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Powering Up the New Leases Standard

The Bottom Line

- The FASB issued [ASU 2016-02](#),¹ its final standard on leases, on February 25, 2016, and the IASB issued its final standard, IFRS 16,² on January 13, 2016. The primary objective of the leases project was to address the current off-balance-sheet financing concerns related to a lessee's operating leases.
- When entities are determining whether a contract is or contains a lease under the new standard, they will need to assess whether (1) performance of the contract depends on the use of an identified asset and (2) the customer obtains the right to control the use of the identified asset for a particular period. Control of the right to use an identified asset under ASC 842 is different from the assessment that is required under today's guidance and therefore may affect the determination of whether an off-take arrangement (e.g., a power purchase agreement (PPA)) is a lease.
- Although the FASB and IASB agreed to bring most leases onto the balance sheet for lessees and reached agreement on a lessee's initial measurement of the related assets and liabilities, the boards differed on the lessee's subsequent measurement. The FASB decided on a dual-model approach, while the IASB will require a single-model approach.
- The renewable energy sector may see significant changes and experience challenges as a result of ASC 842, particularly in an entity's determination of whether the contract is or contains a lease (e.g., in the assessment of the impact of involvement in the generating asset's design and in the determination of how to evaluate certain rights that affect the operation of the generating asset).
- The new standard, which is effective for calendar periods beginning January 1, 2019, for public business entities and January 1, 2020, for all other entities, represents a significant change to lease accounting, and as a result, entities will face significant implementation challenges during the transition period and beyond.

¹ FASB Accounting Standards Update No. 2016-02, *Leases*. The ASU supersedes FASB Accounting Standards Codification (ASC) Topic 840, *Leases*, and creates ASC 842, *Leases*. For titles of additional ASC references, see Deloitte's ["Titles of Topics and Subtopics in the FASB Accounting Standards Codification."](#)

² The IASB issued IFRS 16, *Leases*, on January 13, 2016. For more information on the IASB's standard, see Deloitte's January 13, 2016, [IFRS in Focus](#).

Beyond the Bottom Line

This publication discusses select aspects of the FASB's final standard that are relevant to lessees and lessors in the power and utilities (P&U) industry. For a comprehensive overview of the standard, including illustrative examples, see Deloitte's March 1, 2016, [Heads Up](#).

Overview of the New Standard

Background

After working for almost a decade, the FASB has finally issued its new standard on accounting for leases, ASU 2016-02. The leases project's primary objective was to address the off-balance-sheet financing concerns related to lessees' operating leases. However, developing an approach that requires all operating leases to be recorded on the balance sheet proved to be no small task. The FASB and IASB had to grapple with matters such as (1) whether an arrangement is a service or a lease, (2) what amounts should be initially recorded on the lessee's balance sheet for the arrangement, (3) how to reflect the effects of leases in the statement of comprehensive income of a lessee (a point on which the FASB and IASB were unable to agree), and (4) how to apply the resulting accounting in a cost-effective manner.

Accordingly, the FASB's new standard introduces a lessee model that brings most leases onto the balance sheet. In addition, the standard aligns certain underlying principles of the new lessor model with those in ASC 606, the FASB's new revenue recognition standard (e.g., those that help entities evaluate how collectibility should be considered and determine when profit can be recognized). The ASU also addresses other concerns related to the current leases model, which is almost 40 years old. For example, the new standard eliminates the requirement that entities use bright-line tests to determine lease classification. The standard also requires lessors to be more transparent about their exposure to risks regarding the changes in value of their residual assets and about how lessors manage that exposure.

The changes introduced by the new leases standard may significantly affect entities in the P&U industry because of their extensive use of fixed assets under contracts that may qualify as leases under the new guidance. P&U entities often enter into agreements that are frequently customized and include services and other components critical to completing the contracts. While under current guidance the accounting for operating leases is often similar to that for service contracts, this will no longer be the case under the new standard. P&U entities will therefore need to assess many service and lease contracts to determine whether such agreements meet, or have components that meet, the new definition of a lease.

Scope

Like the scope under current requirements, the scope of the new guidance is limited to leases of property, plant, and equipment (PP&E). The scope excludes (1) leases of intangible assets; (2) leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources; (3) leases of biological assets; (4) leases of inventory; and (5) leases of assets under construction.



Thinking It Through

Under the proposal issued by the boards in May 2013, the scope of the lease accounting guidance would have included inventory (e.g., spare parts and supplies) and construction work in progress (CWIP). However, constituents expressed concerns that if the proposed guidance had applied to CWIP, build-to-suit transactions (in which the customer is involved with the construction activity) may have been accounted for as leases. In response, the FASB revisited the scope of the guidance in late 2015 and decided to limit it to PP&E. However, the FASB also decided to include guidance on a lessee's control of an underlying asset that is being constructed before lease commencement. That is, if a P&U entity that is involved in the construction of PP&E it intends to lease is determined to control the asset during the construction period, it will be considered the owner of the CWIP for accounting purposes and will need to assess the arrangement under the new standard's sale-leaseback guidance once construction is completed.

