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Accounting for Leases

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Session Agenda

- Lease accounting update
- Energy contract case studies involving:
  - Leases
  - Derivatives
  - Variable interest entities (“VIE”)
- Sale leaseback accounting

Session Objectives

- As a result of this session, you will be able to:
  - Understand how to evaluate an energy contract to determine the appropriate accounting model
  - Perform a lease assessment in accordance with Topic 840;
  - Understand the sale leaseback considerations for alternative energy projects
  - Understand the current status of the FASB's lease accounting project and its impact on alternative energy structures

Lease Accounting Update

Lease Accounting Project

Key dates	Description
May 2013	**FASB and IASB issue revised leases exposure draft**
September 2013	**Comments on revised exposure draft due** *More than 640 comment letters received*
November 2013	**Redeliberations plan established** *Almost all key aspects of proposal to be revisited*
January 2014 to March 2015	**Redeliberations** *More significant issues discussed include (1) lessor accounting, (2) lessee accounting, and (3) definition of a lease*
March 2015	**Redeliberations conclude** *Staffs are in the process of drafting final standard*

Final standard expected by the end of 2015

Key takeaway: all leases for lessees (except for certain short-term leases) will go on the balance sheet

Definition of a Lease

A contract that conveys the right to use an asset for a period of time, in exchange for consideration

Identified asset	Requires an identified asset • Explicitly or implicitly specified • Substitution rights must be considered if substantive [i.e., practical ability + economic benefit]
Control	Must have right to *direct the use* and *obtain substantially all economic benefits from use* • <u>Direct the use</u> - should focus on the ability to direct “how and for what purpose” the asset is used • <u>Obtaining substantially all economic benefits from use</u> - can be obtained directly or indirectly in many ways and includes the underlying assets primary output and by-products

Lessor Accounting Model

Existing lessor accounting retained with minimal changes:

- Classification criteria would be similar to IAS 17
  - Finance lease**:** generally consistent with today's sales-type/direct-finance leases
  - Operating lease**:** generally consistent with today's operating leases
- Differing views on recognizing dealer profit for sales-type leases:
  - FASB view**:** up-front recognition of manufacturer's profit would be precluded if control of asset is not transferred to lessee
  - IASB view**:** manufacturer's profit, if any, should be recognized up front

Lessee Accounting Model

Overview

- Most leases on balance sheet (similar to today's capital leases)

Initial measurement

- Introduces the right-of-use ("ROU") asset approach under which a lessee records:
  - ROU asset — right to use the leased asset
    - Present value ("PV") of lease payments + lessee's initial direct costs
    - Initial direct costs: Incremental costs that would not have been incurred if the lease had not been obtained/executed (excludes internal costs — e.g., salaries of employees)
    - Recognize lease incentives as a reduction in the right-of-use asset
  - Lease liability — obligation to make lease payments
    - PV of lease payments

Lessee Accounting Model *(cont.)*

- Subsequent measurement
  - ROU asset
    - Boards are not converged on the subsequent measurement:

<table>
<tr><th colspan="2">FASB approach</th></tr>
<tr><td colspan="2">Dual-model approach — a lessee would apply guidance similar to IAS 17 when determining whether a lease should be classified as Type A or Type B</td></tr>
<tr><th>Finance lease</th><th>Operating lease</th></tr>
<tr><td>Expenses will be front-loaded, consistent with today’s capital leases</td><td>Expense will be recorded on a straight-line basis</td></tr>
<tr><th colspan="2">IASB approach</th></tr>
<tr><td colspan="2">Single-model approach — a lessee would account for all leases as a financed purchase of the ROU asset</td></tr>
</table>

    - Impairment: refer to existing standards (Topic 360)
  - Lease liability
    - Amortized cost: use the effective interest method

Lease Classification

CLASSIFICATION CRITERIA
Would account for as a Type A lease when the lease… ✓ Transfers ownership by end of lease term; ✓ Includes a purchase option that the lessee is *reasonably certain* to exercise; or ✓ There is a transfer of substantially all of the risks and rewards of ownership of the asset

