Energy Accounting, Financial Reporting, and SEC Update

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SEC Environment & Rulemaking

- Political environment
- Strong enforcement program
- Dodd-Frank and JOBS Acts
- Disclosure effectiveness
- Implementation of new revenue recognition standard
- IFRS
- Audit committee report concept release
- PCAOB standard setting agenda
- Cybersecurity

Enforcement

	FY 2015	FY 2014	FY2013
Number of enforcement actions	807	755	676
Orders for penalties and disgorgements	$4.2 billion	$4.2 billion	$3.4 billion
Whistleblower tips received	3,923	3,620	3,238

Policy-related initiatives

- Admission of wrong-doing
- “Broken windows” policy

Financial Reporting and Audit Task Force

- Identify violations related to financial statements, reporting and disclosures, and audit failures
- Monitor restatement activities and analyze industry performance trends
- Use of technology and tools for “data mining” and data analysis

SEC review process

About 9,000 registrants

Focus on 2,500 registrants that comprise 98% of market cap

All issuers reviewed at least 1 out of every 3 years

Percentage of issuers reviewed:

FY10	FY11	FY12	FY13	FY14	FY15
44%	48%	48%	52%	52%	51%

Staff review is not limited to “four corners of the document” – may listen to analyst/earnings calls, review press releases, websites, etc. and issue comments

Comments are posted to EDGAR 20 days after completion of review

Disclosure Effectiveness

What is it?

- Providing better information to investors – more understandable, more useful and eliminating excessive disclosure
- Could result in additional disclosure

What has the SEC staff done lately?

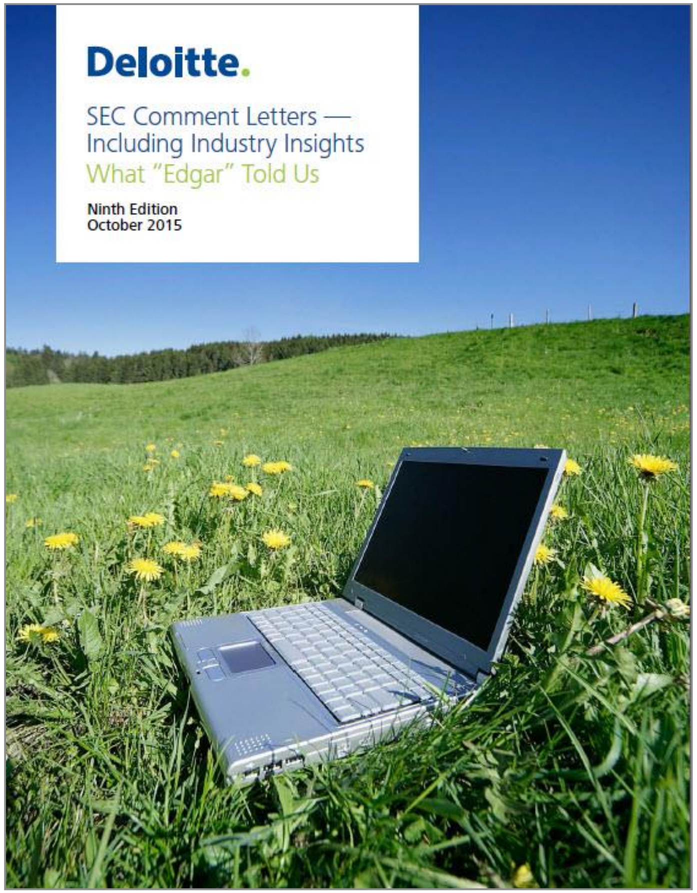
- Request for comment on financial disclosures about entities other than the registrant
- S-K concept release – comments due July 21, 2016

What's next?

- Staff to make specific recommendations including input from issuers and investors

1. Focus on material and relevant matters
2. Reduce or eliminate redundant disclosures
3. Tailor disclosures to company's facts and circumstances

SEC Comment Letter Trends



Insights into areas the SEC staff has focused on in recent comment letters including:

- Financial Statement Accounting and Disclosure Topics
- SEC Disclosure Topics
- Disclosure Topics in Initial Public Offerings
- Industry-Specific Topics
  - Consumer & Industrial Products
  - **Energy & Resources**
  - Financial Services
  - Health Sciences
  - Technology & Telecommunications

SEC Comment Letter Trends: Overall Summary

Topic		12 Months- 7/31/15		12 Months- 7/31/14	
		Rank	Frequency*	Rank	Frequency*
MD&A: • Results of operations • Liquidity issues • Critical accounting policies, estimates		**1**	23% 11% 9%	**1**	23% 15% 11%
Fair value measurement, estimates		**2**	22%	**2**	25%
Revenue recognition		**3**	15%	**4**	14%
Non-GAAP measures		**4**	14%	**6**	13%
Signatures, exhibits, agreements		**5**	12%	**3**	17%
Income taxes		**6**	11%	**5**	13%
Segment reporting		**7**	10%	**10**	10%
Acquisitions, mergers, business combinations		**8**	10%	**7**	12%
Property, plant, and equipment; intangible assets; and goodwill		**9**	9%	**8**	11%
Debt, warrants, equity securities		**10**	8%	**11**	10%

* Percentage of all 10-Ks and 10-Q comment letter-yielding reviews that included at least one comment on the respective topic.