In addition, questions have arisen about whether easements and/or rights-of-way would or could be within the scope of the new standard. These questions are often based on the notion that these arrangements are intangibles and would therefore be automatically excluded from the scope of the standard. We do not believe that these arrangements are automatically excluded from the scope of the standard; rather, we believe that they would require analysis to determine whether they represent leases. We expect that this analysis will often come down to the economic benefits test and an analysis of whether the easement holder has exclusive use of the property in question. For example, in an arrangement in which a company is allowed to run electric transmission assets through a farmer's fields, it will be important to understand if the farmer can still use the acreage that lies over or under the assets. If so, we would generally expect the easement holder to conclude that he or she does not receive substantially all of the economic benefits of the land and therefore that he or she does not have a lease. Given the volume of easements and rights-of-way held by some P&U entities, we recommend segregating these arrangements on the basis of similar terms and investigating the rights retained by the landowner as a starting point to the analysis.

Finally, scoping questions have also arisen regarding pole attachment arrangements, whereby a utility allows a third party to attach equipment (e.g., telephone or cable wires) to its utility poles for a monthly fee. We understand that multiple industry groups (representing both potential lessees and potential lessors) are evaluating these arrangements to determine whether they meet the definition of a lease under ASC 842. We believe that the ability of the pole owner to relocate the equipment on the pole will be a relevant consideration. To the extent that the pole owner can change the location of the equipment on the pole, the owner may be able to conclude that he or she has a substantive substitution right, and therefore there will not be an identified asset in the arrangement. We understand that the pole owner often has the ability to relocate the attached equipment as long as service is not compromised.

Definition of a Lease

Identified Asset

The new standard defines a lease as “a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.” Control is considered to exist if the customer has both of the following:

- The “right to obtain substantially all of the economic benefits from the use of [an identified] asset.”
- The “right to direct the use of the [identified] asset.”

The notion of an identified asset is mostly consistent with that in current U.S. GAAP. Under this concept, a leased asset must be identifiable either explicitly (e.g., by a named generating asset) or implicitly (e.g., the asset is the only one available to meet the requirements of the contract). A specified asset can also be a physically distinct portion of a larger asset (e.g., one floor of a building). However, a capacity portion of a larger asset that is not physically distinct (e.g., a percentage of a natural gas pipeline’s or storage facility’s total capacity) will generally not be a specified asset unless that capacity portion reflects substantially all of the larger asset’s overall capacity.

The evaluation of whether there is an identified asset depends on whether a supplier has a substantive substitution right throughout the period of use. Substitution rights are considered substantive if the supplier has the practical ability to substitute alternative assets throughout the period of use (i.e., the customer cannot prevent the supplier from doing so, and alternative assets are readily available to, or can be quickly sourced by, the supplier), and the supplier could benefit economically from the substitution.

An entity must use significant judgment when determining whether a substitution right is substantive. The entity should consider the facts and circumstances at the inception of the contract and exclude from its assessment circumstances that are not likely to occur over the contract term. The entity should also consider the asset’s physical location. For example, it is more likely that the supplier will benefit from the substitution right if the identified asset is located at the supplier’s rather than at the customer’s premises (i.e., because the costs of substituting the asset may be lower). It may be difficult for a customer to determine whether the supplier’s substitution right is substantive. For example, the customer may not know whether the substitution right gives the supplier an economic benefit. A customer should presume that a substitution right is not substantive if it is impractical to prove otherwise.



Thinking It Through

The requirement that a substitution would provide an economic benefit to the supplier is a higher threshold than that in current U.S. GAAP. Accordingly, we expect more arrangements to be subject to lease accounting by virtue of the new standard’s changes to the evaluation of substitution rights.

Convey the Right to Control the Use

With regard to a customer’s right to control the use of the identified asset, the definition of a lease under the new standard represents a significant change from previous guidance. Under current U.S. GAAP, an entity’s taking substantially all of the outputs of an identified asset was considered indicative of the customer’s right to control the use of that asset if the pricing per unit in the arrangement was neither fixed nor equal to the market price per unit at the time of delivery (e.g., a PPA in which the off-taker purchases substantially all of the outputs of a generating asset).

By contrast, the new standard aligns the assessment of whether a contract gives the customer the right to control the use of the specified asset with the concept of control developed as part of the FASB's new revenue standard. Accordingly, a contract evaluated under the new standard is deemed to convey the right to control the use of an identified asset if the customer has both the right to direct, and obtain substantially all of the economic benefits from, the use of that asset. The right to direct the use of the specified asset would take into account whether the customer has the right to determine — or predetermine — how and for what purpose the asset is used. Economic benefits from the use of the specified asset would include its primary products and by-products or other economic benefits that the customer can realize in a transaction with a third party (e.g., renewable energy credits).



Thinking It Through

In determining whether a lease exists under the new standard, an entity would emphasize its ability to direct the use of the asset. This guidance is significantly different from today's model, under which a lease can exist on the basis of the level of output taken by the customer, and, therefore, we expect fewer off-take arrangements to be leases in the P&U industry. Dispatch rights held by an off-taker will generally convey control; however, off-take arrangements with predefined delivery schedules may not meet the control requirement. To help illustrate the factors for an entity to consider when evaluating whether a contract is or contains a lease, the final standard provides three examples that apply to the P&U sector (see ASC 842-10-55-108 through 55-123).

Lessee Accounting Model

Initial Measurement

The initial measurement of a lease is based on a right-of-use (ROU) asset approach. Accordingly, once the standard is effective, **all** leases (finance and operating leases) other than those that qualify for the short-term lease exception must be recognized as of the lease commencement date on the lessee's balance sheet. A lessee will recognize a liability for its lease obligation, measured at the present value of lease payments not yet paid (excluding variable payments based on usage or performance) and a corresponding asset representing its right to use the underlying asset over the lease term. The initial measurement of the ROU asset will also include (1) initial direct costs³ (e.g., legal fees, consultant fees, commissions paid) that are incremental costs of a lease that would not have been incurred had the lease not been executed and (2) any lease payments made to the lessor before or as of the commencement of the lease. The ROU asset will be reduced for any lease incentives received by the lessee (i.e., consideration received from the lessor will reduce the ROU asset).