Although the evaluation is similar to current U.S. GAAP, items to consider include:

- Land and other elements would evaluated separately unless the land element is clearly immaterial; this may result in more bifurcation of real estate leases than current U.S. GAAP
- The bright-line rules in current U.S. GAAP would be eliminated

Sale Leaseback

Tentative decisions on determining whether a sale occurred in a sale-leaseback transaction:

- Seller-lessee should apply the definition of a sale in the new revenue guidance (i.e., Topic 606 or IFRS 15)
- Existence of leaseback would *not* prevent a conclusion that underlying asset was sold
- Substantive repurchase options would prevent seller-lessee from recognizing a sale
- Leaseback transaction resulting in Type A leases would preclude sale accounting for seller-lessee (FASB-only)

Sale gain recognition "At-market" terms	• FASB: Gain resulting from the sale recognized immediately • IASB: Gain recognition limited to amounts associated with residual asset
Leaseback accounting	• Account for leaseback in a manner consistent with other leases • Seller-lessee applies lessee model; buyer-lessor applies lessor model
"Failed" sale-leaseback	• "Failed" sale to be accounted for as a financing arrangement • FASB considering whether explicit application guidance needed in final standard

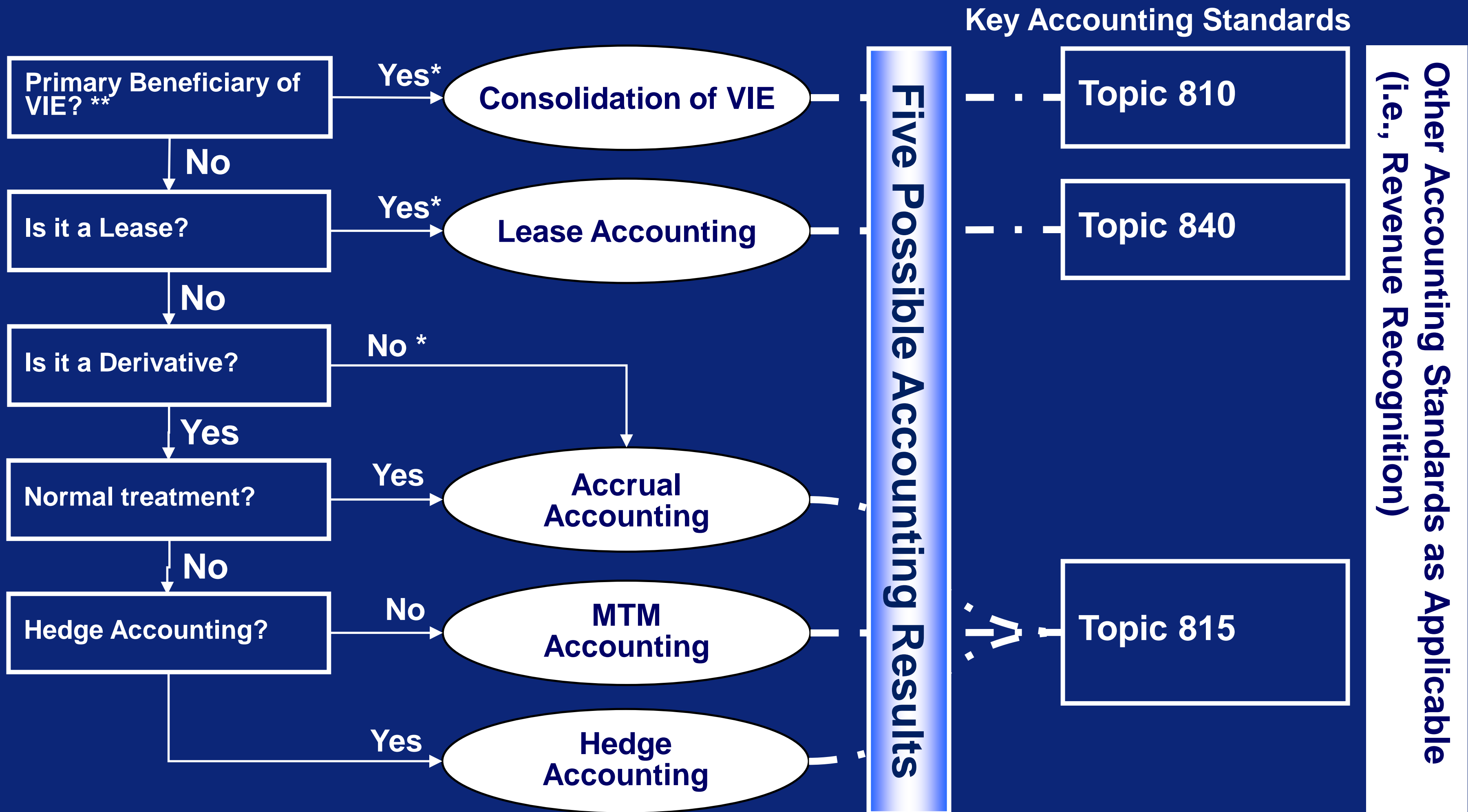
Key Impacts to AE Industry

- On-balance sheet requirement for all leases (except short-term leases) will require recognition and measurement of previously unrecorded leases (i.e., operating leases)

- Scope of the “definition of a lease”
  - Taking substantially all the output is no longer determinative (but design is)

