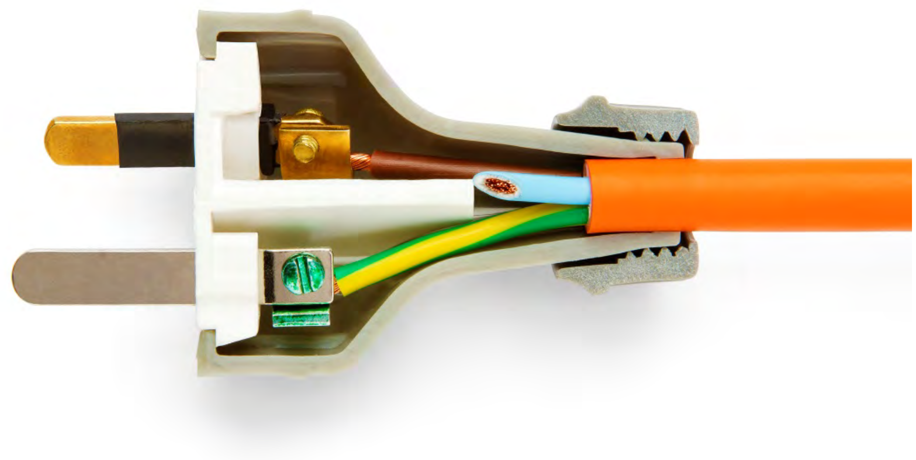
Power & Utilities quarterly accounting update — Q3 2014



September 18, 2014

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Agenda

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Presenters

Bill Graf, Partner, Deloitte & Touche LLP

Bill is an audit partner in the Chicago office of Deloitte & Touche LLP and the organization's National Professional Practice Director and industry leader for power and utilities. He also serves as the advisory partner and engagement quality control reviewer on many of Deloitte's large utility clients. Bill has provided training on regulatory and accounting matters to companies, industry groups, and regulatory agencies and has published extensively on accounting for energy companies.

Tom Kilkenny, Partner, Deloitte & Touche LLP

Tom is an audit partner in the Milwaukee office of Deloitte & Touche LLP and a Deputy Professional Practice Director for the power and utilities industry. He also serves as the lead client service partner and engagement quality control reviewer for several of Deloitte's utility industry clients. Tom has more than 30 years' experience providing audit services to companies in this industry.

Presenters (cont.)

James Barker, Partner, Deloitte & Touche LLP

James is a member of Deloitte's National Office. He is a clearing partner in Accounting Consultation where he focuses primarily on financial instrument issues and lease accounting. Prior to joining National Office, he was a partner in Deloitte's Capital Markets practice where he focused on the energy industry and served as a subject-matter expert for derivatives and hedging activities. James has advised many of Deloitte's utility clients in connection with hedging strategies for energy trading and marketing activities, as well as broader issues around derivative accounting.

Financial Reporting for Pension/OPEB Plans (ASC715)

Mortality Assumptions for 2014

Guidance

- ASC 715-30-35-42:
  - “That is, each significant assumption used shall reflect the best estimate solely with respect to that individual assumption”

- At the 2004 AICPA National Conference, Jane Poulin, an Associate Chief Accountant from Office of Chief Accountant at the SEC stated:
  - *Another key assumption in benefit plan accounting is mortality. We suspect that some plan valuations may be based on 20 year old mortality tables, even though more recent tables are available. In addition to using the* ***most recent tables****, it's important that the mortality tables used in benefit plan computations be reflective of the employee base covered under the plan.*

Recent Developments

Updates to Mortality Tables

- The Society of Actuaries (SOA) has been preparing a new mortality study
- The commonly used RP-2000 base mortality tables were based on plan experience covering 1990-1994
- SOA circulated (for public comment) a proposed new base mortality table for 2014 and new projection scale
- Comment period closed May 31, 2014
- Anticipated release date is October 31, 2014

