

Capitalization Policies and Strategies

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MIDDLEBROOKS & CO**

CERTIFIED PUBLIC ACCOUNTANTS

Outline

- What is Capitalization?
- What is Everyone Doing?
- What Do I Need in My Capitalization Policy?
- What Does the Guidance Say?

Why Do We Capitalize Assets?

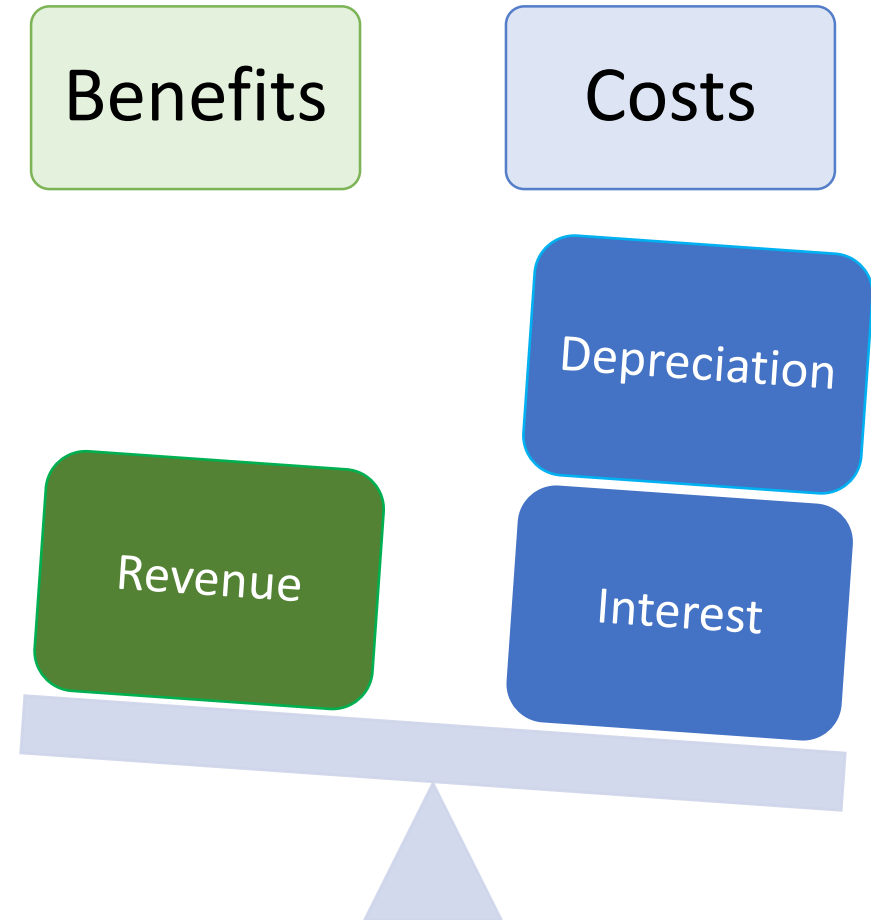
- To Spread the Cost of an Assets Over a Period for Which it Will Produce an Economic Benefit

Why Is a Capitalization Policy Important?

- To Ensure Proper Treatment of Purchases and Ensure Compliance
- To Simplify the Capitalization Process
- To Meet Operational and Long-Term Strategic Goals

Capitalization: The Concept

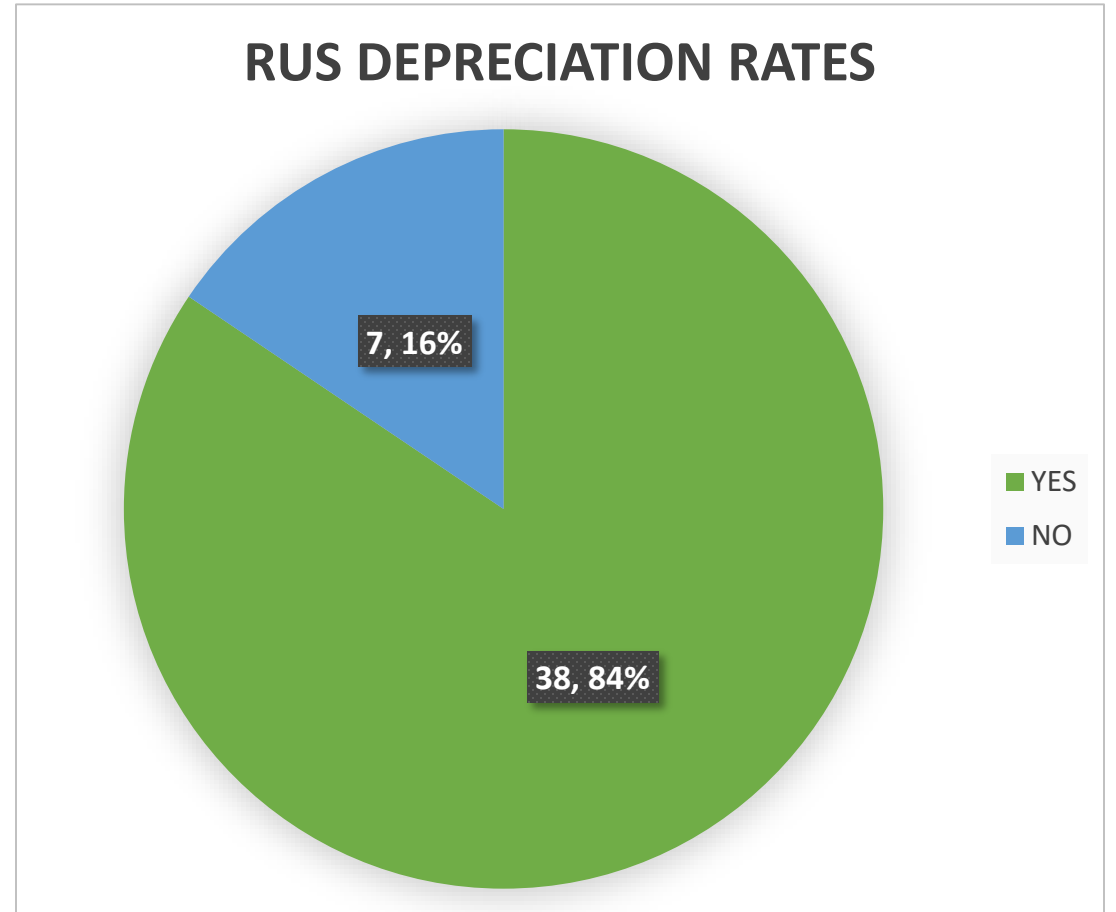
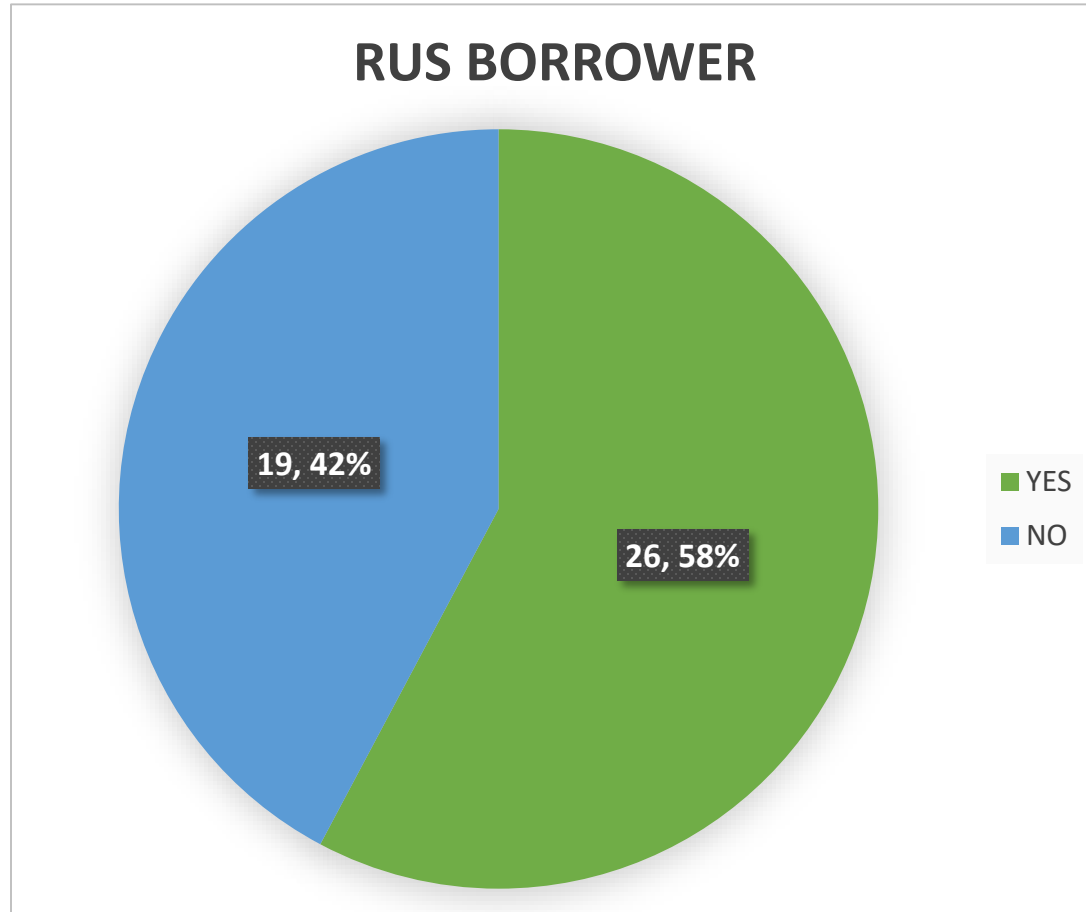
- Matching Principal
 - Match the Cost (Depreciation Expense) with Benefit
 - The Assets Provide Economic Benefits Beyond the Current Year
 - There is a Link Between the Assets and Future Revenues
- Expense Asset Over the Estimated Useful Life