In addition to those payments that are directly specified in a lease agreement and fixed over the lease term, lease payments include variable lease payments that are considered in-substance fixed payments (e.g., when a variable payment includes a floor or a minimum amount). However, the fact that a variable lease payment is virtually certain (e.g., a variable payment for highly predictable output under a renewable PPA) does not make the payment in-substance fixed. Therefore, it will not be included in the determination of a lessee's lease obligation and ROU asset or a lessor's net investment in the lease.

³ The new model defines "initial direct costs" as those incremental costs "that would not have been incurred if the lease had not been obtained" (executed).



Thinking It Through

PPAs for the output of a wind farm may include payment terms that are 100 percent contingent on production. The wind farm developer may undertake an engineering production case to support the wind farm's expected annual energy output at a particular level (e.g., 95 percent probability, or P95 production level). Although the off-taker from the wind farm may consider the expected P95 production to indicate a relatively fixed or minimum amount of annual delivered energy, that expected amount is contingent (i.e., if the wind does not blow, payment will be zero). Therefore, the expected amount in this case would not constitute an in-substance fixed lease payment. Some renewable PPAs provide for a guaranteed minimum production level to give the buyer price certainty over a minimum volume of electricity and to facilitate compliance with renewable portfolio standards. In general, we would not expect such provisions to establish a fixed lease payment obligation, since these provisions typically settle financially with a payment to the off-taker (current market price of power multiplied by volume shortfall) and therefore do not establish a minimum obligation on the part of the lessee. In other words, it is not possible to guarantee physical output from these facilities, given their dependence on weather, and these provisions are designed to protect the off-taker from the financial burden of buying replacement power, not to ensure a minimum level of revenue for the seller.

Subsequent Measurement

The FASB decided in the ASU to maintain a dual-model approach, in which a lessee classifies the lease on the basis of whether the control of the underlying asset is effectively transferred to the lessee (e.g., substantially all the risks and rewards incidental to ownership of the underlying asset are transferred to the lessee). Lessees would classify a lease as either a finance lease or an operating lease by using classification criteria similar to those in IAS 17.⁴

Therefore, lessees will classify a lease as a finance lease if any of the criteria below are met at the commencement of the lease:⁵

- "The lease transfers ownership of the underlying asset to the lessee by the end of the lease term."
- "The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise."
- "The lease term is for the major part of the remaining economic life of the underlying asset."⁶
- "The present value of the sum of the lease payments and any residual value guaranteed by the lessee . . . equals or exceeds substantially all of the fair value of the underlying asset."
- "The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term."

An entity determines the lease classification at lease commencement and is not required to reassess its classification unless (1) the lease is subsequently modified and the modification is not accounted for as a separate contract or (2) there is a change in lease term or a change in the assessment of the exercise of a purchase option.

⁴ IAS 17, *Leases*.

⁵ Quoted text is from ASC 842-10-25-2.

⁶ The ASU provides an exception to this lease classification criterion for leases that commence "at or near the end" of the underlying asset's economic life. The ASU indicates that a lease that commences in the final 25 percent of an asset's economic life is "at or near the end" of the underlying asset's economic life.



Thinking It Through

The FASB adopted the dual-model approach on the premise that all leases are not created equal. That is, some leases are more akin to an alternate form of financing for the purchase of an asset, while others are truly the renting of the underlying property.

While the ASU's classification criteria are similar to those in IAS 17, they vary from the current requirements in U.S. GAAP (i.e., the specific quantitative thresholds have been removed, and a fifth criterion, which does not exist under ASC 840, has been added). As a result, a lease that would have been classified as an operating lease may be classified as a finance lease under the ASU. In addition, as a reasonable approach to assessing significance, an entity is permitted to use the bright-line thresholds that exist under ASC 840 when determining whether a lease would be classified as a finance lease.

An entity will also assess land and other elements in a real estate lease as separate lease components under the new standard unless the accounting result of doing so would be insignificant. This approach is also similar to current guidance under IFRSs but will reflect a change from that in U.S. GAAP, under which a lessee is required to account for land and buildings separately only when (1) the lease meets either the transfer-of-ownership or bargain-purchase-option classification criterion or (2) the fair value of the land is 25 percent or more of the total fair value of the leased property at lease inception. This change may result in more bifurcation of real estate leases into separate lease components and may affect the allocation of the lease payments to the various elements.

Finance Leases

For finance leases, the lessee will use the effective interest rate method to subsequently account for the lease liability. The lessee will amortize the ROU asset in a manner similar to that used for other nonfinancial assets; that is, the lessee will generally depreciate the ROU asset on a straight-line basis unless another systematic method is appropriate. Together, these expense components will result in a front-loaded expense profile similar to that of a capital lease arrangement under current U.S. GAAP. Entities will separately present the interest and amortization expenses in the income statement.

Operating Leases

For operating leases, the lessee will also use the effective interest rate method to subsequently account for the lease liability. However, the subsequent measurement of the ROU asset will be linked to the amount recognized as the lease liability (unless the ROU asset is impaired). Accordingly, the ROU asset will be measured as the lease liability adjusted by (1) any accrued or prepaid rents, (2) unamortized initial direct costs and lease incentives, and (3) impairments of the ROU asset. As a result, the total lease payments made over the lease term will be recognized as lease expense (presented as a single line item) on a straight-line basis unless another systematic method is more appropriate.