SEC Comment Letter Trends

Power and Utilities

- Dividend restrictions
  - Footnote disclosures
  - Schedule of parent company financial information
- Accounting for impacts of ratemaking
- Regulatory disallowance of PP&E
- Identification of possible phase-in plans

Non-GAAP Measures

Considerations

- Cannot be misleading
  - Nature of adjustments (elimination of normal recurring operating expenses, “cherry picking”, non-GAAP revenue)
  - Liquidity per share amounts
- Not more prominent than GAAP measure
- Appropriately defined, described, labeled and reconciled
- Substantive disclosure about why useful and purpose
- Income tax effects of adjustments
- Consistency between periods and comparable to peers
- Disclosure controls and procedures
- Audit Committee oversight

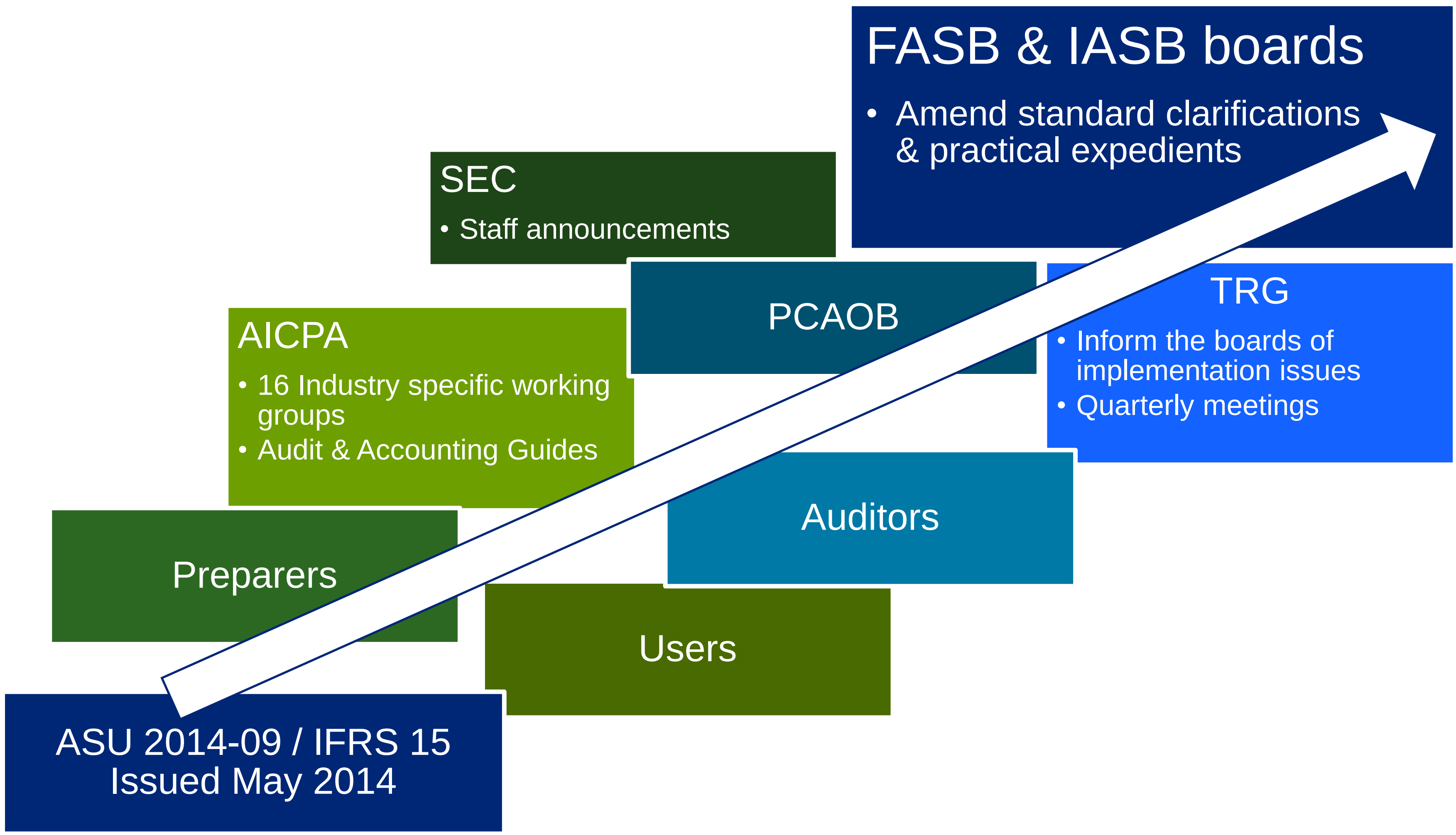
Metrics

- Energy: Price and volume detail

Questions?