Electric Cooperative Capitalization Survey

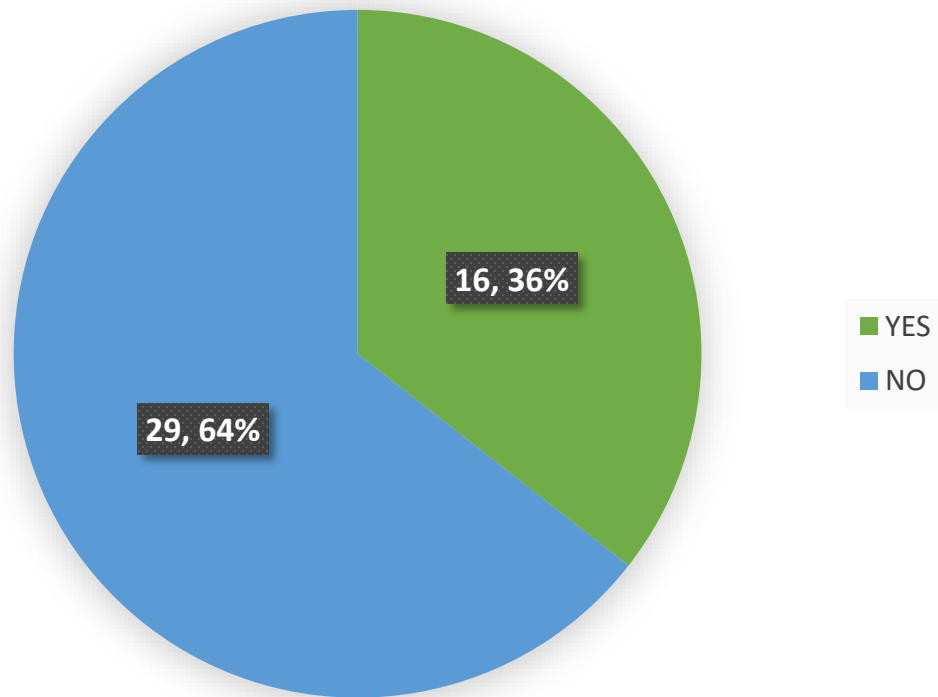
- 45 Responses
- 16 States
- Average Meter Count - 77,376
 - Smallest Coop – 4,108
 - Largest Coop – 236,992
- Average Total Utility Plant - \$408,704,605
 - Smallest TUP - \$31,526,144
 - Largest TUP - \$1,245,921,733
- Average Depreciation Reserve - 32%
 - Lowest Reserve – 17%
 - Highest Reserve – 54%

RUS Borrowers vs. RUS Guidance

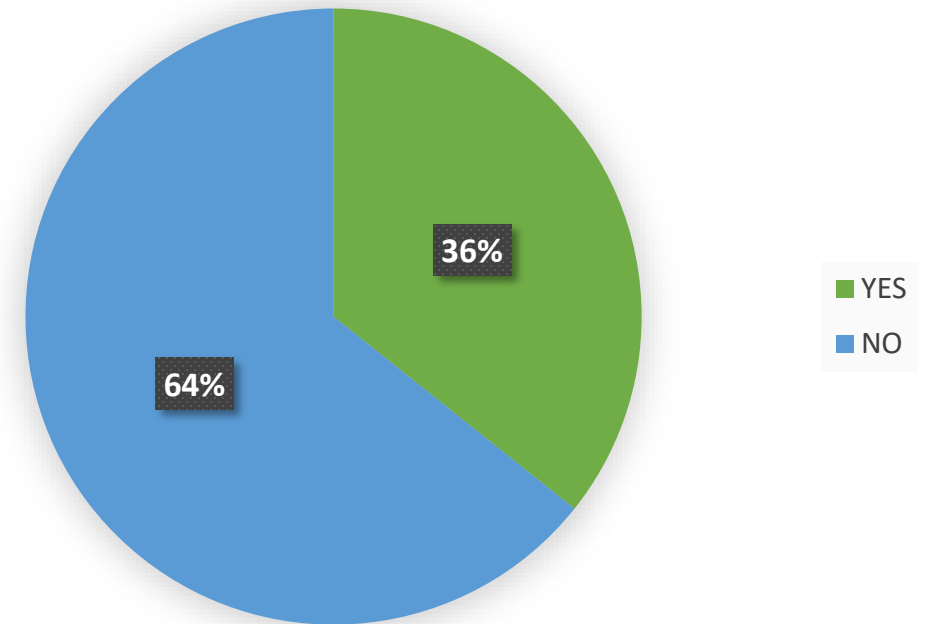


Depreciation Studies

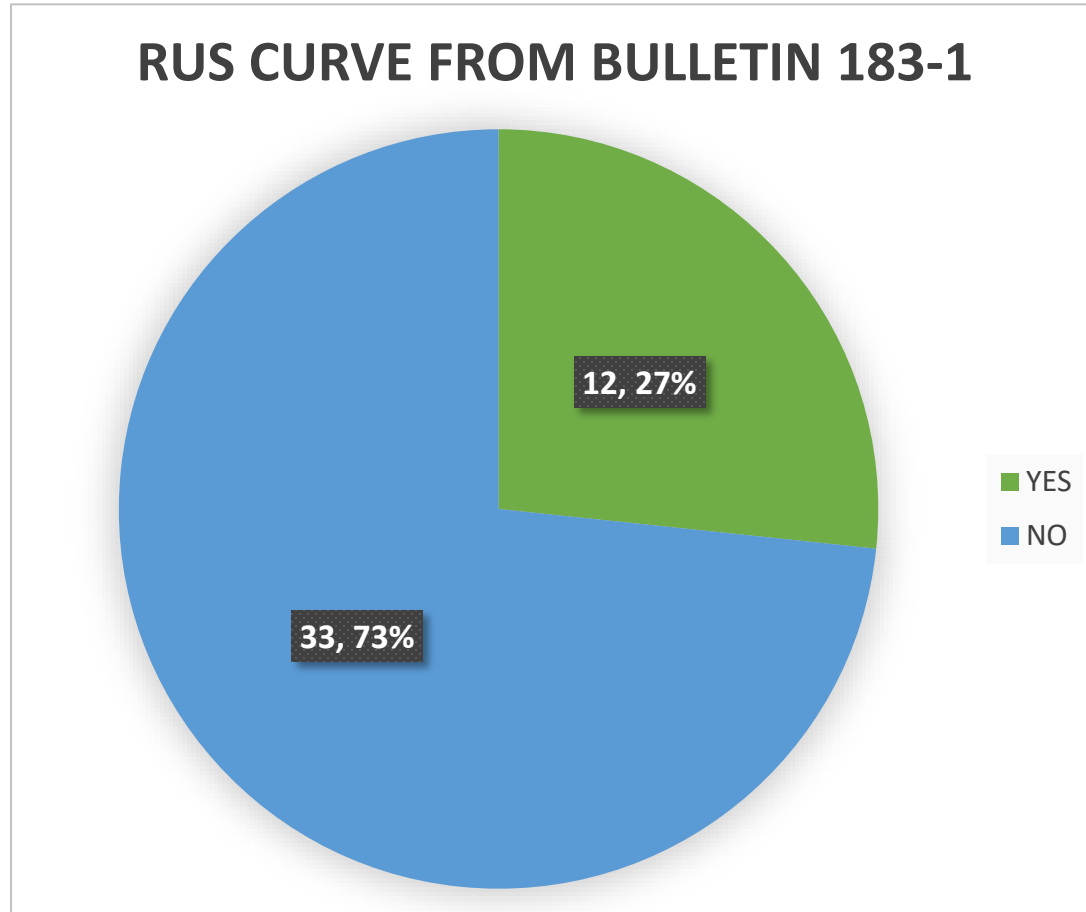
**COMPLETED DEPRECIATION STUDY
IN THE PAST 10 YEAR**