Thinking It Through

While the ASU discusses subsequent measurement of the ROU asset arising from an operating lease primarily from a balance sheet perspective, a simpler way to describe it would be from the viewpoint of the income statement. Essentially, the goal of operating lease accounting is to achieve a straight-line expense pattern over the term of the lease. Accordingly, an entity effectively takes into account the interest on the liability (i.e., the lease obligation consistently reflects the lessee's obligation on a discounted basis) and adjusts the amortization of the ROU asset to arrive at a constant expense amount. To achieve this, the entity first calculates the interest on the liability by using the discount rate for the lease and then deducts this amount from the required straight-line expense amount for the period (determined by taking total payments over the life of the lease, net of any lessor incentives, plus initial direct costs, divided by the lease term). This difference is simply "plugged" as amortization of the ROU asset to result in a straight-line expense for the period. By using this method, the entity recognizes a single operating lease expense rather than separate interest and amortization charges, although the effect on the lease liability and the ROU asset in the balance sheet reflects a bifurcated view of the expense. Note, however, that the periodic lease cost cannot be less than the calculated interest on the lease liability (i.e., the amortization of the ROU asset, or plug amount, cannot be negative).

Regulated utilities will be pleased that the FASB carried forward the guidance that allows lease expense treatment to be consistent with the effects of rate-making. Specifically, ASC 980-842-45-1 states, "Topic 842 specifies criteria for classification of leases and the method of accounting for each type of lease. For rate-making purposes, a lease may be treated as an operating lease even though the lease would be classified as a finance lease under those criteria. In effect, the amount of the lease payment is included in allowable costs as rental expense in the period it covers." This language is virtually identical to the guidance currently in ASC 980-840-45 and, accordingly, we do not expect a change in practice in this area as a result of ASC 842.

Impairment

Regardless of the lease classification, a lessee will subject the ROU asset to impairment testing in a manner consistent with that for other long-lived assets (i.e., in accordance with ASC 360). If the ROU asset for a lease classified as an operating lease is impaired, the lessee will amortize the remaining ROU asset under the subsequent measurement requirements for a finance lease — evenly over the remaining lease term unless another systematic method is appropriate. In addition, in periods after the impairment, a lessee will continue to present the ROU asset amortization and interest expense as a single line item.

Lessor Accounting

After proposing various amendments to lessor accounting, the FASB ultimately decided to make only minor modifications to the current lessor model. The most significant changes align the profit recognition requirements under the lessor model with those under the FASB's new revenue recognition requirements and amend the lease classification criteria to be consistent

with those for a lessee. Accordingly, the ASU requires a lessor to use the classification criteria discussed above to classify a lease, at its commencement, as a sales-type lease, direct financing lease,⁷ or operating lease:

- *Sales-type lease* — The lessee effectively gains control of the underlying asset. The lessor derecognizes the underlying asset and recognizes a net investment in the lease (which consists of the lease receivable and unguaranteed residual asset). Any resulting selling profit or loss is recognized at lease commencement. Initial direct costs are recognized as an expense at lease commencement unless there is no selling profit or loss. If there is no selling profit or loss, the initial direct costs are deferred and recognized over the lease term. In addition, the lessor recognizes interest income from the lease receivable over the lease term.

In a manner consistent with ASC 606, if collectibility of the lease payments plus the residual value guarantee is not probable, the lessor does not record a sale. That is, the lessor will not derecognize the underlying asset and will account for lease payments received as a deposit liability until (1) collectibility of those amounts becomes probable or (2) the contract has been terminated or the lessor has repossessed the underlying asset. Once collectibility of those amounts becomes probable, the lessor derecognizes the underlying asset and recognizes a net investment in the lease. If the contract has been terminated or the lessor has repossessed the underlying asset, the lessor derecognizes the deposit liability and recognizes a corresponding amount of lease income.

- *Direct financing lease* — The lessee does not effectively obtain control of the asset, but the lessor relinquishes control. This occurs if (1) the present value of the lease payments and any residual value guarantee (which could be provided entirely by a third party or consist of a lessee guarantee coupled with a third-party guarantee)⁸ represents substantially all of the fair value of the underlying asset and (2) it is probable that the lessor would collect the lease payments and any amounts related to the residual value guarantee(s). The lessor derecognizes the underlying asset and recognizes a net investment in the lease (which consists of the lease receivable and unguaranteed residual asset). The lessor's profit and initial direct costs are deferred and amortized into income over the lease term. In addition, the lessor recognizes interest income from the lease receivable over the lease term.
- *Operating lease* — All other leases are operating leases. In a manner similar to current U.S. GAAP, the underlying asset remains on the lessor's balance sheet and is depreciated consistently with other owned assets. Income from an operating lease is recognized on a straight-line basis unless another systematic basis is more appropriate. Any initial direct costs (i.e., those that are incremental to the arrangement and would not have been incurred if the lease had not been obtained) are deferred and expensed over the lease term in a manner consistent with the way lease income is recognized.

⁷ The FASB decided not to allow leveraged lease treatment for new leases after the effective date of ASC 842. Existing leverage leases are grandfathered unless modified after adoption.

⁸ If the present value of lease payments plus a lessee-provided residual value guarantee represents substantially all of the fair value of the underlying asset, the lessor classifies the lease as a sales-type lease.



