Capitalization Policies and Strategies

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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

RUS BORROWER

- YES: 26, 58%
- NO: 19, 42%

RUS DEPRECIATION RATES

- YES: 38, 84%
- NO: 7, 16%
Depreciation Studies

**COMPLETED DEPRECIATION STUDY IN THE PAST 10 YEAR**
- Yes: 29 (64%)
- No: 16 (36%)

**IF NO, DO YOU PLAN ON COMPLETING ONE IN THE NEXT 3 YEARS**
- Yes: 64%
- No: 36%
Depreciation

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

DEPRECIATION GUIDELINE CURVES

Applicable To Distribution Borrowers With An Elapsed Age Since Energization Of At Least 20 Years

Reserve Ratio = Accumulated Provision For Depreciation On Distribution Plant Divided By Distribution Plant In Service.

Maximum Curve

Minimum Curve

Optimum Curve

25 R3 - 10% Salvage
30 R1 - 10% Salvage
35 R1 - 10% Salvage

Average Annual Compounded Rate Of Growth Of Distribution Plant In Service (Percent) For At Least The Last 10 Years

0 1.0 2.0 3.0 4.0 5.0 6.0 7.0 8.0 9.0 10.0 11.0 12.0 13.0 14.0 15.0 16.0 17.0 18.0 19.0 20.0

Ratio Of Current Distribution Plant In Service To Distribution Plant In Service 10 Years Ago

2000 2010 2015 2018
Capitalization Strategies

![Capitalization Strategy](chart1)

![Capitalization Strategy vs. Labor Capitalization Rate](chart2)
Does your cooperative capitalize interest?

- Yes: 6, 13%
- No: 39, 87%

What process is used to capitalize interest?

- AFUDC: 3, 50%
- ICC: 3, 50%
General Plant Capitalization Threshold

$ Threshold to Capitalize

CATEGORICAL EXCLUSION?

- YES: 17, 38%
- NO: 28, 62%
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
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**

• \( A_i = \text{Gross allowance for borrowed funds used during construction rate.} \)

• \( A_c = \text{Allowance for other funds used during construction rate.} \)

• \( S = \text{Average short-term debt.} \)

• \( s = \text{Short-term debt interest rate.} \)

• \( D = \text{Long-term debt.} \)

• \( d = \text{Long-term debt interest rate.} \)

• \( P = \text{Preferred stock.} \)

• \( p = \text{Preferred stock cost rate.} \)

• \( C = \text{Patronage capital assigned.} \)

• \( c = \text{Entity's incremental borrowing rate.} \)

• \( W = \text{Average balance in construction work in progress plus nuclear fuel in process of refinement, conversion, enrichment, and fabrication, less asset retirement costs related to plant under construction.} \)

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