**IF NO, DO YOU PLAN ON
COMPLETING ONE IN THE NEXT 3
YEARS**



Depreciation



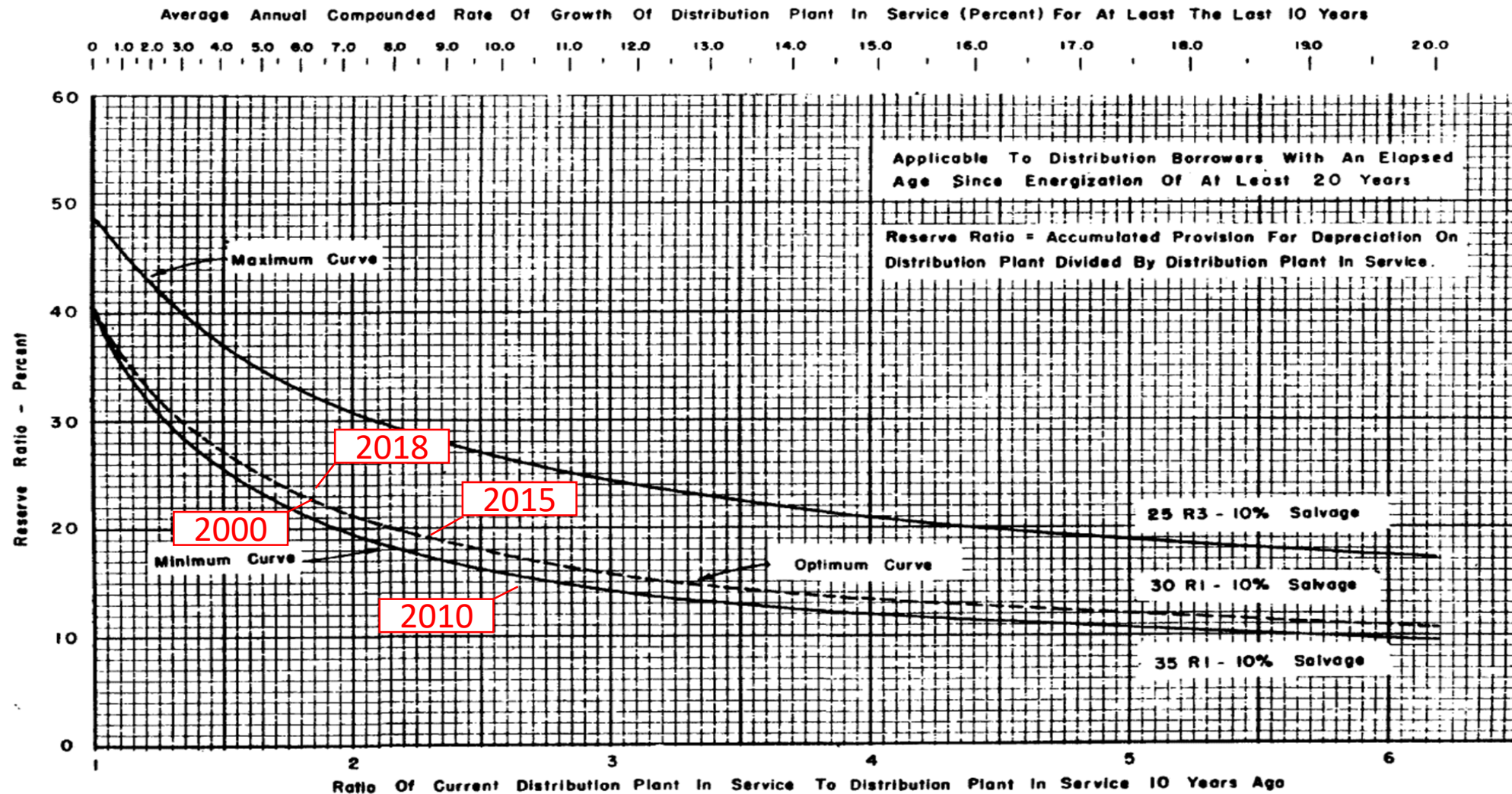
- Bulletin 183-1
 - General Depreciation Guidelines for RUS Borrowers
 - Has not been significantly updated in 40 years