Thinking It Through

While the FASB's goal was to align lessor accounting with the new revenue guidance in ASC 606, an important distinction may affect P&U lessors, particularly those in the renewable energy sector. Under ASC 606, variable revenues are estimated and included in the transaction price, subject to a constraint. By contrast, under the new leases standard, variable lease payments would generally be excluded from the determination of a lessor's lease receivable. Accordingly, direct financing leases or sales-type leases that have a significant variable component may result in inception losses for the lessor if the lease receivable plus the unguaranteed residual asset is less than the net carrying value of the underlying asset being leased. This could occur if payments on a lease of, for example, a solar farm are based entirely on the production of electricity (i.e., 100 percent variable). Most constituents agree that this outcome does not faithfully represent the economics of these transactions. We are therefore considering other possible approaches to applying the new standard to such contracts and are also working with others in the profession, including industry groups, to develop proposed solutions for consideration by the FASB that would address the apparent disconnect between the accounting and the economic substance.

In addition, for those leases that are classified as sales-type or direct financing leases, there are still open questions on the accounting for nonrecurring capital projects, such as major maintenance to a plant, that are typically performed and capitalized by the asset owner under a defer and amortize model. Because the lessor will derecognize the underlying asset, there is an open question about whether it would be appropriate to capitalize the major maintenance costs for an asset that is no longer recorded on the balance sheet.

Lessors affected by either of these issues should consult with their professional advisers and monitor developments during the ASU's implementation phase.

Effective Date and Transition

The new guidance is effective for public business entities for annual periods beginning after December 15, 2018 (i.e., calendar periods beginning January 1, 2019), and interim periods therein. For all other entities, the ASU is effective for annual periods beginning after December 15, 2019 (i.e., calendar periods beginning January 1, 2020), and interim periods thereafter. Early adoption is permitted for all entities. Entities are required to apply a modified retrospective method of adoption, and the FASB has proposed several forms of transition relief that should significantly ease the burden of adoption.



Thinking It Through

Under current U.S. GAAP, entities may adopt the new leases standard before they adopt the new revenue guidance (even though the new revenue standard has an earlier mandatory effective date). On the basis of our discussions with FASB staff, it is our understanding that such early adopters will be expected to apply the relevant new revenue guidance to the extent that it affects their lease accounting, and must wait to apply all other aspects of the new revenue standard until they have fully adopted that standard.

Implications for P&U Entities

Power Purchase Agreements

Under current lease accounting guidance, a PPA is accounted for as a lease if the off-taker (1) agrees to buy all, or substantially all, of the output(s) of a specified generating asset and (2) pays for the output(s) at pricing terms that are neither fixed per unit nor equal to the current market price per unit at the time of delivery. However, the new definition of a lease focuses on whether the off-taker has control of the right to use the specified generating asset. That is, an arrangement is not considered a lease solely on the basis of the pricing, and the extent, of outputs purchased under the contract. Rather, P&U entities have to determine whether a PPA gives the off-taker control of an identified generating asset because the off-taker has the right to direct, and obtain substantially all of the economic benefits from, the use of the asset.

Right to Direct the Use of the Asset

An off-taker has the right to direct the use of a specified generating asset if it can determine how and for what purpose that asset is used. Further, the extent to which an off-taker determines how and for what purpose the specified generating asset is used will depend on whether the PPA grants the off-taker decision-making rights over that asset. Therefore, an off-taker should (1) identify the decision-making rights that most affect how and for what purpose the generating asset is used throughout the off-taker's period of use (i.e., which decision-making rights most affect the economic benefits to be derived from the use of the generating asset) and (2) determine who controls those rights. Dispatch rights will generally convey control to the off-taker. Curtailment rights should also be analyzed. If the decisions related to how and for what purpose the asset is used are predetermined (by contract or the nature of the asset), the assessment will focus on whether the off-taker controls operations and maintenance (O&M) or designed the asset, either of which would be deemed to convey the right to direct the use of the identified asset to the off-taker. We expect that the decisions related to how and for what purpose the asset is used will be predetermined for many arrangements involving renewable energy generation, given the limited number of strategic decisions about generating assets that are made during the commercial operations phase.



Thinking It Through

As described above, we expect that dispatch rights held by the buyer will constitute control under the new standard. In some markets, however, dispatch decisions are ultimately made by an independent system operator on the basis of a consideration of bid prices and any transmission system constraints (i.e., assuming no constraints, generating units will be dispatched economically by accepting the lowest bids first), and therefore neither the owner nor the off-taker can mandate physical production. While the bid-in process is not explicitly the same as dispatch rights held by an off-taker, companies should consider whether controlling the bidding process conveys control to the off-taker, since that is the right that an owner would normally exercise in these markets to influence whether and when the owner's plant runs.

In the renewable energy sector, off-takers typically buy under must-take arrangements and dispatch rights are not present because of the weather-dependent nature of the generating assets. However, it is common for off-takers to have curtailment rights for both operational (e.g., to protect the grid) and economic (e.g., to avoid buying at a loss when locational marginal prices are negative) reasons. While such rights should be analyzed to understand their purpose and financial consequences to the off-taker, we do not expect curtailment rights to convey control in most circumstances. We believe that the important control decisions (those about how and for what purpose) have effectively been predetermined for weather-dependent assets such as wind and solar farms. Curtailment rights protect a purchaser from unforeseen operational and market pricing anomalies but are inherently different from dispatch rights on a unit that is standing ready to produce.