Case Studies in Energy Contracts

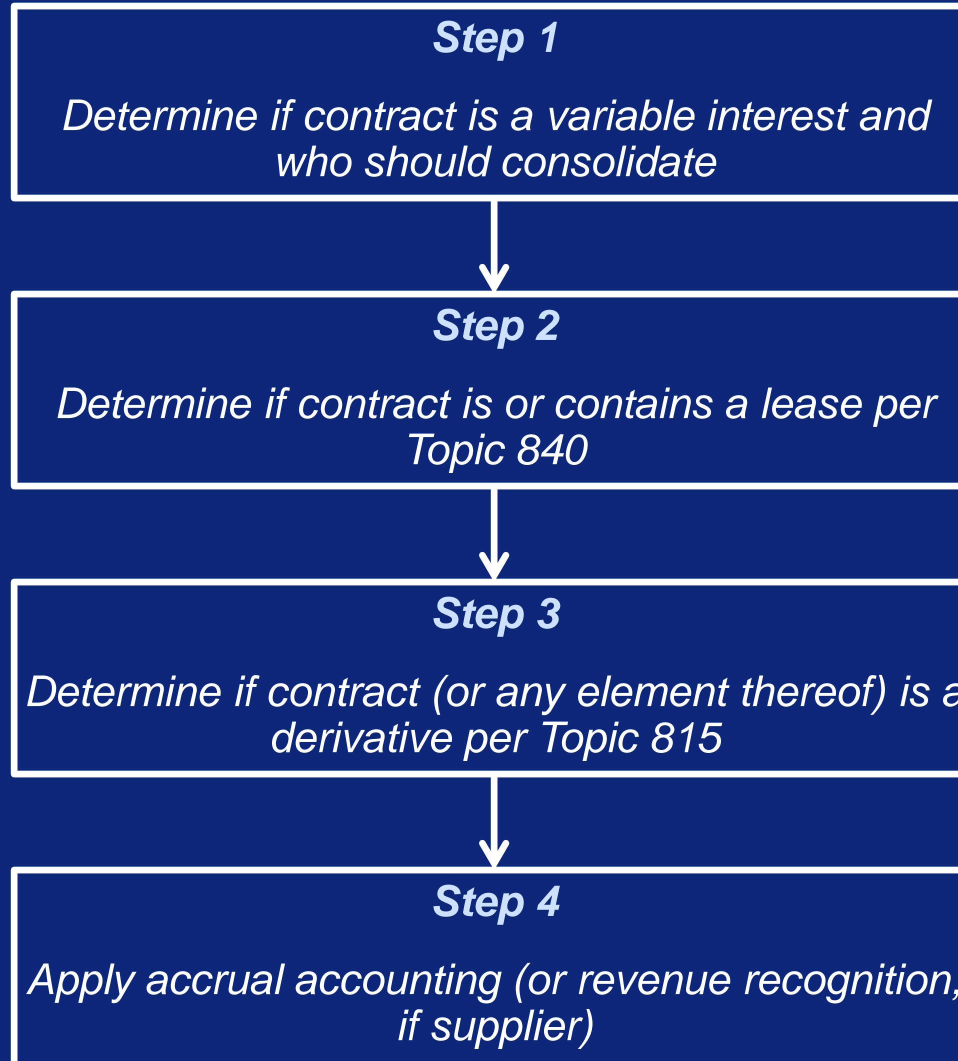
US GAAP Accounting Framework



* Requires embedded derivative review

** Consolidation Accounting may be applicable

Evaluating Energy Contracts



Case Study 1 Facts

- Buyer: Municipal Power (“MP”)
- Seller: Wind Energy, LLC (“WE”) owner of 60 MW wind power facility
- Start Date: 1/1/16 | End Date: 1/1/36
- Volume: WE commits to MP at point of delivery all renewable energy produced and related renewable energy credits (“RECs”)
- Price: Up to 115% of the Estimated Renewable Energy, MP will pay WE $52.00 per MWh and for volumes above 115% will pay 75% of $52.00 per MWh
- Curtailment Clause: MP has the ability to curtail energy for any reason, but MP has to pay the product of the contract rate and the curtailed MWh, plus associated production tax credits (“PTC”) associated with curtailed MWh
- Assumes power purchase agreement (“PPA”) does not require off-taker to consolidate power provider

Determining Whether an Arrangement Contains a Lease

The identification of property, plant, or equipment in the arrangement need not be explicit; it may be implicit.

The arrangement conveys a right to use the asset if:

- Purchaser has the ability or right to operate the asset or direct others while obtaining or controlling more than a minor amount of output or other utility of the asset
- Purchaser has the ability or right to control physical access to the underlying asset while obtaining or controlling more than a minor amount of output
- It is remote that one or more parties other than the purchaser will take more than a minor amount of the output, and the price that the purchaser will pay for the output is neither fixed per unit of output nor equal to the current market price

(ASC 840-10-15-5 to -6, formerly EITF 01-08)

Guidance is essentially identical to IFRS, IFRIC 4 ("minor" vs. 'insignificant')