Depreciation – Bulletin 183-1

Bulletin 183-1

Page 7

DEPRECIATION GUIDELINE CURVES

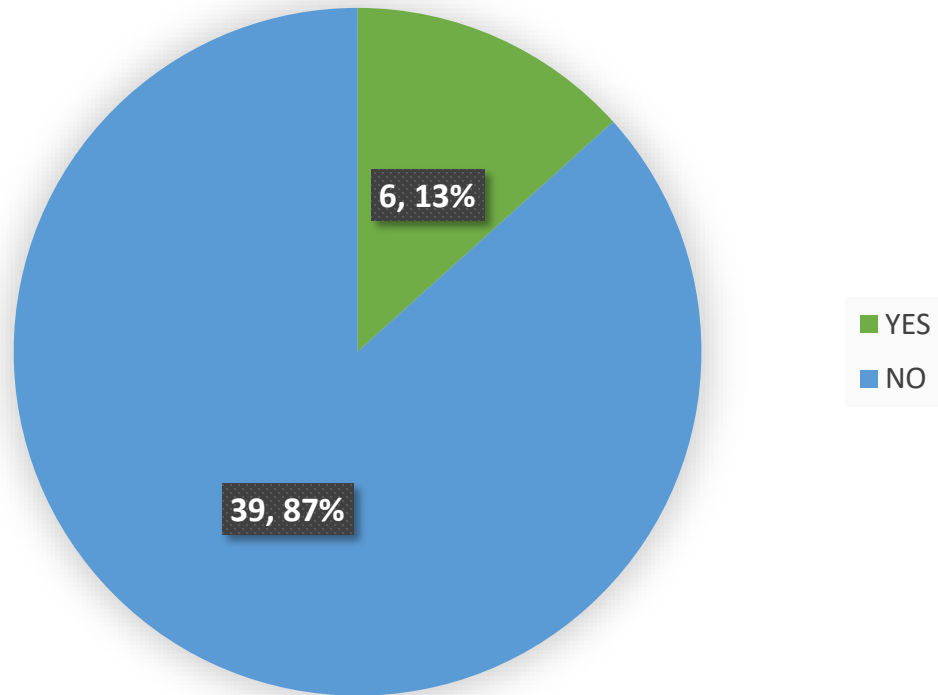


Capitalization Strategies

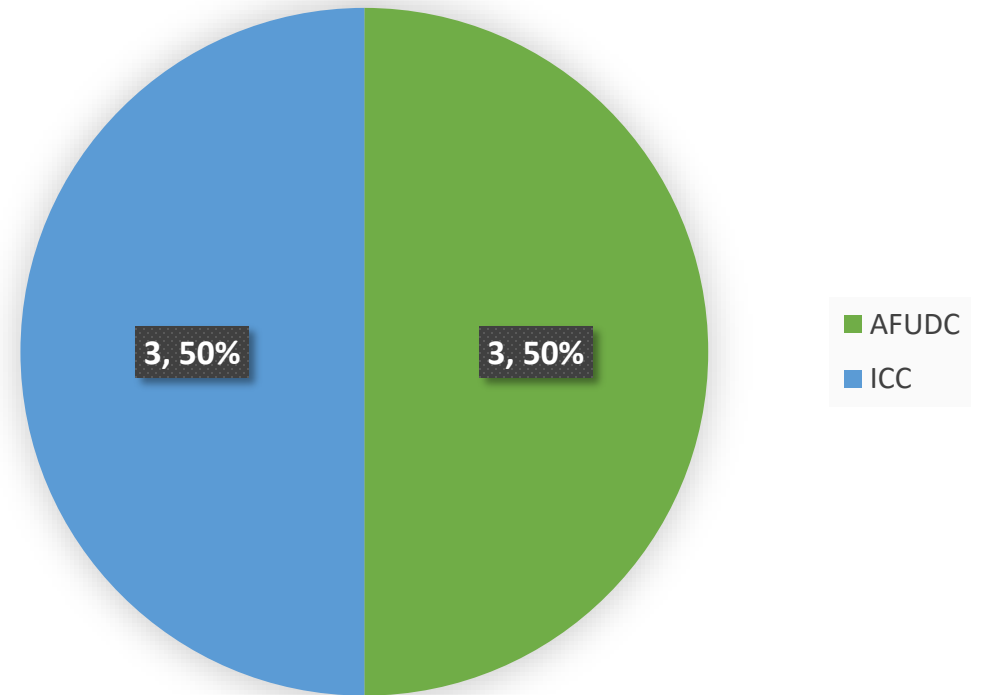


Capitalizing Interest

**DOES YOUR COOPERATIVE
CAPITALIZE INTEREST?**

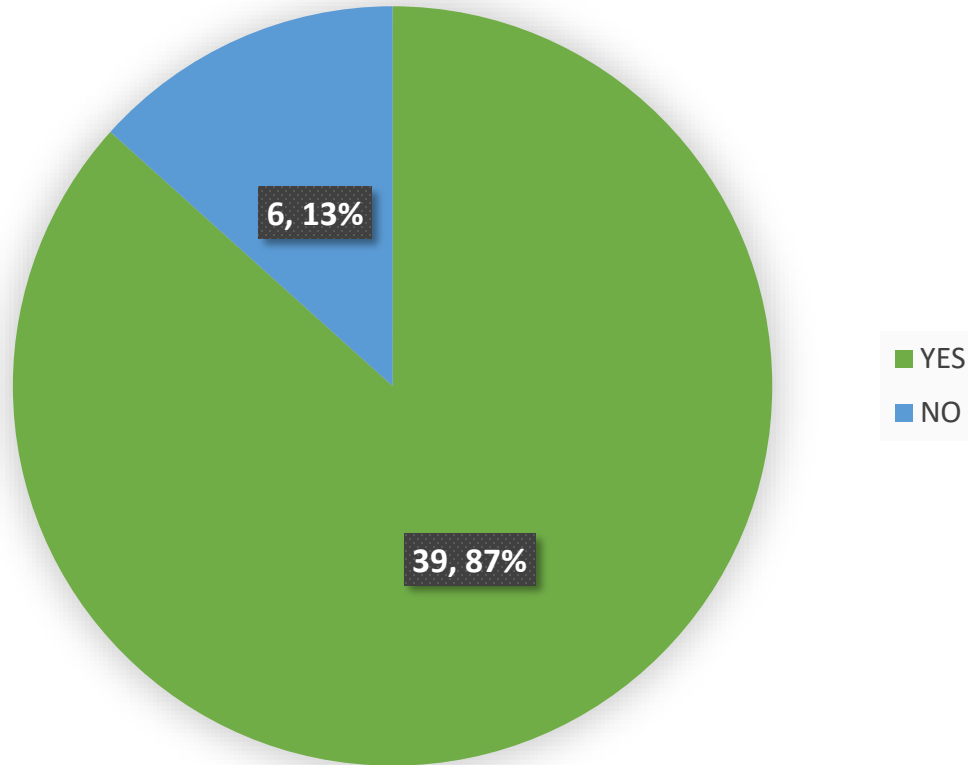


**WHAT PROCESS IS USED TO
CAPITALIZE INTEREST?**

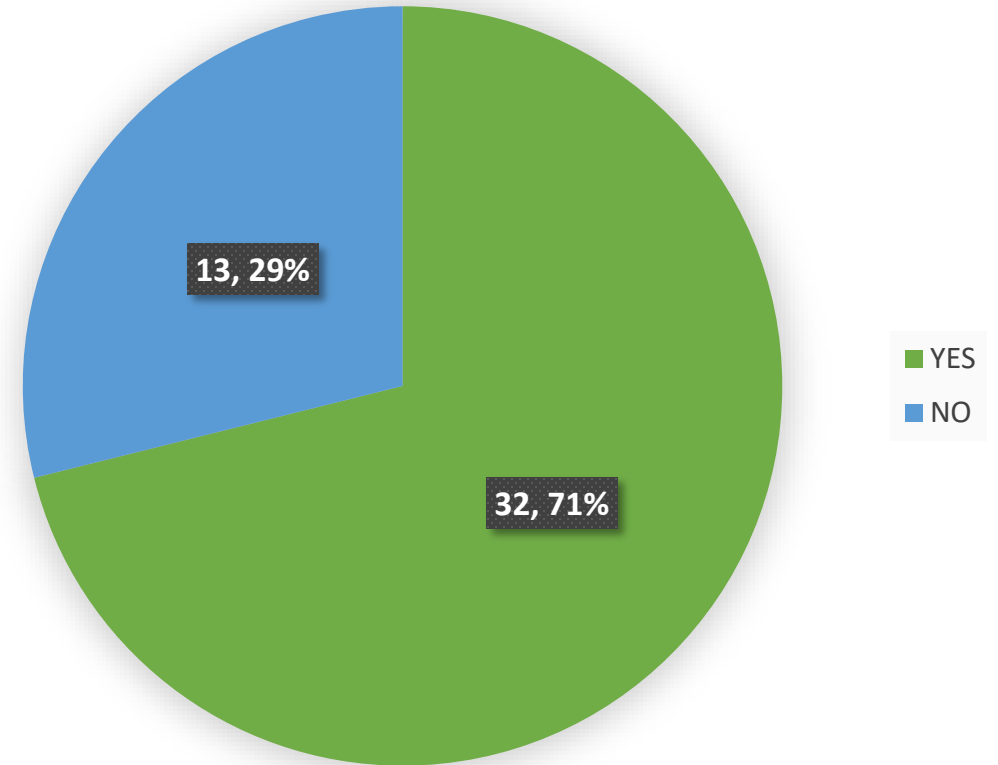


Special Equipment Treatment

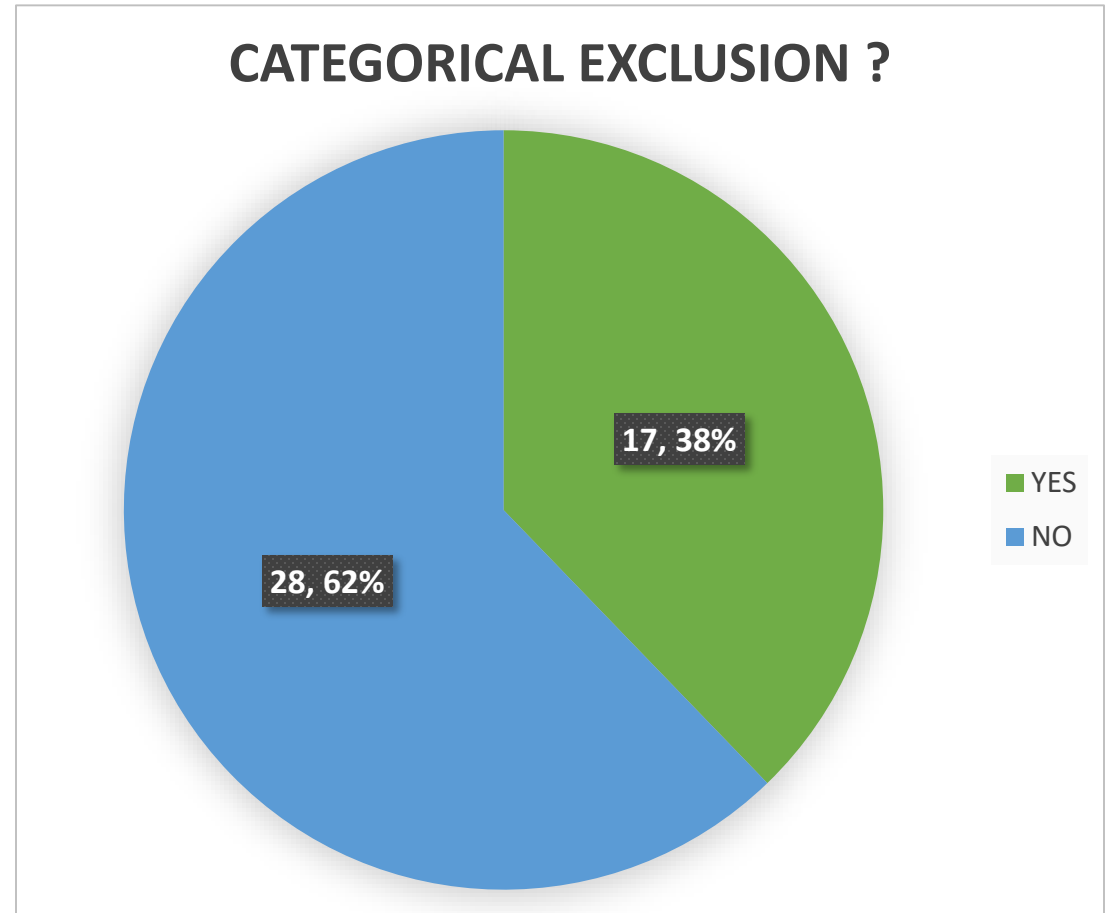
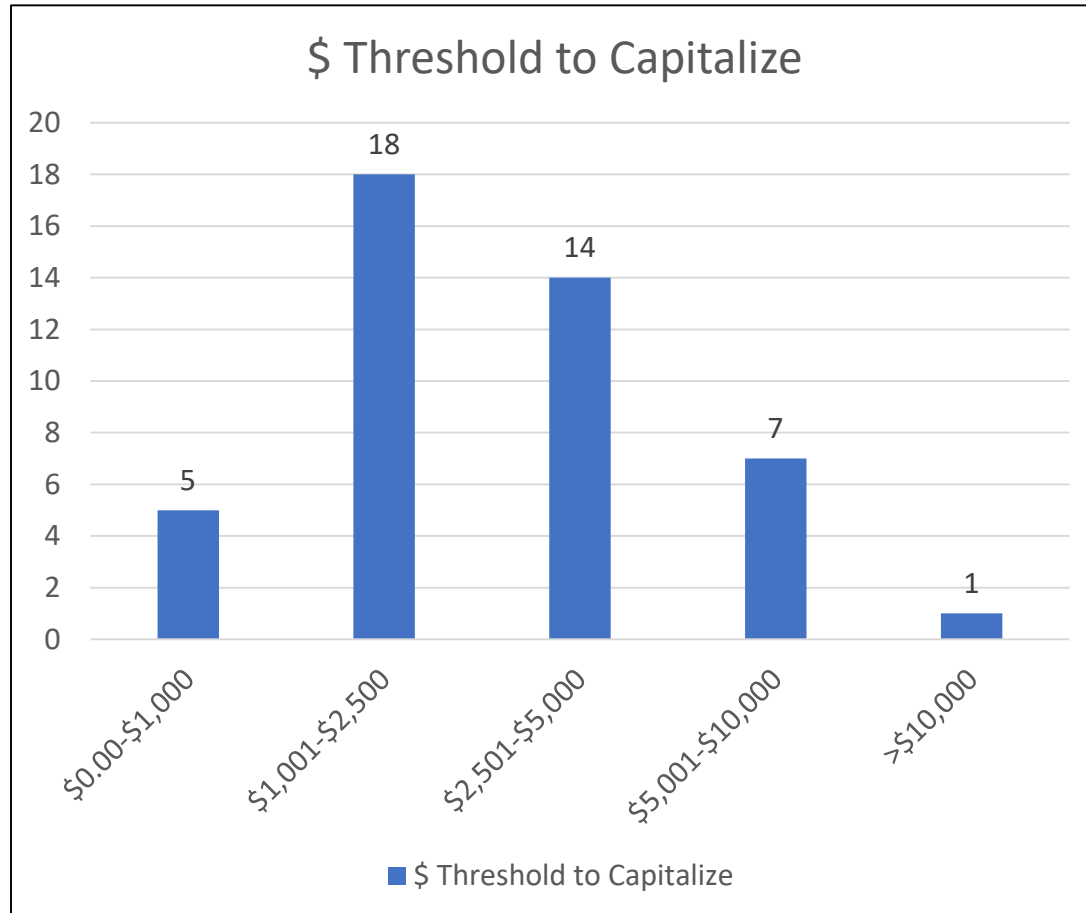
METERS