Update on Power and Utility Revenue Recognition Implementation Efforts

Implementation efforts — Key participants



New revenue guidance

AICPA working groups

Purpose — To analyze implementation issues and develop a new Accounting Guide (16 industry teams)

- Aerospace and defense
- Airlines
- Asset management
- Broker-dealers
- Construction contractors
- Depository institutions
- Gaming
- Health care
- Insurance
- Not-for-profit
- Oil and gas
- Power and utility
- Software
- Telecommunications
- Timeshare
- Hospitality

P&U Task Force

Implementation Update

Industry Task Force Focus Areas	Considerations	Status
Tariff-based sales	• Scope clarification • Carve out of alternative revenue programs	• Task force consensus that tariff-based sales are in scope • RRWG and FinREC agreed with task force consensus • Next step is public exposure
Blend-and-extend contract modifications	• Does a B&E modification represent a new agreement or a separate extension? • If a separate extension, is a financing element present?	• Task force did not reach consensus on B&E treatment • Issue was elevated to the FASB staff for a Technical Inquiry • FASB staff believes both views can be supported
Step vs. Strip Pricing	• Can same performance result in different revenue profiles?	• Task force consensus that different revenue profiles can be supported • RRWG agreed – next step FinREC

P&U Task Force

Implementation Update

Industry Task Force Focus Areas	Considerations	Status
Variable consideration	• Dealing with various forms of price and volume variability • Application of the constraint guidance	• General view that many forms of price variability can be linked to discrete delivery of power • Task force view that volume variability will often represent optional purchases (e.g. requirements contract)
Partial Terminations	• Timing of P&L – Immediate or over remaining term?	• Task force consensus differs from Big 4 feedback • Issue to be elevated to RRWG
Bundled arrangements (e.g. PPAs)	• Identification of separate performance obligations • Allocation of transaction price • Timing of revenue (customer control)	• Task force consensus on treatment • Focus on items that do not transfer to customer contemporaneously • Consideration of level of integration of products/services • Separate analysis of RECs and capacity

P&U Task Force

Implementation Update

Industry Task Force Focus Areas	Considerations	Status
Sales of RECs	• Eligible to be accounted for as a series? • Transfer of control upon generation of electricity or certification?	• Consensus reached at March meeting • Recognition of revenue upon generation • Paper being finalized for RRWG consideration
Sales of Capacity	• Stand ready = service • Application of the series guidance • Time-based measure of progress	• Consensus reached at March meeting • Focus on series guidance and ability to apply Invoice PE • Paper being finalized for RRWG consideration
Contributions in aid of construction	• Revenue vs. offset to PP&E	• Task force reached consensus at March meeting that CIAC is not revenue • Paper being finalized for RRWG consideration

P&U Task Force

Implementation Update

Industry Task Force Focus Areas	Considerations	Status
SASP for commodities	• Alternatives to the forward curve? • Replaced "series for storable commodities" issue	• FASB staff completed TI • Forward curve not required in many cases • Next step – debrief TI with RRWG and FinREC
Collectibility – Sales to low credit quality customers	• Ability to socialize credit losses through rates • Price concession?	• Added to TF agenda at March meeting • Issue paper being developed
Alternative Revenue Programs	• Presentation of revenue when billed through tariff	• Added to TF agenda at March meeting • Issue paper being developed
Sales of non-financial assets	• Replacing real estate sale rules • Partial sales – unit of account?	• Active FASB project on asset vs. business • Task force may not address

FASB's New Lease Accounting Standard

Topic 842
Issued February 2016

The "Big Picture"

Key takeaways – Refer to Deloitte *Heads Up* for Details

Most leases on balance sheet for lessees

- *Classification will drive expense profile*

Lessor model largely unchanged

- *Most changes result from alignment with ASC 606*

FASB tried to make things easy

- *Classification, reassessment, transition*

Effective 2019 but don't wait to assess impact

- *Process and systems changes may be required*
- *Potential impact on debt covenants*

Effective date and transition

Effective date

- Public business entities — effective for calendar periods beginning on January 1, 2019 and interim periods therein
- All other entities — effective for calendar periods beginning on January 1, 2020, and interim periods thereafter
- Early adoption will be permitted

Transition

- Lessees and lessors are required to use a modified retrospective transition method for all existing leases
- Would apply the new model for the earliest year presented in the financial statements
- Application of approach linked to current lease classification and new lease classification
- An entity can use hindsight when evaluating lease term

TRANSITION RELIEF PACKAGE

Lessees and lessors are not required to reassess the following upon transition:

- ✓ Whether any expired or existing contracts are leases or contain leases
- ✓ The lease classification for any expired or existing leases
- ✓ Initial direct costs for any existing leases

New Lease Accounting Standard

What are the likely implications to the industry?

