LG&E and KU Energy LLC Accounting Policy and Procedures

953 – Reserve for Bad Debts (Retail & Wholesale)

(Note: Text in italics indicates a key SOX control.)

Policy:

The reserve for bad debts is evaluated monthly to ensure the amounts are appropriate.

Procedure:

Reserve for retail bad debts is calculated monthly by utilizing a balance sheet approach based on an aging accounts receivable methodology. The calculation first determines the estimated monthly charge off amount based on a three-year or twelve-month average depending on current market conditions. The estimated monthly charge off amount is then assigned to each aging bucket utilizing a waterfall approach to determine the monthly charge off percentages for each aging bucket.[1] The monthly charge off percentages for each aging bucket are then applied to the current period's receivable and accrued revenue balances, by aging bucket, in order to determine the bad debt reserve. Accounts with no payment activity are charged off after four months, although collection efforts continue thereafter absent a disconnection moratorium.

The reserve for wholesale and municipal customer and sundry bad debts is based on specific identification.

Scope:

Applicable to Louisville Gas & Electric Company ("LG&E") and Kentucky Utilities Company ("KU") retail, wholesale, municipal and sundry accounts receivable.

Objective of Procedure:

The objective of evaluating the accounts receivable reserve balances is to identify, quantify, and correct any material over or under accrual and recognize bad debt expense in the same period as the related revenues.

ASC 326 provides that an entity recognize an allowance for credit losses that results in the financial statements reflecting the net amount expected to be collected from the financial asset.[2]

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[1] The waterfall approach assigns the monthly charge off amount for each aging bucket (30+, 60+, 90+, 120+, 365+) generally producing a higher charge off percentage as receivables increase in age.

[2] ASC 326-20-30 provides that "*The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net amount expected to be collected on the financial asset. At the reporting date, an entity shall record an allowance for credit losses on financial assets within the scope of this Subtopic. An entity shall report in net income (as a credit loss expense) the amount necessary to adjust the allowance for credit losses for management's current estimate of expected credit losses on financial asset(s).*

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It requires organizations to measure all expected credit losses for financial instruments held at the reporting date based on historical experience, current conditions and reasonable and supportable forecasts.

The guidance was issued as part of ASU 2016-13 and subsequently codified in ASC 326.

General Requirements:

Detailed Procedures Performed:

Retail:

1. *Each month, the retail reserve balances for (bad debts) uncollectible accounts receivable, for LG&E and KU, are evaluated by the Revenue Accounting and Analysis department.*

2. *A historical charge off percentage is calculated by dividing the net charge offs by total sales based on a three-year or twelve-month average depending on current market conditions. The monthly net charge offs and total sales are accumulated on a spreadsheet using data from the following source documents under normal conditions:*
   - *The monthly net charge offs and forfeited discounts (late payment charges) are obtained from the Oracle Account Analysis reports for general ledger accounts 144002 (total charge offs), 144003 (total recoveries), 450001 (electric forfeited discounts) and 487001 (gas forfeited discounts), as applicable, for LG&E and KU. KU and ODP data is segregated by organization when running these reports.*
   - *The total sales are obtained from the "LGE CM Revenue By Comp By Class – Test" and "KU Revenue By Comp By Class CM – Test" FSGs in Oracle. KU and ODP data is segregated by organization by running two versions of the KU FSG.*

3. *The historical average charge off percentage is then applied to (multiplied by) the prior average revenue balances to calculate the average monthly net charge off balance for the current period. The revenue balances are accumulated on a spreadsheet using data from the revenue volume analysis report prepared monthly by the Revenue Accounting and Analysis department. Please see Reserve for Bad Debts Appendix, Section (A) for an illustration of this calculation.*

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4. *Using the waterfall method, a percentage of charge offs is calculated and applied for each aging bucket based on the average aging charge off balance of the prior calendar periods, using data from the CCS 4011 Charge (Write) off Aging report. Please see Reserve for Bad Debts Appendix, Section (B) for an illustration of this calculation. The waterfall balances are multiplied to the average aging balances to create the current month charge off percentages by aging bucket. Please see Reserve for Bad Debts Appendix, Section (C) for an illustration of this calculation.*