TRANSFORMERS



General Plant Capitalization Threshold

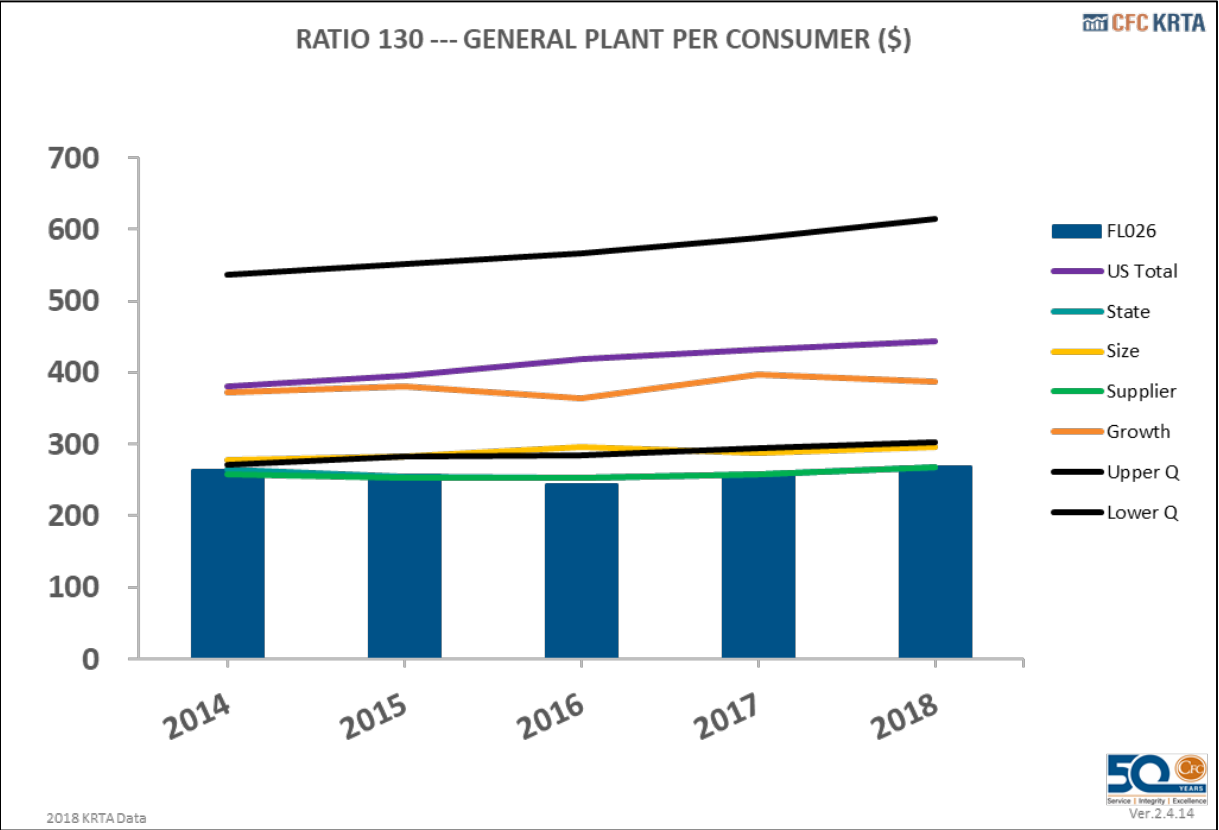
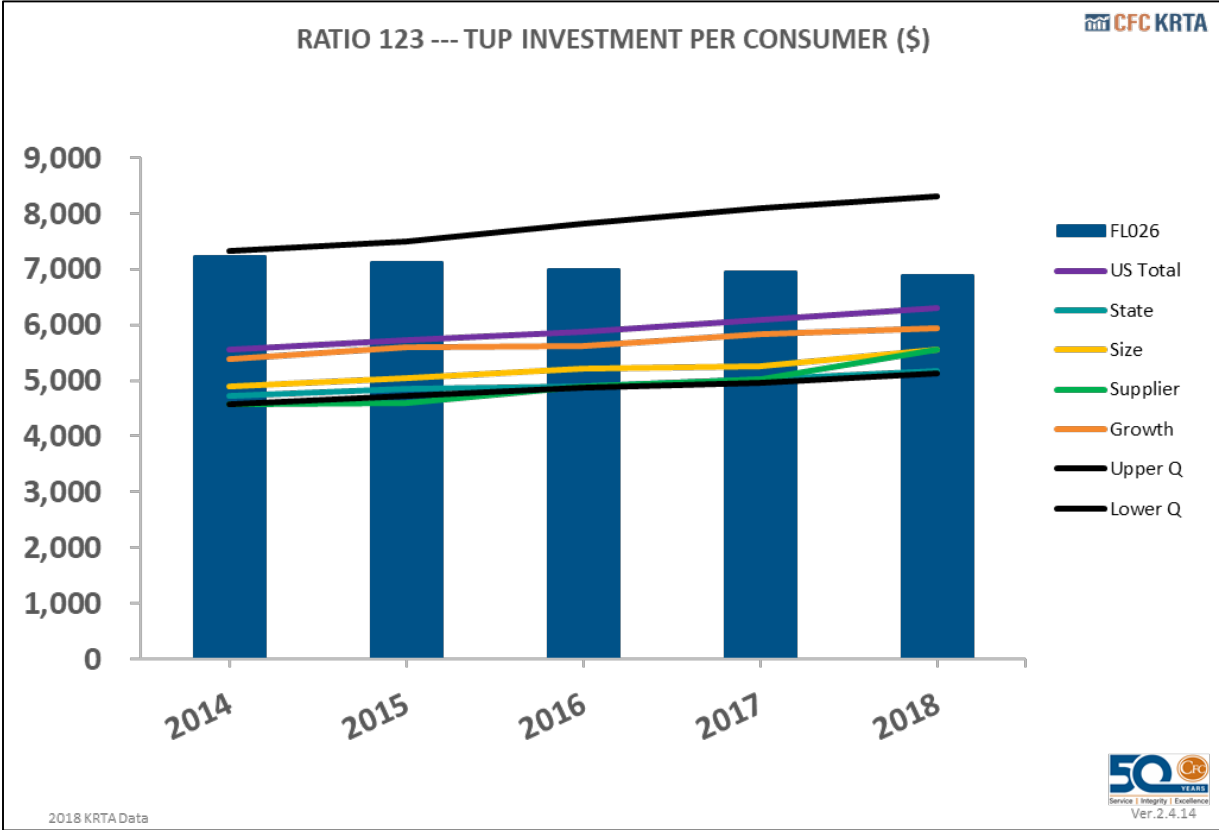