It is important to note that the decision-making rights that most affect the economic benefits to be derived from a generating asset will differ depending on the nature of the asset. The table below discusses decision-making rights that an off-taker may be granted in a PPA and presents our current thinking on whether those rights determine how and for what purpose fossil fuel and alternative generating assets are used.

Nature of Generating Asset	Off-Taker's Decision-Making Rights	Do the Off-Taker's Decision-Making Rights Determine How and for What Purpose the Generating Asset Is Used?
Fossil fuel (e.g., coal, natural gas)	Dispatch rights (i.e., rights to make decisions about whether, and how much, to produce from the generating asset).	Yes. Dispatch rights provide the off-taker with the right to change whether electricity is produced from the generating asset and the quantity of the electricity that is produced, which is the decision-making right that most affects the economic benefits to be derived from the generating asset and thus represents the right to determine how and for what purpose the asset is used throughout the period of use.
	Rights to provide the fuel used by the generating asset to generate electricity and determine generation timing (i.e., a tolling arrangement).	Yes. The off-taker's right to toll fuel through the generating asset for conversion into electricity inherently provides the off-taker with the right to change when and whether the electricity is produced from the generating asset. Those decision-making rights most affect the economic benefits to be derived from the generating asset and thus determine how and for what purpose the asset is used throughout the period of use.
	Rights to make decisions about the operation and maintenance of the generating asset throughout the period of use.	No. Although operating and maintaining the generating asset is essential to its efficient use, decisions about those activities do not by themselves most affect how and for what purpose the generating asset is used; rather, they are contingent upon the decisions about how and for what purpose the generating asset is used (e.g., dispatch rights, contractually stated production schedule).
	Rights that require the supplier to follow prudent utility operating practices in running the generating asset.	No. Requirements that either party in an off-take arrangement must follow appropriate utility operating practices define the scope of the parties' rights related to the generating asset but do not affect which party has the right to direct the use of the asset.

(Table continued)

Nature of Generating Asset	Off-Taker's Decision-Making Rights	Do the Off-Taker's Decision-Making Rights Determine How and for What Purpose the Generating Asset Is Used?
Alternative (e.g., wind, solar)	Design of the generating asset before its construction.	Yes. The relevant decisions about how and for what purpose the asset is used are predetermined on the basis of the nature of the asset. However, the off-taker made the decisions about the generating asset's design before contract inception that predetermined how and for what purpose the generating asset will be used throughout the off-taker's period of use.
	Rights to make decisions about the operation and maintenance of the generating asset throughout the period of use.	Yes. The relevant decisions about how and for what purpose the asset is used are predetermined on the basis of the nature of the asset. Accordingly, decisions about operating and maintaining an alternative generating asset are often among the only decisions available to be made throughout the period of use that do affect the economic benefits to be derived. Thus, the off-taker's decision-making rights over O&M — and the lack of any rights held by the supplier to change those instructions — give the off-taker the right to direct the asset's use throughout the period of use.
	Rights that require the supplier to follow prudent utility operating practices in running the generating asset.	No. Requirements that either party in an off-take arrangement must follow appropriate utility operating practices define the scope of the parties' rights related to the generating asset but do not affect which party has the right to direct the use of the asset.



Thinking It Through

We anticipate that the assessment of an entity's involvement in design will require the use of significant judgment under the new standard and will be particularly relevant for arrangements involving renewable generating assets. Because those assets are not dispatchable, an entity is likely to conclude that how and for what purpose a generating asset is used are predetermined (on the basis of the nature of the asset). Accordingly, the analysis will focus on control over O&M or design. Control over O&M will probably be easy to determine; typically, the asset owner (the supplier) retains responsibility for O&M. However, it will often be more difficult to determine whether the off-taker had sufficient involvement in the design of the facility to effectively convey control. Important decisions regarding design are likely to include siting and determining the specific technology to be used. We understand that Edison Electric Institute's lease accounting group will be working on guidance in this area to assist companies in making informed judgments about design, and we plan to participate in that process.

Other important decision-making rights that affect the economic benefits to be derived from a generating asset should also be considered in the assessment of whether the off-taker's decision-making rights most affect how and for what purpose the asset is used. Such rights may include but are not limited to:

- The off-taker's right to determine the facility's operator.
- The off-taker's right to determine specific operating procedures, outside those requiring the operator to follow prudent utility operating practices.

In all scenarios, the off-taker needs to evaluate, on the basis of the specific facts and circumstances, whether it has the right to determine how and for what purpose a generating asset is used and, thus, the right to direct the use of the asset. The off-taker will need to use judgment when performing this evaluation.

Right to Obtain Substantially All of the Benefits From the Use of the Asset

For a PPA to be considered a lease, the off-taker must also have the right to obtain substantially all of the economic benefits from the use of the generating asset throughout the period of use. Although the FASB did not define “economic benefits,” the term as used in the new standard encompasses all economic benefits from the use of an asset, including products, by-products, and those benefits that may be realized through a subsequent transaction with a third party. Therefore, an off-taker will conclude that certain other benefits provided in a PPA (e.g., capacity, renewable energy credits, or steam) constitute economic benefits. An off-taker will have to consider how the receipt or nonreceipt of such additional benefits from the use of a facility affects the accounting for a particular contract. Note that tax attributes related to ownership of the asset are not considered economic benefits (e.g., investment tax credits and production tax credits).