Case Study 1 Assessment

- Lease Assessment
  - Is there a lease term?
    - Yes, 1/1/16 through 1/1/36
  - Is fulfillment of the arrangement dependent on specified property, plant, & equipment (“PP&E”)?
    - Yes, the 60 MW facility
  - Ability to operate while taking more than a minor amount of output?
    - No
  - Control physical access while taking more than a minor amount of output?
    - No

Case Study 1 Assessment *(cont.)*

- Lease Assessment *(cont.)*
  - Taking substantially all output and price is neither fixed per unit of output, nor current market price per unit of output at time of delivery?
    - Yes
      - MP takes all of the output from the facility
      - For all energy delivered in excess of 115% of the Estimated Renewable Energy, the Purchaser pays the Seller a payment equal to 75% of the $52 MWh contract price
      - Therefore, depending on whether total energy is produced in excess of 115%, the average rate per unit can vary
- Conclusion: Lease
- Impact given new lease accounting guidance?

Case Study 1 Assessment *(cont.)*

- Lease Assessment *(cont.)*
  - What about the Curtailment Clause?
    - Depends – diversity in practice
    - Companies should create a policy and apply it consistently
  - Lease accounting should only be applied to the lease elements of the contract; other areas of GAAP should be applied to other elements of the contract
    - E.g., revenue recognition, if supplier

Case Study 2 Facts

- Buyer: Municipal Power ("MP")
- Seller: Solar Generation Company ("SG")
- SG is constructing a 50 MW solar generation asset and will sell MP 75% of the generation and REC's to MP's interconnection
- Start Date: Commercial Operation Date ("COD")
- End Date: 12/31/2035 (20 years after COD)
- Price: Fixed per year ranging from $45 MWh to $53 MWh during the 20-year term
- Assumes PPA does not require off-taker to consolidate power provider