Industry Benchmarking

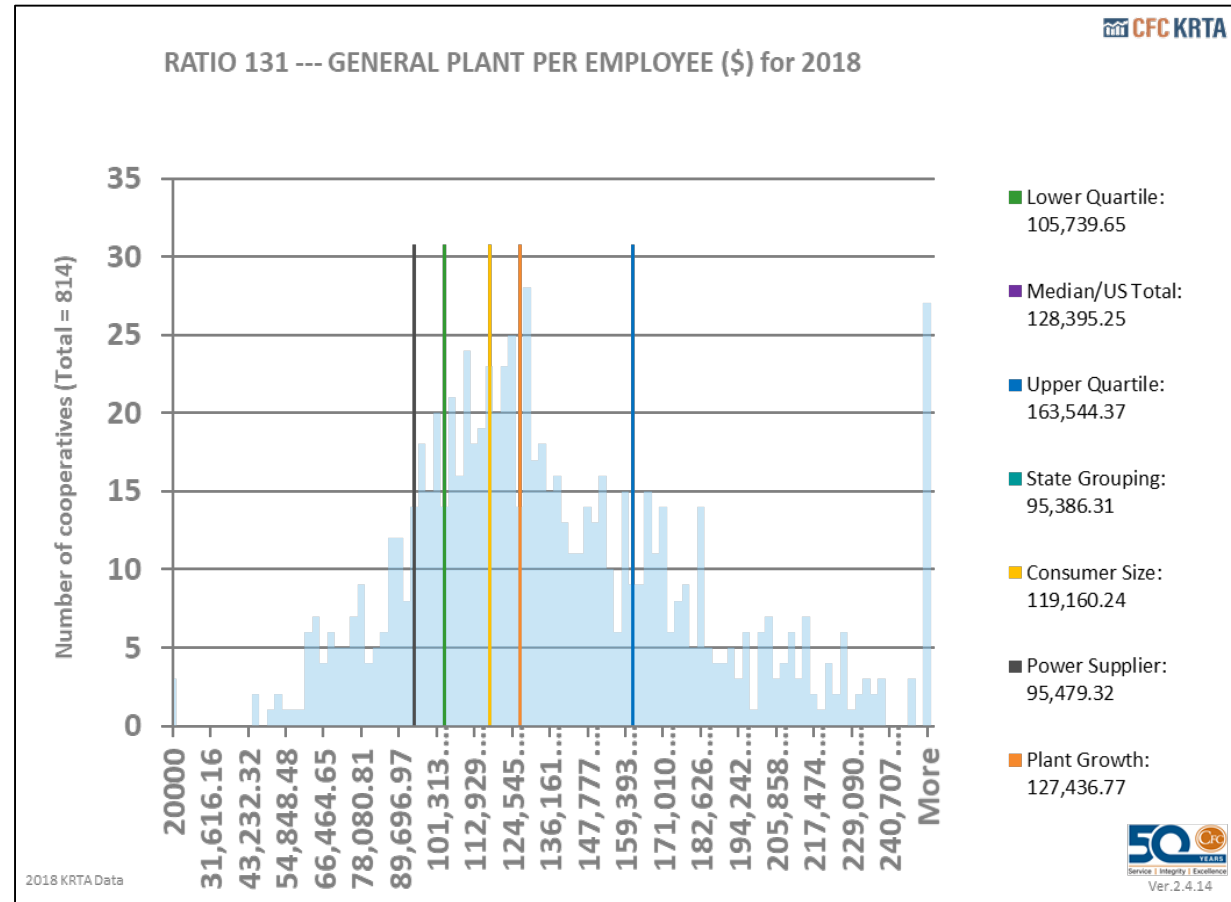
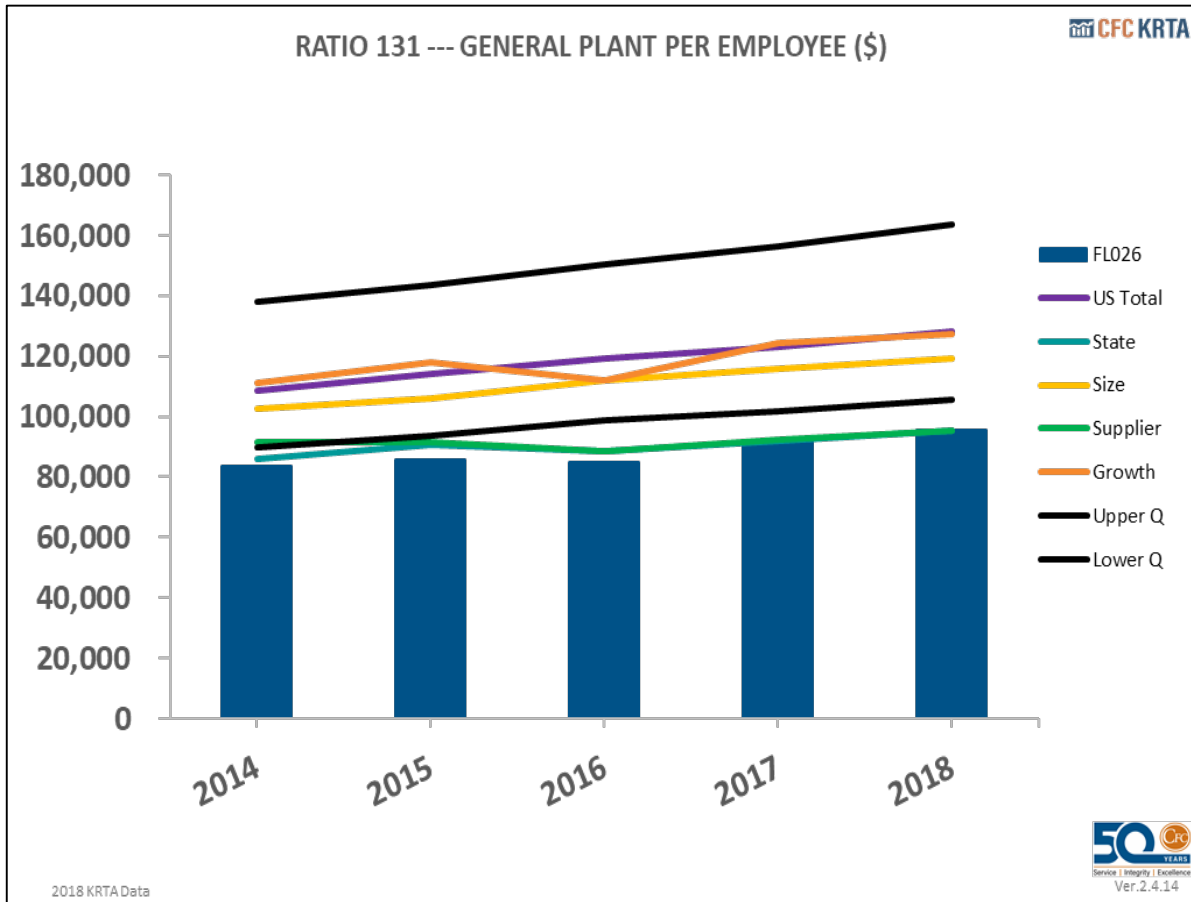
KRTAs – CFC Key Ratio Trend Analysis

- #123 – TUP Investment per Consumer (\$)
- #95 – Depreciation Expense as a % of TUP
- #112 – Capitalized Payroll/Total Payroll %
- #114 – Annual Growth in kWh Sold
- #122 – TUP per kWh Sold
- #123 – TUP per Consumer
- #124 – TUP per Mile of Line