5. *The current month total reserve for bad debts is calculated by multiplying the current month charge off percentages by aging bucket by the current month's accounts receivable and accrued revenues balances by aging bucket using data from the CCS 4010 AR Aging report and Oracle GL connect. Each reserve amount by aging bucket is added together to compute the total needed reserve for bad debts for the current month. Please see Reserve for Bad Debts Appendix, Section (D) for an illustration of this calculation.*

6. *The total calculated reserve is split between the billed accounts receivable reserve balance and the unbilled (accrued) revenues reserve balance based on the current month-end balances for each. Please see Reserve for Bad Debts Appendix, Section (E) for an illustration of this calculation.*

7. *The actual billed and unbilled (accrued) reserve balances per the general ledger are compared to the calculated reserves, and a journal entry is created to record the net charge offs in CCS to bad debt expense and adjust (true-up) the resulting billed and unbilled (accrued) reserve balances to the calculated balances.*

8. *An adjustment to the accrual (e.g. change from the historical-charge off percentage to a different charge off percentage or change resulting from regulatory decisions such as customer disconnection moratoriums) will be performed when it is believed the historical charge off percentage is not representative of current conditions and reasonable and supportable forecasts as required by ASC 326.*

9. *In addition to the calculated billed and unbilled reserve accruals, additions to the reserve balances are made by specific identification. If a customer balance is identified as uncollectible before it is 120 days old, the reserves are increased for the specific amount of the balance. (See cycle/transaction 10.04 Control Activity 13 in the Sarbanes-Oxley Compliance documentation.)*

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10. *The Revenue Collections department is responsible for the collection and dunning process for retail customers.*

Wholesale:

1. *The Revenue Accounting and Analysis department performs counterparty checkouts via email and issues an invoice in the month following the month of flow.*

2. *Balance sheet account reconciliations include an aging of the accounts receivable, showing balances over 30, 60 and 90 days past due. (See 250 – Balance Sheet Accounts Reconciliation Policy)*

3. *After a receivable becomes over 30 days past due, the Revenue Accounting and Analysis department will contact the counterparty and inquire about the payment status of the invoice.*

    a. *If the counterparty states the balance will be paid, the cash receipts is monitored to ensure payment is made as stated.*

        i. *If payment is not made as stated, the counterparty is contacted a second time.*

    b. *If the counterparty states it will not pay the invoice in full or in part, an explanation of the non-payment is requested and the validity of the counterparty's claim is investigated.*

        i. *If the counterparty's claim is that the bill was for an improper amount and the claim is validated, an adjusting entry is recorded and a corrected invoice is issued.*

        ii. *If the counterparty's claim of an incorrect bill is discredited, the counterparty is contacted to confirm that the invoice has been investigated and determined to be accurate.*

        iii. *If the counterparty still does not pay, the Revenue Accounting and Analysis department will notify the Manager, Credit and Contract Administration, of the default and refusal to pay. The Manager, Credit*

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and Contract Administration, makes a decision whether to grant additional credit and thus permit selling to this counterparty to continue.

c. *The Revenue Accounting and Analysis department sends a dunning letter to the counterparty in default stating the invoice number, flow month of power sold, due date, amount invoiced, payment received (if any), open balance and "please respond by" date (which is 10 days from the date of the letter).*

d. *If no response, or a negative response, is received by the date indicated in the letter, a second letter is sent to the counterparty offering assistance if it needs further information regarding the open balance. The counterparty would again be requested to respond within 10 days. This letter would be reviewed by the Legal department and sent via registered mail.*

e. *If no response, or a negative response, is received from the second letter by the date indicated, the Revenue Accounting and Analysis department notifies the Legal department of the situation and works with it to resolve the issue.*

f. *For transactions occurring outside the Independent System Operator (ISO) and Regional Transmission Organization (RTO) markets, a reserve for doubtful accounts is established for balances over 90 days past due, with the exception of a mutual agreement between parties that may constitute balances over 90 days. An additional reserve is established for any receivable that is denied by the counterparty or deemed impaired due to a triggering event (e.g. significant financial difficulty of the counterparty, a breach of contract, such as a default or delinquency in payments, the disappearance of an active market (ISO or RTO)).*