The Draft Study

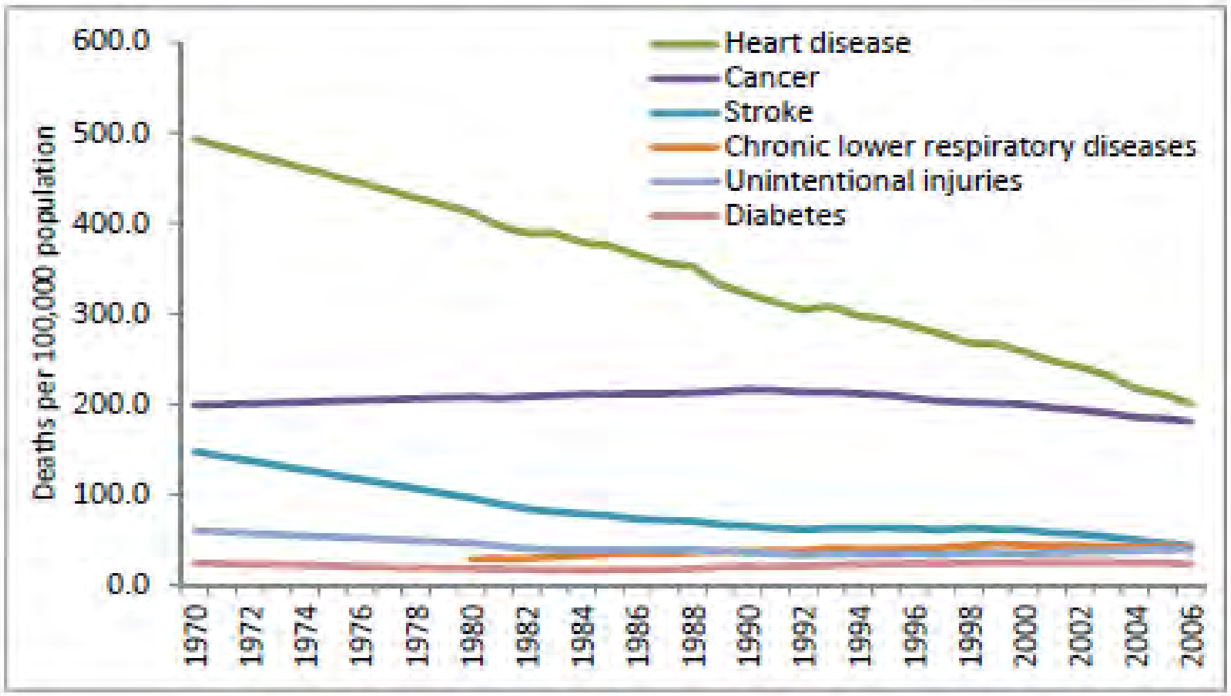
Highlights

- An update was needed—RP 2000 is now 14 years old
- Life expectancies have been rising
- No indication that improvements in life expectancies will slow down
- The new study reflects more recent experience and also assumes that improvements in life expectancies will continue

Sources of Improvement

- Recent trends in major death causes have been quite differentiated with much of the improvement in mortality arising from decreases in death from heart disease

Figure 3. Death rates for cause of death, across all ages/genders
Source: CDC/NCHS, National Vital Statistics System



Impact on 2014 Year End Measurement

Changes to Liabilities

- SOA is expected publish RP-2014 table around October 31, 2014
- A company changing from the RP-2000 table for its mortality assumption to the new table will likely see an increase in pension and OPEB liabilities
- Some companies have estimated an increase in the obligation of 5 to 10 percent

Timing and Impact

Use of Best Estimate

- ASC 715 requires explicit approach to assumption setting each significant assumption used should reflect the plan sponsor’s best estimate of plan’s future experience solely with respect to that assumption
- Companies with a year end of October 31 or later should consider the updated information in the study
- Companies should use the best estimate for the mortality assumption

Coal Ash EPA Regulation

Regulation of Ash Ponds-Current Environment

Setting the Stage

- Historically, there has not been any regulation of ash ponds at the federal level
- However, many states have had some regulation related to ash ponds
- As a result, some companies have AROs for their ash ponds in certain states as a result of the state requirements
- The EPA proposed rules in 2010 to regulate coal ash; after two rounds of public comment, the final rule is expected to be issued late in 2014
- Those rules could result in new AROs for some ash ponds where no state requirements have existed, or could result in increases in ARO estimates where coal ash has been subject to state requirements

Introduction to US EPA Proposed Rules

About the Proposed Rules

- In August 1993 and May 2000, EPA concluded that disposal of coal combustion residuals “CCRs”) should be regulated as **solid waste** (Subtitle D), not hazardous waste (Subtitle C)

- However, EPA never issued federal regulations for this coal ash deemed to be solid waste

- In response to the TVA spill, the EPA commenced efforts to regulate coal ash

- The EPA has proposed rules on the determination of how to regulate the disposal and management of coal ash (i.e. solid waste vs. hazardous waste)

- The proposed rules contain two approaches (Subtitle C and D)

Introduction to US EPA Proposed Rules (cont.)