Case Study 2 Facts *(cont.)*

- Mechanical Availability Percentage Guarantee: SG guarantees that the facility will be in operating condition and ready to generate power 85% of the year. If SG fails to meet this, SG pays MP damages for the amount of availability below the 85% threshold
- Expected Solar Energy (“ESE”) – 50,000 MWh per year
- Committed Solar Energy (“CSE”) – 70% of ESE
- Penalty for CSE Shortfall – SG pays MP market-based damages for the amount of power below the 70% CSE threshold

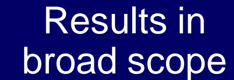
Case Study 2 Assessment

- Lease Assessment
  - Is there a specified lease term?
    - Yes – COD until the date that is 20 years after COD
  - Is fulfillment of the arrangement dependent on specified PP&E?
    - Yes, the 50 MW facility specified in the contract
  - Ability to operate while taking more than a minor amount of output?
    - No
  - Control physical access while taking more than a minor amount of output?
    - No

Case Study 2 Assessment *(cont.)*

- Lease Assessment *(cont.)*
  - Taking substantially all output and price is neither fixed per unit of output, nor current market price per unit of output at time of delivery?
    - No, MP only has rights to 75% of the output
    - Does the escalation in our price cause a problem?
    - No, pricing considered to be “fixed”
- Conclusion: Not a lease
- Impact given new lease accounting guidance?

Refresh on Derivative Criteria



- Financial instrument or other contract having each of the following:
  - One or more underlyings and one or more notional amounts or payment provisions or both
  - No (or small) investment at inception
  - Requires/permits net settlement or de facto net settlement
- If **all** 3 criteria exist, then the contract is a derivative

Case Study 2 Assessment *(cont.)*

- Derivative Assessment
  1) Underlying?
     - Yes – price of power at interconnection facility
  2) Notional?
     - Yes – explicitly stated as 75% of the 50,000 MWhs for the year
  3) No or little initial net investment
     - None
  4) Net Settlement
     - Yes, delivered to Power Pool
- Conclusion: Derivative (and may want to consider scope exceptions from Topic 815)

Case Study 3 Facts

- Buyer: More Power Company ("MPC")
- Seller: Caution to the Wind ("CW")
- CW operates wind generation assets and will sell MPC up to 200 MWs of capacity, energy, and environmental credits (100% of output) to CW's interconnection facilities from its wind plant
- Start Date: 1/1/16, End Date(s): 12/31/40
- Price: $40 per MWh
- Liquidating damage clause only in the case of gross negligence, willful misconduct, or willful breach by CW
- Assumes PPA does not require off-taker to consolidate power provider

Case Study 3 Assessment

- Lease Assessment
  - Is there a specified lease term?
    - Yes
  - Is fulfillment of the arrangement dependent on specified PP&E?
    - Yes*

* Consideration needs to be given to any contractual language which states output can be sourced from other unspecified PP&E as well as specified PP&E

Case Study 3 Assessment *(cont.)*

- Lease Assessment *(cont.)*
  - Ability to operate while taking more than a minor amount of output?
    - No
  - Control physical access while taking more than a minor amount of output?
    - No
  - Is it remote that parties other than MPC will take more than a minor amount of the output of PP&E during the term and is the price neither contractually fixed or equal to market price?
    - No, $40 fixed price throughout the contract
- Conclusion: Not a lease

Case Study 3 Assessment *(cont.)*

- Derivative Assessment
  1. Underlying?
     - Yes – price of power at interconnection facility
  2. Notional?
     - No
     - Quantity delivered is up to 200 MWhs of output from project. Thus, no contractual minimum.
     - The clause that allows for liquidating damages as a result of gross negligence, misconduct, or willful breach does not constitute a notional (i.e., asymmetrical default provisions).

Case Study 3 Assessment *(cont.)*

3. No or little initial net investment
   - None
4. Net Settlement
   - Yes, delivered to Power Pool

- Conclusion: Non-derivative – apply accrual accounting (or revenue recognition if supplier)

- Impact given new lease accounting guidance?
  - What if MPC had been involved in the design of the wind generation assets?