   For transactions that occur within the ISO and RTO markets, the administrator of the ISO and RTO markets will notify the company when a counterparty defaults. At that time the Financial Accounting and Analysis department adjusts the reserve for doubtful accounts accordingly.

g. *If a reserve for wholesale doubtful accounts is established, it is re-evaluated quarterly. Upon receipt of payment by a defaulting counterparty, the allowance account is adjusted accordingly for the bad debt expense originally recorded.*

Municipals:

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Revenue Accounting & Analysis performs a process similar to the wholesale process for receivables from municipal customers.

Sundry:

Monthly, the Regulatory Accounting and Reporting Department runs the Aged Trial Balance of open Sundry Accounts Receivable in Oracle and sends to Revenue Collections, which is the department responsible for the collection and dunning process for sundry customers. Accounts not paid in full are reserved after 360 days, unless information is provided to indicate that the accounts are still collectable.
For damage claims, a determination of collectability of accounts over 60 days past due is made with the following actions taken. First, Revenue Collections sends a dunning letter once the claim has been turned over by Underwriters Safety and Claims providing 15 days for payment. If no payment is made, Legal is then contacted for outstanding invoices over $5,000 to provide or confirm valid contact information and to determine whether legal action should be taken in coordination with Revenue Collections and Operations.

The other sundry past-due receivables receive two collection letters. Revenue Collections distributes the first dunning letter on day 46, providing 15 days for payment. If no payment occurs, Revenue Collections sends a second letter on day 61 stating possible further legal action if not paid. Legal consideration for past-due sundry invoices is determined in coordination with Revenue Collections and the department responsible for the invoice.

Reports Generated and Recipients:

The evaluation of the retail accounts receivable reserve balance is documented within the respective files used to create the journal entry for each company (LG&E – "JE098 Adj Bad Debt Reserve YYYY.MM.xlsm" and KU – "J517 AR Reserve Adj YYYY.MM.xlsm").

For wholesale accounts, an aging of the open accounts receivable balance is maintained on the financial accounting shared drive (LG&E – "100.142003, 144009, 232010.xlsx"; KU – "100.142003, 144009, 232010.xlsx"). Additional reports include the first and second (if applicable) informational letters to the counterparties.

For municipal customers, an aging of the open accounts receivable from CCS is maintained on the revenue accounting (fs3:\\revacct) share drive (AR Aging Snapshot – yyyy.mm.xlsx).

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For sundry accounts, an aging of the open accounts receivable balance is maintained in the Oracle AR module. The evaluation of the reserve balance is documented within the respective files used to create the quarterly journal entry for each company (LG&E – J075-0100; KU – J070-0110). Accounts included in the aging are 143006-AR Billed Projects, 143007-AR Non-Project, 143012-AR Miscellaneous, 143017-AR Damage Claims and 172001-Rents Receivable. The reserve account used is 144006-AR Miscellaneous.

Additional Controls or Responsibility Provided by Other Procedures:

- Counterparty checkout prior to issuance of wholesale invoices
- 250 – Balance Sheet Account Reconciliation Policy

Review and approval of the monthly calculations, evaluations, and journal entries by the Manager, Revenue Accounting and Analysis.

Regulatory Requirements:

None

Reference:

- FASB ASC 326-20-30-1, Assets – Investments – Financial Instruments–Credit Losses – Measured at Amortized Cost – Initial Measurement
- Accounting Standards Updates (ASU) 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments

Corresponding PPL Policy No. and Name:

- 903 Reserve for Bad Debts
- 904 Reserve for Bad Debts – Unregulated

Key Contact:

Manager, Revenue Accounting and Analysis

Administrative Responsibility:

Director, Utility Accounting KY

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