About the Proposed Rules

- Most observers anticipate the EPA pursuing a Subtitle D rule—i.e. continue to label this waste **solid waste**
- Even if EPA labels the waste solid waste, the new rule would now regulate these CCR's under Subtitle D or Subtitle D prime
- Difference between Subtitle D and Subtitle D prime:

  - Under D prime, existing surface impoundments would not have to close or install composite liners, but could continue to operate for their useful lives

Proposed Rule Options – RCRA C vs D

Key Differences Between Subtitle C and Subtitle D Options		
	SUBTITLE C	SUBTITLE D
Effective Date	Timing will vary from state to state, as each state must adopt the rule individually-can take 1 – 2 years or more	Six months after final rule is promulgated for most provision: certain provisions have a longer effective date
Enforcement	State and Federal enforcement	Enforcement through citizen suits; States can act as citizens.
Corrective Action	Monitored by authorized States and EPA	Self-implementing
Financial Assurance	Yes	Considering subsequent rule using CERCLA 108 (b) Authority
Permit Issuance	Federal requirement for permit issuance by States	No
Requirements for Storage, Including Containers, Tanks, and Containment Buildings	Yes	No
Surface Impoundments Built Before Rule is Finalized	Remove solids and meet land disposal restrictions; retrofit with a liner within five years of effective date. Would effectively phase out use of existing surface impoundments	Must remove solids and retrofit with a composite liner or cease receiving CCRs within 5 years of effective date and close the unit
Surface Impoundments Built After Rule is Finalized	Must meet Land Disposal Restrictions and liner requirements. Would effectively phase out use of new surface impoundments.	Must install composite liners. No Land Disposal Restrictions
Landfills Built Before Rule is Finalized	No liner requirements, but require groundwater monitoring	No liner requirements, but require groundwater monitoring
Landfills Built After Rule is Finalized	Liner requirements and groundwater monitoring	Liner requirements and groundwater monitoring
Requirements for Closure and Post-Closure Care	Yes; monitored by States and EPA	Yes; self-implementing

http://www.epa.gov/osw/nonhaz/industrial/special/fossil/ccr-rule/ccr-table.htm

EPA's Estimate of Cost of Proposed Regulation

Present Value of Proposed Cost of Regulation (millions)			
	Subtitle C	Subtitle D	Subtitle "D prime"
Total Regulatory Costs:	$20,349	$8,095	$3,259
Engineering Controls	$6,780	$3,254	$3,254
Ancillary Costs	$1,480	$5	$5
Conversion to Dry CCR Disposal	$12,089	$4,836	$0

Source - Table 10—Comparison of Regulatory Benefits to Costs of Docket ID No. EPA-HQ-RCRA-2009-0640

Impact of New Rules on Active Facilities

About the Proposed Rules

Most observers anticipate the EPA will select the RCRA Subtitle D proposal (not a hazardous waste). The EPA is currently expected to issue a final rule on December 19, 2014.

- The rule will be effective 180 days after promulgation.
- Puts a closure date on most existing facilities of the sooner of 5 years or 30 days after receipt of last waste – Closure would begin immediately on retired structures. An amendment to the D closure – D-Prime, could alter this requirement.
- Requires all new construction to meet RCRA Subtitle D standards.
- 30yr Post Closure Care period – including operations, management, and monitoring (OM&M).
- Enforcement managed at the state level. There is an opportunity for individual states to be more restrictive (but not less).

The Challenge of ARO Accounting

- If the final rule is published before year end, that may trigger a new ARO or a change in estimate of an existing ARO for some ash pond sites

- Companies should be prepared to estimate the ARO liability at year-end 2014

- The key assumptions needed to estimate an ARO for an ash disposal site are:
  - Volume of ash
  - Costs for handling the ash
  - Timing of cash payments

- Given complexity involved in estimating, companies should consider starting the estimation process soon since a liability could be incurred when the final rule is published

Closure Scenarios and Observations on Estimates

At closure there are typically three options for permanent closure with each option having a number of assumptions critical to the development of a cost estimate. The following are assumptions where we have observed significant diversity in practice.

Off-Site – Excavation and disposal off-site	• Volume for Relocation • Disposal facility identification and costs
On-Site Consolidation	• Volume for Relocation • Cost to move
On-Site In Place	• Volume to achieve closure grades • Sourcing fill materials and cost

Observations on Estimates - Volumes

In any closure scenario an Entity will have to estimate the volume of either CCR or fill materials required for closure.

CCR

- Estimates may be based on historic information which has not been updated or verified.
- Survey data should be used to verify upper extents of CCR. Core sampling could be used to estimate lower extents and to assess density of CCR materials.
- We have observed significant changes in estimates following the completion of surveys.