Case Study 4 Facts

- Buyer: Smallville Municipal Power ("SMP")
- Seller: Wind Generation Co. ("WG")
- WG operates wind generation assets and will sell SMP minimum of 30 MWs of generation and RECs of the 150MWs generated from the Open Plains project to WG's interconnection
- Start Date: 1/1/16 | End Date: 12/31/35
- Price: Fixed per year, ranging from $45 to $53 per MWh
- Default Provision: The damages are based on the delivery of replacement power
- Assumes PPA does not require off-taker to consolidate power provider

Case Study 4 Assessment

- Lease Assessment
  - Is there a specified lease term?
    - Yes
  - Is fulfillment of the arrangement dependent on specified PP&E?
    - Yes

Case Study 4 Assessment *(cont.)*

- Lease Assessment *(cont.)*
  - Ability to operate while taking more than a minor amount of output?
    - No
  - Control physical access while taking more than a minor amount of output?
    - No
  - Taking substantially all output and price is neither fixed per unit of output, nor current market price per unit of output at time of delivery?
    - Does the escalation in our price cause a problem?
      - No, pricing considered to be "fixed"
- Conclusion: Not a lease
- Impact given new lease accounting guidance?

Case Study 4 Assessment *(cont.)*

- Derivative Assessment
  1) Underlying?
     - Yes
  2) Notional?
     - Yes, contractual minimum specified
     - The default provision may constitute a notional too
  3) Initial net investment
     - No
  4) Net Settlement
     - Yes, delivered to Power Pool

- Conclusion: Derivative

Case Study 5 Facts

- Buyer: Energy Municipal Power (“EMP”)
- Seller: Clean Energy Corp. (“CEC”)
- CEC is planning to develop, design, construct, own or lease, and operate a renewable electric generating facility with a total expected capacity of 350 MW; EMP is contracting to purchase the entire production in a PPA
- Term: 20 years after the First Initial Delivery Date
- Price: Fixed during the life of the contract at $35.18/MWh

Case Study 5 Facts *(cont.)*

- Cost of Production: Limited to the cost of operations and maintenance with no variable payment to pass on O&M costs
- Other: While the contract will be used to obtain financing for the construction of plant, the buyer does not have ability to influence construction decisions or post contract terms, including dispatch rights
- Other: The PPA does not contain puts, calls, or guarantees related to the value of the underlying plant

Performing a VIE Assessment

- Identify the potential VIE
- Identify any variable interests held by the reporting entity
- Identify the risks inherent in the VIE that could be transferred to VI holders
- Identify the activities of the entity that most significantly impact the economic performance of the entity, taking into account the risks identified
- Identify which VI holders have the power over those activities and economic exposure – this is the primary beneficiary

Case Study 5 Assessment

- VIE Assessment
  - Is CEC a VIE?
    - Probably – most single-asset entities meet the definition of a VIE either because the entity does not have sufficient equity to finance on-going activities or because the entity benefitting most from the asset has limited power as compared to the risk it absorbs
  - What are the risks that CEC was designed to absorb?
    - Electricity price risk?
    - O&M risk?
    - Residual value risk?
    - Credit risk?
    - Regulatory risk?
    - Construction risk?
    - Others?

Case Study 5 Assessment *(cont.)*

- Does EMP absorb any of the previously identified risks creating a variable interest in CEC?
  - Maybe – need to consider other features that CEC has that absorb variability
- Given the above risks, what are the activities of CEC that most significantly impact its financial performance? And who controls those activities?