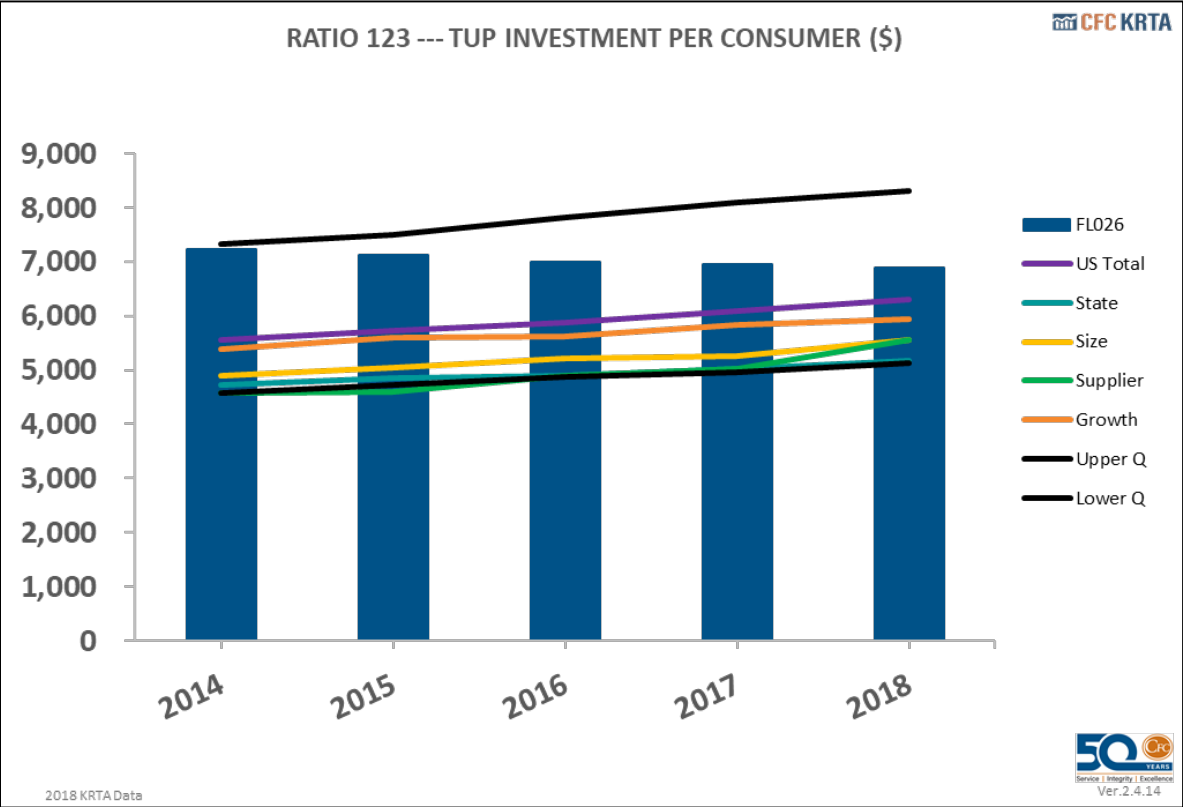
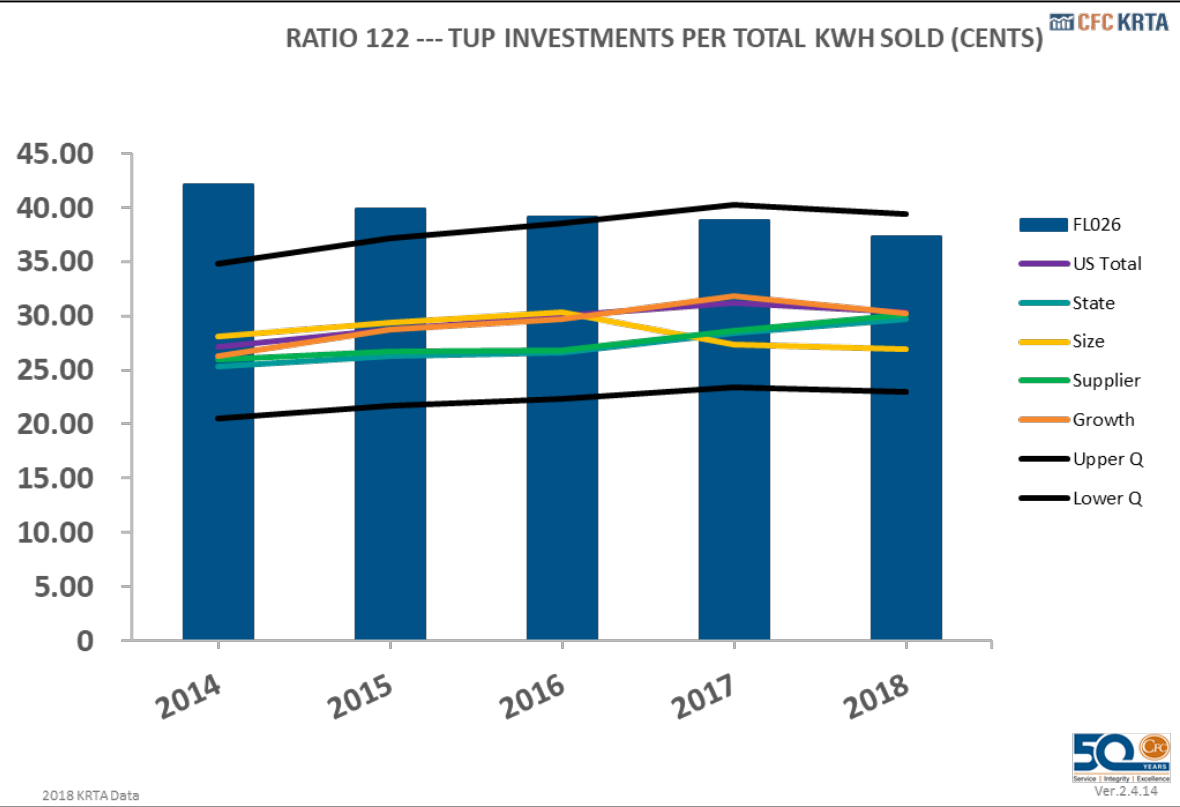
Capitalization per Consumer (\$)



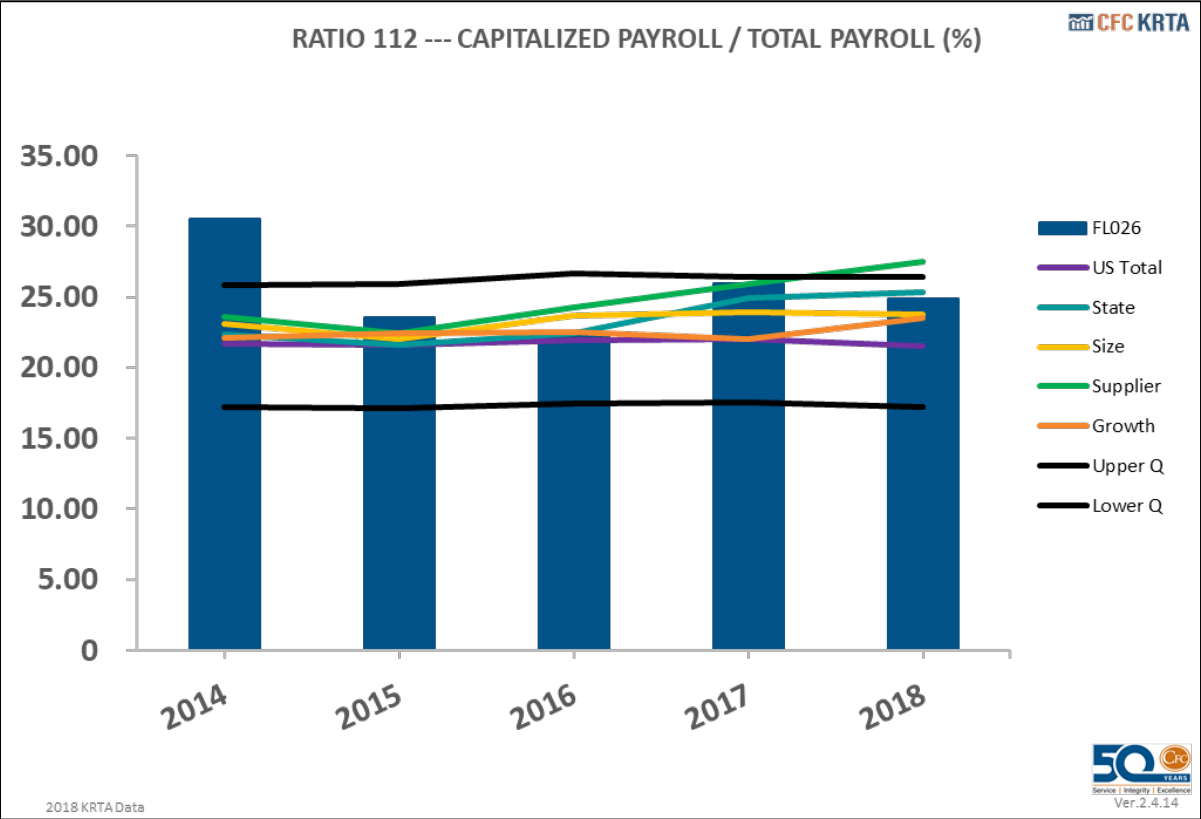
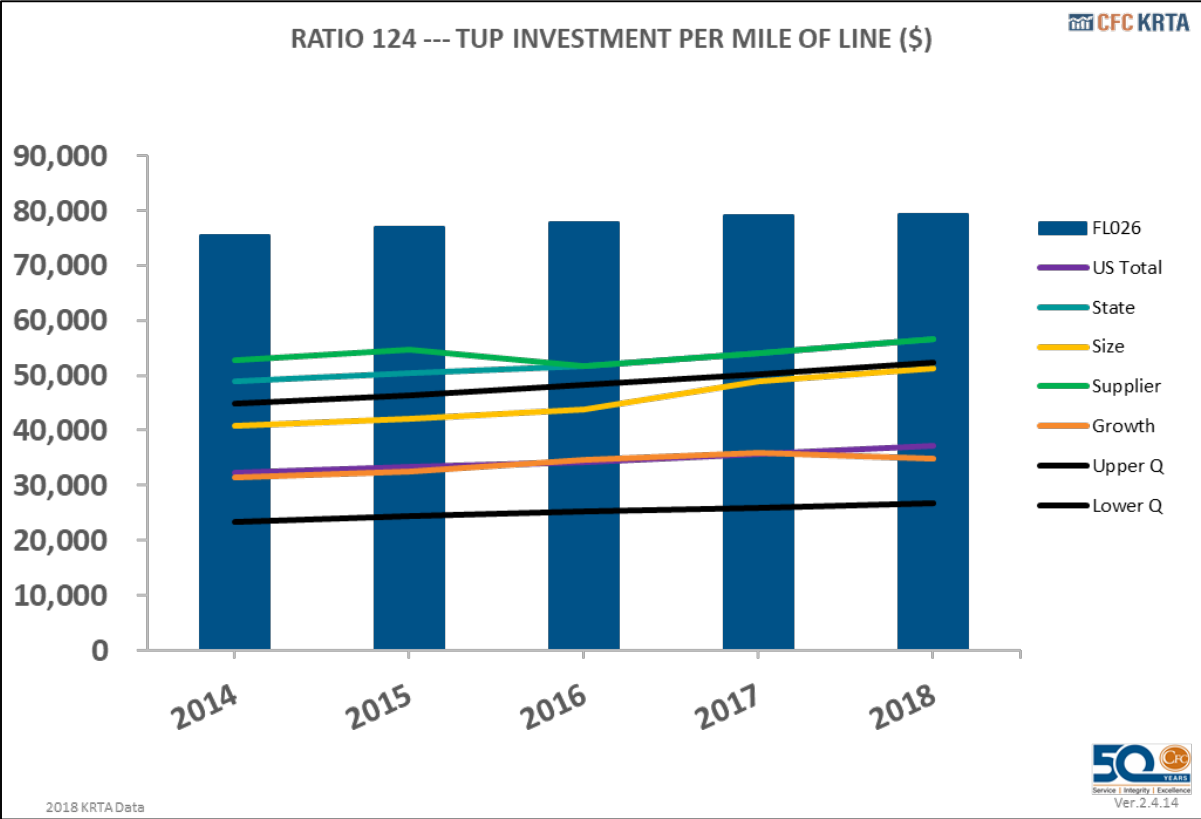
Capitalization per Employee (\$)