Fill Material

- Slope required to achieve drainage grade should be considered in closure estimates. Fill material required to achieve grade should be calculated and material source should be identified
- We have observed fill to achieve drainage not being considered or insufficient grades being used.

Observations on Estimates - Costs

Costs associated with closure activities should be estimated and assumptions documented. Assumptions should be site specific and average numbers should be avoided without sufficient evidence of similarity across multiple sites.

Off-Site Disposal

- For off-site disposal a facility should be identified and costs for transportation and disposal rates should be determined and updated annually.
- Disposal costs are typically site specific and may vary significantly even regionally.

Closure Materials and Tasks

- Volume of material should be estimated and cost support should be developed for those materials. For fill materials a source should be identified and costs to transport determined and updated.
- Costs for major tasks including CCR handling, earthwork, and O&M should be estimated and supported.

FASB Project Update:

Customer's Accounting for Fees in a Cloud Computing Arrangement

Background

What is a Cloud Computing Arrangement?

- Clouds can take various forms, from a singe software application to outsourcing of an entity's IT infrastructure
- Over the past several years, cloud computing has revolutionized the business and technology landscape, offering more flexible and lower-cost IT solutions that allow businesses to outsource their traditional ERP systems or any other on-site application to an off-site, on-demand solution
- Cloud arrangements can be structured in various ways, including:
  - Public clouds
  - Private clouds
  - Community clouds
  - Hybrid clouds

Background

- Issue :
  - Current GAAP does not provide explicit guidance on how customers should account for fees in a cloud computing arrangement
  - Various costs to consider
    - Web site development
    - Development or acquisition of software
    - Infrastructure purchases
    - Contract & acquisition
    - Maintenance for ongoing services

- Diversity in practice exists in accounting for these arrangements
- Companies have been analogizing to various literature:
  - ASC 350-40 (internal use software)
  - ASC 360 (dedicated server or other equipment)
  - ASC 840 (operating vs. capital leases)
  - ASC 985-20 (costs of software to be sold)

FASB Update

- Added to technical agenda on April 28, 2014, and discussed at the June 18, 2014 FASB Meeting

- Project taken up by FASB under the Simplification Initiative

- Exposure Draft issued August 20, 2014, with comment deadline of November 18, 2014

- Proposed effective date:
  - Public Entities – effective for annual periods, including interim periods within those annual periods, beginning after December 15, 2015.
  - Other Entities – effective for annual periods beginning after December 15, 2015, and interim periods in annual periods beginning after December 15, 2016

- Reporting entities may elect retrospectively or prospectively

Exposure Draft Highlights

- Adds guidance to ASC 350-40
- Based on the proposed ASC 350-40-15-4C, it is anticipated that many of the cloud arrangements would fall under the service contract model; however, the ED does not give clarity on how to account for service contracts
- ASC 350-40-15-4A provides clarification on when an arrangement has an internal-use software element
- Companies must continue to analogize to other guidance to assess overall accounting for a cloud computing arrangement:
  – Need to consider if software will be sold, leased, or marketed (ASC 985-20), or if the software is for internal use (ASC 350-40)
  – Web Site Development—ASC 350-50 provides guidance on capital vs. expense for each of the stages of development
  – Contract Acquisition Costs – SEC has stated “expensing customer or contract acquisition is almost always acceptable,” but also need to consider ASC 310-20 or ASC 605-20
  – Maintenance Costs – Generally expensed (ASC 350-40 and ASC 985-20)

Regulatory Accounting Reminders:

Phase-in Plans
Cost Caps & Disallowance

Regulatory Accounting Reminders

- **Phase-in Plan**
  - Cost deferrals not permitted for Phase-in Plans
  - Any deferral of cost on a major, newly completed plant is likely a Phase-in Plan
  - Refer to criteria at ASC 980-360-20

- **Cost Caps and Regulatory Disallowances**
  - In comment letters, SEC staff has requested disclosure when cost caps exist about estimated costs and detail of costs that could change during construction
  - SAB Topic 10.E (ASC 980-360-S99-2) requires "disallowed costs for recently completed plants to be charged to expense when the disallowances becomes probable and reasonably estimated."

Topics:

- Revenue Recognition
- Lease Accounting

Revenue Recognition

Revenue Recognition

Industry Considerations

AICPA P&U Task Force:

- Reps from companies, EEI and accounting firms
- Tasked with identifying top implementation issues and developing guidance

Areas of Focus:

- Scope clarification for tariff based sales
- Variable consideration scenarios
- Contract modifications including blend-and-extend
- Implications for bundled sales
- Sales of PP&E (including partial sales)

Timing Considerations:

- Task force timeline
- Potential for deferral of effective date?