Thinking It Through

Questions have arisen about whether production tax credits should be deemed economic benefits, given that they are tied to the use of the productive asset (as opposed to investment tax credits, which are tied to installed cost). We believe that all tax attributes should be excluded from the economic benefits test, as they all belong to the owner(s) of the asset and cannot be sold in a market transaction. This approach is consistent with the way outputs are determined today in the identification of leases under ASC 840.

Transportation and Storage Contracts

Contracts to transport or store gas or other fuel products will need to be evaluated under the new definition of a lease. To be considered a specified asset under the new leases standard, a capacity portion of a larger asset has to be physically distinct or have substantially all of the larger asset's capacity. Because the terms of pipeline and storage contracts vary significantly (e.g., regarding the rights to a percentage of an asset's capacity or other economic benefits), P&U entities need to evaluate such contracts to determine whether to account for them under the guidance on leases, revenue recognition (suppliers), derivatives, or other U.S. GAAP.

In addition, P&U companies should also be aware that the new standard specifically highlights by way of example that a pipeline lateral that is dedicated to one user is a distinct portion of a larger asset that would be considered an identified asset. On the surface, this seems to capture any arrangements for transportation service that include dedicated stretches of service — most notably those involving infrastructure connecting a single customer (e.g., a commercial or industrial customer) to the natural gas pipeline in a utility's territory. These are commonly called last-mile scenarios in reference to the connection to the customer site using infrastructure that is effectively dedicated. P&U entities should consider the potential ramifications of this guidance for elements of their distribution systems, including wires, meters, and other equipment that serve a single customer. The lateral example that was included in the final ASU was never formally subject to public exposure. Accordingly, we anticipate further discussion between affected companies and the FASB to obtain clarity on

the intent of the requirement and to understand its application to different fact patterns. While the lateral example is highlighted as an identified asset, it will also be necessary to assess control over the infrastructure before concluding that these assets are subject to lease accounting.



Thinking It Through

The guidance that supports laterals as being identified assets could have much broader implications for P&U entities. In particular, it raises a question about whether certain P&U electric transmission and distribution assets would represent identified assets. For example, an analogy could be made that power lines connecting one customer to the broader distribution system would represent identified assets under the new standard. Similarly, questions could be raised about whether meters and other equipment maintained at a customer location would be considered identified assets (as indicated above, an assessment of control would also be required, and this aspect is not presupposed by ASC 842). From a practical standpoint, equipment supporting at-will customers will probably not be subject to a lease because of the lack of a term arrangement between the utility and the customer. However, where term arrangements do exist (e.g., with some commercial and industrial customers), this guidance could be relevant.

Implementation Considerations

The ASU may present significant implementation challenges for P&U entities during the period of transition and beyond, including the following:

- Evaluating new requirements that will involve the use of significant judgment, including estimations related to recognition of leases on the balance sheet.
- Managing the complexities of data collection, storage, and maintenance for a potentially large population of contracts.
- Enhancing information technology systems to perform the necessary calculations and reporting requirements.
- Refining internal controls and other business processes related to identification and capture of contracts subject to lease accounting.
- Determining whether debt covenants will be affected and, if so, working with lenders to avoid violations.
- Identifying and addressing income tax effects.

Application of Judgment and Estimation

Entities will be required to apply judgment and make estimates under a number of the new (as well as current) leases requirements. Judgment is often required in the assessment of a lease's term, which will affect whether the lease qualifies for the short-term exemption and therefore for off-balance-sheet treatment. In addition, an entity's judgment in distinguishing between leases and services becomes more critical under the new guidance since almost all leases will be recognized on the balance sheet.



Thinking It Through

In particular, upon transition, P&U entities will need to recognize ROU assets and lease obligations by using an appropriate discount rate on the date of transition. Compliance with this requirement may be difficult for P&U entities with a significant number of leases, since they will need to identify the appropriate incremental borrowing rate for each lease on the basis of factors associated with the underlying lease terms (e.g., lease tenor, asset type, residual value guarantees). In other words, P&U entities will not be permitted to use the same discount rate for all their leases unless the leased assets and related terms are similar.

Data Management

P&U entities may have numerous lease agreements at multiple decentralized locations and may, in many instances, maintain their lease data in spreadsheets or physical documents. Consequently, collecting and abstracting the data may be time-consuming and resource-intensive. Further, even if P&U entities already have such information in an electronic format, it may reside in disparate systems or need to be enhanced to ensure that it complies with ASU 2016-02's accounting and disclosure requirements.

In addition, P&U entities may need to gather information required by the ASU that may not be contained in lease agreements. For example, entities may need to acquire information about (1) the fair value of an asset, (2) the asset's estimated useful life, (3) the incremental borrowing rate, and (4) certain judgments related to lease options. Acquiring this data may be particularly challenging for multinational P&U entities whose lease documentation may be prepared in a foreign language and could also vary as a result of local business practices.

As P&U entities identify and collect the data they need for compliance with the ASU's requirements, they should also consider the challenges of ongoing data maintenance. Data gathering and abstraction efforts may take many months to complete, during which time new leases will be executed, renewed, modified, or terminated. Accordingly, management will need to establish an approach to data maintenance and controls during the implementation period and beyond.

Given the relationship between lease maturity disclosures under current guidance and lease liabilities that will be recognized upon adoption of the ASU (and will be subject to modified retrospective transition, which will affect 2017 financial reporting), we believe that in preparing their December 31, 2016, financial statements, P&U entities should strive to ensure that they have identified a complete population of leases.