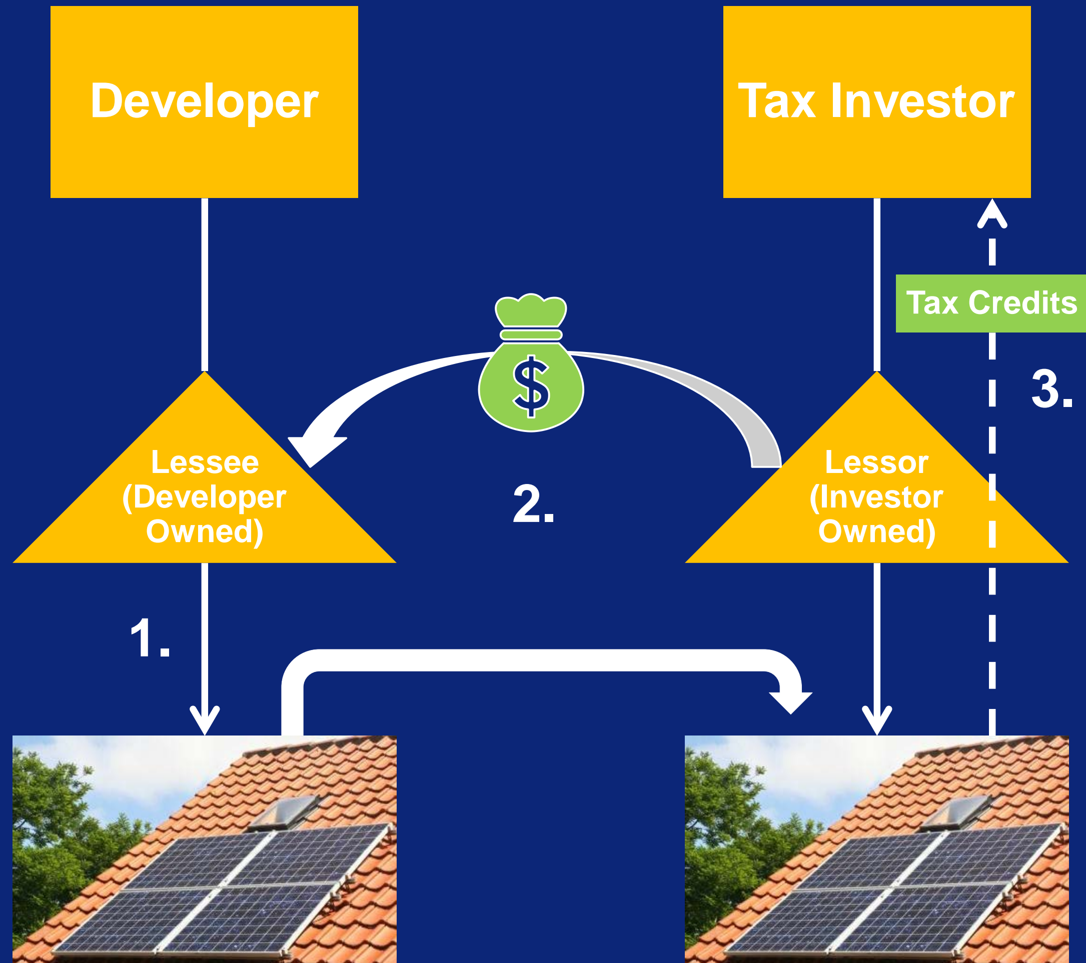
Case Study 5 Assessment *(cont.)*

- Assuming EMP has a variable interest in CEC, is EMP the primary beneficiary of CEC?
  - No – EMP does not have the power to direct any of the activities of CEC that would most significantly impact its economic performance
- Conclusion – EMP is not the primary beneficiary based on the above assessment and therefore would not consolidate CEC
- What changes in facts could change this conclusion?