TUP Benchmarking



Labor Capitalization



A Capitalization Policy Should:

- Clearly Denote the Purpose
- Aim to Achieve Uniformity
- Clearly Define the Definition of a Fixed Asset
- Clearly Provide Guidelines
 - Threshold
 - Cost or Costs to be Capitalized
 - Asset Life (Depreciable Life)
 - Residual Value (If Any)
 - Classification of Asset
- Describe the Depreciation Method to be Employed
- Outline Costs to be Expensed (Repairs and Maintenance)
- Establish Procedures for Retirement of Assets

CAPITALIZATION

U.S. GAAP

ASC 360, Property, Plant and Equipment
ASC 835-20, Capitalization of Interest
ASC 410, Asset Retirement and Environmental Obligations

Industry Specific Guidance

FERC Uniform System of Accounts (18 CFR 101)
RUS Uniform System of Accounts (7 CFR 1767)

Internal Revenue Code (IRC)

IRC Section 162
IRC Section 263

Capitalization Under U.S. GAAP

- U.S. GAAP Requires the Capitalization of Cost When a **Future Benefit** for an Expenditure Exists
 - An Asset Provides a Benefit Beyond the Current Year
 - An Asset has an Expected Useful Life of More than One Year
- U.S. GAAP Allows the Capitalization of Expenditures to Bring an Asset into Service (shipping, installation, etc.)
- The Cost of Maintaining Assets Cannot be Capitalized

Costs of Capital Assets

- **Assets Purchased**
 - Purchase Price
- **Internally Constructed Assets**
 - Cost to the Utility/Cooperative
 - Direct Labor & Benefits
 - Indirect Labor & Benefits
 - Materials and Supplies
 - Transportation and Equipment Costs
 - Contract Labor

FERC and RUS Capitalization Procedures

- **Electric Plant Should be Recorded at Cost**
 - Stated on the Basis of **Cost to the Utility** – Purchased or Constructed
 - Reduced by Contribution-in-Aid of Construction
 - Specifically, electric plant accounts shall not include the cost or other value of electric plant contributed to the company. Plant constructed from contributions of cash or its equivalent shall be shown as a reduction to gross plant constructed.
 - When the consideration given for property is other than cash, the value of such consideration shall be determined on a cash basis

Electric Utility Plant (Distribution Cooperative)

Distribution Plant

- Land and Land Rights
- Structure and Improvements
- Station Equipment
- Poles, Towers and Fixtures
- Overhead Conductors
- Underground Conductors
- Line Transformers
- Meters

General Plant

- Land and Land Rights
- Structures and Improvements
- Office Furniture and Equipment
- Transportation Equipment
- Stores Equipment
- Tool, Shop, & Garage Equipment
- Power Operated Equipment
- Communication Equipment

Distribution Plant - Components of Construction Cost *Shall* Include When Applicable:

- Contract Work
- Labor
- Materials and Supplies
- Transportation
- Special Machine Service
- Shop Service
- Protection
- Injuries and Damages
- Privileges and Permits
- Rents
- Engineering and Supervision
- General Admin Capitalized
- Engineering Services
- Insurance
- Law Expenditures
- Taxes
- Allowance for Funds Used During Construction (Interest)
- Earnings and Expenses During Construction
- Training Costs
- Studies
- Asset Retirement

Allowance for Funds Used During Construction: **Capitalized Interest**

$$A_i = s \left(\frac{S}{W} \right) + d \left(\frac{D}{D+P+C} \right) \left(1 - \frac{S}{W} \right)$$
$$A_c = \left[1 - \frac{S}{W} \right] \left[p \left(\frac{P}{D+P+C} \right) + c \left(\frac{C}{D+P+C} \right) \right]$$

- A_i = Gross allowance for borrowed funds used during construction rate.
- A_c = Allowance for other funds used during construction rate.
- S = Average short-term debt.
- s = Short-term debt interest rate.
- D = Long-term debt.
- d = Long-term debt interest rate.
- P = Preferred stock.
- p = Preferred stock cost rate.
- C = Patronage capital assigned.
- c = Entity's incremental borrowing rate.
- W = Average balance in construction work in progress plus nuclear fuel in process of refinement, conversion, enrichment, and fabrication, less asset retirement costs related to plant under construction.

Capitalization of Interest During Construction

- Allowance for Funds Used During Construction Includes the Net Cost for the Period of Construction of Borrowed Funds Used for Construction Purposes and Reasonable Rate on Other Funds When So Used.
- The Rates Shall be Determined Annually.
- Interest Cannot be Capitalized on Projects which Have Been Abandoned.
- Capitalization of Interest is Not Allowed Once Plant is Placed Into Service.

Special Equipment Accounting

- **Why is it Special?**

- Items are classified as such because they are continually being moved from one location to another due to changes in load and maintenance practices.
 - Meters
 - Transformers
 - Oil Circuit Reclosures
 - Line Regulators

- **Special Equipment is Capitalized When Purchased**

- Capitalized with the Estimated Cost of Installation (All Costs Necessary to Install the Equipment [*1st Installation*] and Prepare the Equipment for Use)
- All Subsequent Costs are Expensed

Maintenance vs. Capitalization

- Does the expenditure create a **future benefit**?
- Does the expenditure constitute a **retirement unit**?
 - Per FERC and RUS, the cost of replacing items that do not constitute a retirement unit should be charged to maintenance.
 - Must be able to remove the old asset from the books in order to add the replacement to the books.

Maintenance vs. Capitalization

RUS Accounting Procedure 127 – Continuing Property Records for Buildings

When establishing continuing property records for a building where there is no detailed breakdown of contract costs, it is necessary to estimate the cost of each component part.

*It should be noted that the establishment of continuing property records is not required for buildings; however, **if CPRs are not maintained, all repairs including the replacement of major component parts shall be expensed in the period incurred.***

Depreciation

- **Method** – Must Allocate in a Systematic and Rational Manner the Service Value of Depreciable Property Over the Service Life of the Property.
- **Service Lives** – Estimated Useful Service Lives Must Be Supported by Engineering, Economic, and Other Depreciation Studies.
- **Rate** – Must use percentage rates of depreciation that are based on a method of depreciation that allocates in a systematic and rational manner the service value of depreciable property to the service life of the property.

RUS Bulletin 183-1

- Revised: *October 28, 1977*
- Based on a review of “current” industry depreciation rates and practices
- Provides depreciation rates for generation, transmission, distribution, and general plant.

UNITED STATES DEPARTMENT OF AGRICULTURE
Rural Electrification Administration
October 28, 1977

REVISION OF RRA BULLETIN 183-1

Attached is revised RRA Bulletin 183-1, Depreciation Rates and Procedures. Depreciation rates and procedures prescribed in this bulletin are effective January 1, 1978. However, borrowers wishing to make the changes retroactive to January 1, 1977, may do so. Borrowers may continue to use those rates which RRA has approved on the basis of special studies.

A recent review of current industry depreciation rates and practices indicates RRA's prescribed rates for generation and transmission and the ranges of rates for distribution plant are generally in agreement with current industry data. The review did indicate an upward trend in certain prescribed rates which have been reflected in the new rates as follows:

1. The prescribed rate for steam production plant is changed from 2.82 percent to 3.10 percent.
2. The prescribed rate for transmission lines is changed from 2.60 percent to 2.75 percent. If communication equipment is not "significant" (see page 14) borrowers may now use a composite rate of 2.75 percent for all transmission plant.
3. The prescribed range of rates for Account 364, Poles, Towers and Fixtures is changed from a range of 3.0 to 3.5 percent to a range of 3.0 to 4.0 percent.

The revised bulletin requires that the accumulated provision for depreciation of distribution plant be analyzed on at least an annual basis. The only other major change in the bulletin is the clarification (page 14, B) of the handling of depreciation rates for nuclear production plant.

To eliminate some apparent confusion, the following points concerning this bulletin are emphasized.

1. RRA will not object to the use of the "unit method" of depreciation for "General Plant," where the board of directors approve of this procedure as being necessary to meet their management needs.
2. The use of RRA approved rates for general plant has not been necessary since the 1969 revision of Bulletin 183-1. We recommend that borrowers use the range of rates for general plant provided in the bulletin. However, a rate based upon the experience of the cooperative, representing the estimated service life and salvage is satisfactory.

Attachment

Questions