Information Technology Systems

P&U entities may need to enhance their information technology systems to implement the ASU's requirements. The extent of such enhancements will be based on the size and complexity of a P&U entity's lease portfolio and its existing leasing systems. As with any changes to existing systems, a P&U entity will need to consider the business ramifications (i.e., the potential effect on existing processes, systems, and controls) and the requirements of system users (e.g., the entity's legal, tax, financial planning and analysis, real estate, treasury, and financial reporting functions).

Also, management may need to consider system changes that will enable the entity to estimate, before adoption, the ASU's effect on key performance indicators and metrics, tax filings, debt covenants, or other filings. In addition, to the extent that a P&U entity prepares

IFRS statutory reports for foreign subsidiaries, its systems will need to distinguish between ASC 842 and IFRS 16 and be equipped to handle the differences between the two standards.

Internal Controls and Business Process Environment

To a significant extent, current systems with lease data are used for operational purposes, and thus some aspects of the related internal controls may be outside the scope of the internal control requirements of the Sarbanes-Oxley Act of 2002. Given the increased relevance of the leasing data to the financial statements under the ASU, P&U entities may face additional scrutiny from auditors and regulators regarding the design and effectiveness of associated controls. Accordingly, P&U entities will need to examine their internal controls related to their processes for capturing, calculating, and accounting for their leases. If additional internal controls and processes are needed, P&U entities may also need to issue organizational communications and establish change management and employee training programs.

In addition, during their implementation of the standard, entities may identify potential enhancements to their current processes to achieve operational efficiencies. For example, P&U entities may seek to automate manually intensive processes or consider organizational changes such as a shared services model.

Debt Covenants

Given the requirement to bring most leases onto the balance sheet, many P&U entities will reflect additional liabilities on their balance sheets after adopting the ASU. Such entities should determine whether the increased leverage will negatively affect any key metrics or potentially cause debt covenant violations. This may depend in part on how various debt agreements define and limit indebtedness as well as on whether the debt agreements use “frozen GAAP” covenants (i.e., covenants that are based on GAAP at the time the debt was issued). The ASU requires presentation of operating lease liabilities outside traditional debt, which may provide relief for some P&U entities. Regardless, we believe that it will be critical for all P&U entities to determine the ASU’s potential effects on debt covenants and begin discussions with lenders early if they believe that violations are likely to occur as a result of adopting the ASU.

Income Taxes

A lease’s classification for accounting purposes does not affect its classification for tax purposes. A P&U entity will therefore continue to be required to determine the tax classification of a lease under the applicable tax laws. While the classification may be similar for either purpose, the differences in tax and accounting principles and guidance often result in book/tax differences. Thus, once a P&U entity implements the new standard, it will need to establish a process to account for these differences.

The ASU’s requirement for P&U entities to reevaluate their leases under the new guidance presents an opportunity for them to also reassess the tax treatment of such leases as well as their data collection and processes. Because the IRS considers a taxpayer’s tax treatment of leases to be a method of accounting, any changes to existing methods may require IRS consent.

P&U entities should also consider the potential state tax issues that may arise as a result of the new guidance, including how the classification of the ROU asset may affect the apportionment formula in the determination of state taxable income and how the significant increase in recorded lease assets could affect the determination of franchise tax payable.



Thinking It Through

Because the potential tax implications are many and varied, it is essential for a P&U entity's tax department to be involved in the evaluation of the leases standard as well as in discussions related to policy adoption and system modifications.

Getting Started

P&U entities should develop a robust plan and establish a cross-functional implementation team to ensure an efficient and timely approach to implementation. In developing such a plan, they should consider doing the following:

- Performing a current-state assessment of their lease portfolio, including lease volumes and types, availability of electronic lease data and data gaps, and any potential changes related to accounting, taxes, or processes.
- Establishing a granular project plan and road map to manage the effort across multiple functions, business units, and countries, as necessary.
- Developing an approach to, and the resources to perform, the abstraction of the lease data.
- Determining their specific system requirements and developing a plan for enhancing system capabilities to satisfy the new storage, calculation, and reporting requirements while keeping in mind the associated internal control implications.
- Assessing the ASU's effect on their key metrics and debt covenants.

Time is truly of the essence. As the effective date approaches (i.e., January 1, 2019, for public entities and January 1, 2020, for all other entities), the most important action a P&U entity can take is to start the efforts related to this accounting change now. It can be a challenge to anticipate the data gaps and overcome the data abstraction hurdle, but with adequate support and sufficient time, it can be achieved. By planning properly, P&U entities can help ensure that their transition to the new leases standard is smooth and successful.

How Deloitte Can Help

Deloitte Expertise

Deloitte professionals both in the U.S. and globally across the member firms of Deloitte Touche Tohmatsu Limited are equipped with the latest tools and technology to help you develop an action plan for implementing the new standard.

Our services include help with accounting interpretations, process revisions, system changes (including development of system business requirements), new system implementations, and tax analysis. Specific areas of assistance include but are not limited to:

- *Contract assessment* — Reviewing existing contracts to determine the new standard's effect.
- *Data challenges* — Gathering data from various locations (both physical contracts and system information) and creating a standardized gathering framework.
- *Process challenges* — Implementing a standardized process for consistent reporting and application throughout an entity.

Deloitte Tools

Deloitte has developed a suite of user-friendly, Web-based tools to help P&U entities maintain lease data and perform lease calculations under the new standard. These tools can help you automate the process of analyzing and abstracting lease contracts; manage a centralized, secure repository; and identify and address key data deficiencies associated with leases.

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