Sale Leaseback Considerations

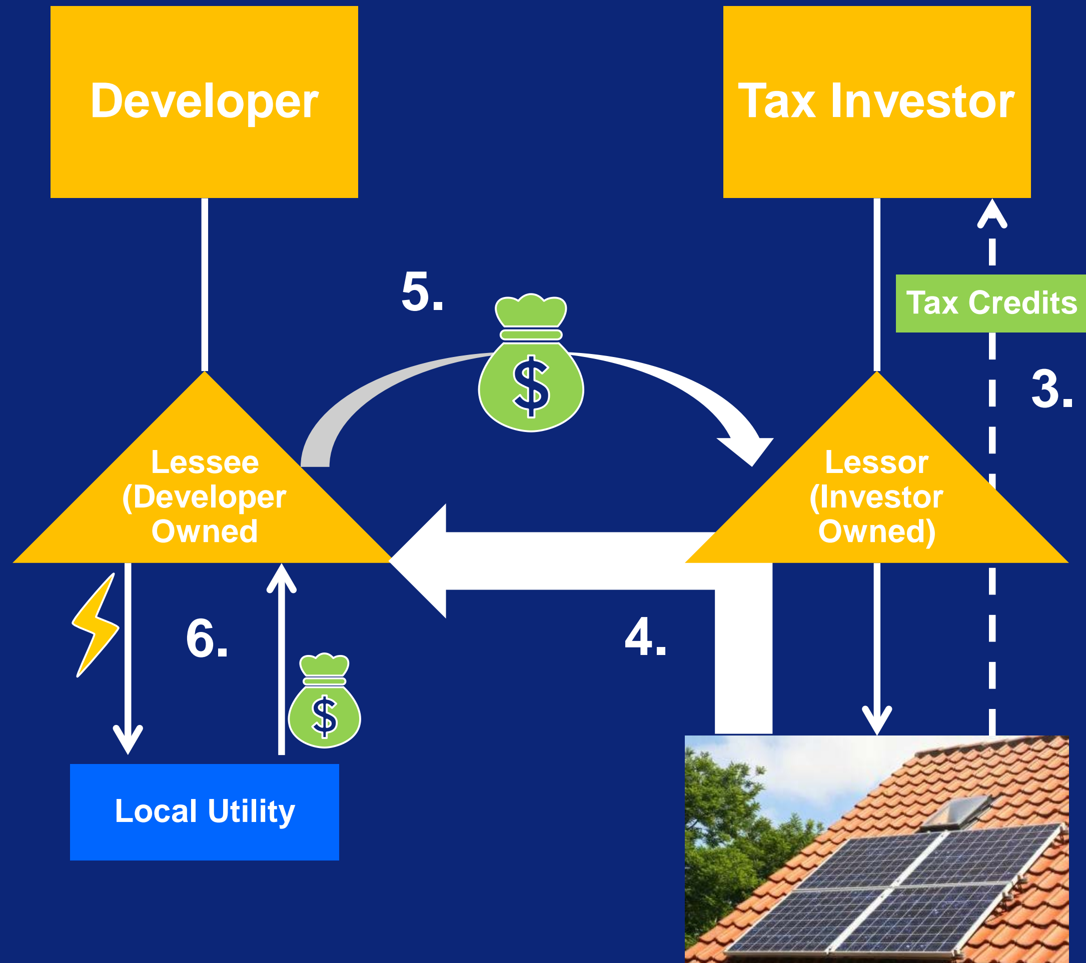
Sale Leaseback

1. Developer buys or obtains long-term (LT) roof lease rights and installs solar panels
2. Tax Investor purchases the installed panels from Developer and leases them back under LT lease
3. Tax Investor receives the 30% tax credit based on the purchase price paid for the panels and accelerated depreciation



Sale Leaseback *(cont.)*

4. Tax Investor leases the panels back to the Developer
5. Developer makes annual lease payments to the Tax Investor to cover debt service
6. Developer enters into PPA to sell electricity to utility or other party seeking green attributes



Sale Leaseback *(cont.)*

- Determine if transaction is in the scope of Real Estate Guidance (ASC 360-20-15)
  - In scope of Topic 360 if assets are considered to be integral equipment
- If considered real estate, determine if transaction is considered a sale
  - Sale accounting permits immediate recognition of profit
  - In practice, transactions are often not considered sales because of continuing involvement by the seller (e.g., repurchase option)

Sale Leaseback *(cont.)*

- If a failed sale of real estate: transaction accounted for using one of four possible methods
  - Financing method
  - Deposit method
  - Profit-sharing method
  - Leasing method
- If a sale of real estate: sale is recorded and the associated lease is recorded as either capital or operating
- If not real estate, in scope of Subtopic 840-40 *only* (i.e., not within scope of Topic 360)
- Impact given new lease accounting guidance?

Questions?

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