Leases Project

Leases Project

Highlights of 2014 Redeliberations

- Short-term lease exception broadened
- Exception for small ticket items considered
- Raising the bar on substitution rights
- Lessor accounting
- Nature of a lease (Type A vs. Type B)
- Various reassessment requirements
- Presentation of lease activity
- Sale leaseback accounting
- Leveraged lease grandfathered

<u>To be continued:</u>

– Lessee dual approach model (and small ticket exemption)
– Control when more than one party has decision-making rights
– Transition and effective date

Accounting for Business Combinations of Power & Utility Companies

Topics:

- Hierarchy and Application of Applicable GAAP
- Valuation of Assets and Liabilities
- Applicability of Regulatory Offset
- Substance of Goodwill in an ASC 980 Acquisition
- Other Common Questions and Items

Applicable GAAP

Valid and Appropriate Considerations of :

- ASC 805, *Business Combinations*
- ASC 820, *Fair Value Measurement*
- ASC 980, *Regulated Operations*

Rate Base Assets, including Property, Plant and Equipment

Relevant considerations include:

- ASC 820, Highest and Best Use
- Original Cost Ratemaking
  - Recoverability Typically Limited to Original Cost
  - Provision for Plant Acquisition Adjustment
  - Treatment of Accumulated Depreciation
- Restrictions on Use of Rate Base Assets
  - Impact of Regulation on Valuation
  - Regulatory Commission Approval of Asset Disposition

Other Balance Sheet Items

- Regulatory Assets and Liabilities
- Assumed Debt and Asset Retirement Obligations
- Pension Obligations
- Working Capital Components

Consideration of Other Potential Fair Value Items

- Intangible Assets
- Executory Contracts, Including Energy Contracts Subject to a Reconciling Energy Clause
- Leases
- Derivatives, Including Impact of a Normal Purchase, Normal Sale Election for Certain Transactions

Application of Regulatory Offset

When Is It Appropriate to Have a Regulatory Offset?

- Considerations Inherent in Original Cost Ratemaking
  - Premise in and application of ASC 980
- Gains and Losses on Disposition of Assets or Settlement of Liabilities Addressed in the Ratemaking Process

Accounting for Goodwill

- ASC 805 Definition: An asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by a not-for-profit entity that are not individually identified and separately recognized

  (AKA: Consideration > Identifiable Assets Acquired and Liabilities Assumed)

- Going Concern Aspects Representing Existing Assembled Assets and Work Force That Cannot Be Duplicated At The Same Cost by a New Entrant

- Significant and Insurmountable Barriers to Entry

- Franchise Rights and Other Intangibles Not Separately Identifiable Because Inextricably Linked to Utility Service

Registrant Considerations

- SEC Staff Commentary:

In addition, please further explain your statement that " since XX Company records assets and liabilities resulting from the rate making process, the fair values of the individual assets and liabilities are considered to approximate their carrying values." If your above assertion is appropriate, explain to us in detail why you are paying more than their fair values for these assets and liabilities.

Registrant Considerations

- SEC Staff Commentary:

We are unclear as to why any goodwill would result from the acquisition of the regulated delivery operations as no apparent synergies will be created from the acquisition of the regulated business. Further, your implicit assumption appears to be that the fair value of regulated assets is equal to their carrying value because future recovery of historical cost plus a return in rates would be equal to the discounted cash flows assuming the rate of return is the discount rate. Assuming that the fair value of the regulated delivery segment is its discounted cash flows and the rate of return represents the appropriate discount rate, it appears inconsistent to allocate additional fair value to the regulated operations in excess of their carrying value. To reflect a fair value in excess of the carrying value of the regulated operations would suggest that the total future cash flows expected to be recovered would be discounted at a rate other than the rate of return authorized, the cash flows assumed in the fair value determination differ from what is assumed will be recovered in rates or some combination of the two.

Other Common Questions and Items

- Conforming Accounting Policies
- Use of Push Down Accounting in Subsidiary Registrant Financial Statements
- Asset Versus Business Acquisition
- Regulatory Compacts and Future Commitments
  - Agreed-Upon Rate Decreases
  - Contributions to a Local Environmental Clean Up Fund
  - Specifications Around an Integrated Resource Plan
  - Maintain a Geography Presence for a Period

Questions

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