Definition of a lease

- EITF 01-8 model will be replaced
  - Replaced with focus on who controls "how and for what purpose" an asset is used
  - Dispatch rights will indicate control
  - See Example 9 – Three power plant examples
- Secondary consideration of O&M <u>and</u> involvement in design
  - Approach to design inconsistent with consolidation practice
  - May impact lease decision for renewable PPAs
    - When is an off-taker deemed to have designed the plant?

Other

- Sale-leaseback rules to change
- Build-to-suit guidance overhauled (for the better)
- No more leveraged leases after effective date – existing leveraged leases grandfathered

New Lease Accounting Standard

More potential industry implications

Lessor Accounting

- Uncertainty regarding impact of <u>variable rents</u> on initial recognition of sales-type lease or direct finance lease
  - Payments are deemed variable if they are contingent on production
  - Even if they are virtually certain (e.g. P95 confidence level)
- To record STL or DFL, lessor derecognizes asset (e.g. plant) and records investment in lease
- Lease guidance will not allow variable rents to be included in the lessor's lease receivable
  - Potential to lead to inception losses
  - Use of negative discount rate?
  - Could impact sellers of renewable energy

New Lease Accounting Standard

More potential industry implications

<u>"Last Mile" Considerations</u>

- Pipeline laterals
- Implications for electric distribution?

<u>Guaranteed Min Production in Renewable PPA</u>

- Result in fixed lease payments?
- Weather neutral vs. weather adjusted

<u>Considerations for ISO participants</u>

- Right to bid = control?

<u>Curtailment Rights</u>

- Convey control to buyer?
- Difference between economic and operational?

Ratemaking Dilemma and Accounting Implications

The Math Does Not Lie…

$$\frac{\text{Cost of electricity sold (\$)}}{\text{Number of kilowatt hours (kWh) consumed}} = \text{Cost per kWh sold (\$/kWh)}$$

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

The Math at Work

The numerator – capital costs

New generation ↑
- Aging plants
- Early retirements

New transmission and distribution ↑
- Reliability
- Smart grid
- Renewable portfolio standards

Environmental – Emissions restrictions ↑
- Capital retrofits
- Parasitic load

Interest rates ↑

The numerator – operations costs

Fuel ↑
- Natural gas at historic lows

Emissions retrofits ↑

New technologies ↓

The denominator – killowatt hours consumed

New sources of demand ↑

Impact of Recession ↔

Efficiency technology advances ↓

Distributed generation ↓

The Dilemma

$$\frac{\text{Increased Costs}}{\text{Decreased kWh Consumed}} = \text{Higher Cost Per kWh}$$

Recent Trends in Ratemaking

- Some actions to keep rates down reduce earnings
  - Lower ROE
  - Assume higher sales growth for test year
  - Disallow or “cap” new plant investment amount
  - Reduce various test year costs (for example by assuming efficiencies or not allowing some elements of costs)

Recent Trends in Ratemaking

- Other actions to keep rates down potentially do not reduce earnings
  - Reduce depreciation rates prospectively
  - Refund accumulated cost of removal
  - Refund “excess” accumulated depreciation
  - Stepped rate increases for large capital project
  - Permission to defer certain costs until the next rate case
  - “Flow through” ratemaking for certain tax temporary differences
  - Use a policy for timing of including certain costs in rates more slowly than under GAAP

Overview of Accounting Implications

- Ongoing application of ASC 980
- 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
  - Deferral of various test year costs to a future rate case
  - 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—see also “planned” and “accidental”

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 Abandonments

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
- Frequent application today – older plants retired early rather than adding pollution control equip
  - Fact that this applies to operating plants and assets is often overlooked

Abandonment Considerations

- Question Arises— When my 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 your regulatory commission approves it

Proposed Pension Accounting Standard Update

Proposed Pension ASU – Overview

- Currently, no specific US GAAP guidance on presenting net benefit cost in the income statement
  - Net benefit cost comprised of several components that reflect different aspects of an employer's financial arrangements and the cost of benefits
- Proposed amendments would require an entity to present
  - **Current service cost component** of net benefit cost with other compensation costs for the related employees
  - **Remaining components** of net benefit cost elsewhere in the income statement
    - Outside of income from operations, if such a subtotal presented
    - Disaggregation of the other components permitted, but not required
- Proposal would limit the portion of net benefit cost eligible for capitalization to **current service cost component**

Questions?