Accounting Issues Related to Construction of Alternative Energy Assets

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Agenda

• Capitalization
• Test Energy
• Capitalized Interest
• Asset Retirement Obligations
• Long-term Service Agreements
• Depreciation
• Liquidated Damages
Renewable Energy Projects

Issue:
Which guidance do we follow for renewable energy projects?

Answer: Real Estate  ASC 360-20-15-2
Capitalization vs Expense of Costs

- Start up Phase
- Development Phase
- Construction Phase
- Operation
Start-up Phase

• Start-up costs are specifically addressed by ASC 720-15

• Start-up costs are to be expensed as incurred
Start-up Phase

Start-up activities are defined broadly as activities related to any of the following:

• Opening a new facility
• Introducing a new product or service
• Conducting business in a new territory
• Conducting business with an entirely new class of customers or beneficiary
Start-up Phase

Start-up activities do not include:

• Routine ongoing efforts to refine, enrich, or otherwise improve upon the qualities of an existing product, service, process or facility
• Costs of acquiring or constructing long-lived assets and getting them ready for their intended uses
• Costs of acquiring or producing inventory

Note: This list is not meant to be inclusive of all activities that are not considered start-up activities
Development Phase

970-340-25-3

“…all other costs related to a property that are incurred before the entity acquires the property… shall be capitalized if all of the following conditions are met and otherwise shall be charged to expense as incurred:

• Costs are directly identifiable to a specific property
• Costs would be capitalized if the property were already acquired
• ….acquisition of the property is probable (likely to occur)…..”
Development Phase

Issue – When is acquisition of a property probable?

Answer – Determining when acquisition of a property is probable is a matter of judgment based upon case specific facts and circumstances.
Development Phase

Project costs should be capitalized when management believes a specific project is probable of completion based upon certain criteria such as the following:

- Wind/Solar Resource
- Transmission
- Regulation/Environmental
- Technology
- Energy Market/PPA
- Financing
- Land
Development Phase

Impairment

• Assessment should be made when events or circumstances indicate that the carrying value may not be recoverable
• Measure using ASC 360-10-35
Development Phase

• Example costs to capitalize
  – Property acquisition fees
  – Cost of permits and licenses
  – Legal and other professional fees

• Examples of costs to expense
  – Organizational costs
  – Overhead
  – Training costs
  – Legal fees to negotiate the power purchase agreement
Construction Phase

Construction costs

• Costs incurred which are necessary to get the asset ready for its intended use
• Substantially all costs incurred in the construction phase are capitalizable
• Capitalization should cease at commercial operation date
Construction Phase

Example Costs to Capitalize:

- EPC contractor fees
- Interest paid to third parties
- Test power costs (and related income) (for short periods of time)
- Property tax incurred during the construction period
- Development fees (under certain circumstances)
Capitalization for Tax Purposes

• Start-up costs v. business expansion costs
  – Amortizable v. currently deductible
• Tangible property regulations
  – Effective in 2014
  – Amounts paid to acquire or produce tangible property
  – Amounts paid to improve tangible property
• Allocable indirect costs
Accounting for Test Energy
Accounting for Test Energy

• Recorded as a reduction of construction in progress
• Incidental to the facilities’ operation (ASC 970-10-20)
• Cost necessary to prepare the asset for its intended use (ASC360-10-20)
Tax Treatment of Test Energy

• Placed-in-service date differences
• Understanding the book treatment
Accounting for Interest Costs during the Construction Period
Capitalized Interest

ASC 835-20-05-1

“The historical cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use. If an asset requires a period of time in which to carry out the activities necessary to bring it to that condition and location, the interest cost incurred during that period as a result of expenditures for the asset is a part of the historical cost of acquiring the asset.”
Capitalization Period

The capitalization period begins when the following three conditions exist:

• Expenditures for the asset have been made
• Activities that are necessary to get the asset ready for its intended use are in progress
• Interest cost is being incurred
Amount to Capitalize

Capitalization Rate
×
Average Accumulated Expenditures during the period
Common Pitfalls

• Ensure amount capitalized is not in excess of interest expense recorded
• Ensure only cash expenditures are included in weighted average capital expenditures calculation
• Failure to use the weighted average rate of all borrowings if there is no borrowing specific to the asset being constructed
Interest Capitalization for Tax Purposes

• Projects subject to tax interest capitalization
  – Varies for real property v. tangible personal property

• Beginning of production period
  – Varies for real property v. tangible personal property
Accounting for Asset Retirement Obligations
Asset Retirement Obligation

• ASC 410-20
• Legal obligation associated with the retirement of a tangible long-lived asset
• AROs for renewable generating assets typically result from land lease / easement agreements/ permits
• Considerations for trigger to record initial Asset Retirement Obligation
• Asset retirement obligations are recognized at fair value in the period in which they are incurred, and when the amount of the liability can be reasonably estimated
Asset Retirement Obligation

Settlement Date ASC 410-20-25-11

- The estimated economic life of the asset might indicate a potential settlement date for the asset retirement obligation. However, the original estimated economic life of the asset may not, in and of itself, establish that date because the entity may intend to make improvements to the asset that could extend the life of the asset or the entity could defer settlement of the obligation beyond the economic life of the asset. In those situations, the entity would look beyond the economic life of the asset in determining the settlement date or range of potential settlement dates to use when estimating the fair value of the asset retirement obligation.
Tax Treatment of Removal Costs

• Generally deductible in the year the asset is demolished
  – Effects of the tangible property regulations
• Demolition of buildings
• Consideration of ARO liabilities upon sales of plant assets
Accounting for Long Term Service Agreements
Accounting for LTSAs

Issue:
Which guidance do we follow in accounting for long term service agreements?

Answer:
### Accounting Methods for Major Maintenance

<table>
<thead>
<tr>
<th>Type</th>
<th>Guidance</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct Expense</td>
<td>908-360-25-2a</td>
<td>Cost is recognized as expense as it is incurred.</td>
</tr>
<tr>
<td>Deferral</td>
<td>908-360-30-3 and 35-6</td>
<td>Actual cost of each overhaul is capitalized and amortized to the next overhaul</td>
</tr>
<tr>
<td>Built-in-overhaul</td>
<td>908-360-30-2 and 35-5</td>
<td>The cost of the initial overhaul is capitalized and amortized to the next overhaul and is repeated each time</td>
</tr>
</tbody>
</table>

The use of the accrue in advance method is prohibited.
Variable Priced LTSAs

- Routine maintenance expensed as incurred
- Major maintenance recorded in accordance with policy
- Differences between expense and payments recorded as either a payable or a prepaid
Fixed Price LTSAs

• Fixed price over a period of time
• May transfer risk to the service provider
• If risk is transferred to the service provider expense on a per MWH basis
# Transfer of Risk Criteria

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Details</th>
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</table>
| **True-ups**                  | • Service provider absorbs costs of maintenance  
• If the contract provides for any true-ups to cover actual costs the contract does not transfer risk |
| **Contract adjustment provisions** | • May provide for an adjustment for out of scope work and still transfer risk  
• If the contract includes adjustments based upon the service providers cost experience this does not transfer risk  
• Can include adjustments based upon inflation indices |
| **Termination provisions**     | • Can include exit provisions based upon performance criteria  
• Cannot include payments upon termination based upon cost provisions  
• Termination provisions cannot allow either party to exit at any time. |
Tax Treatment of Repair Costs

- Determining the unit of property and major components for tax purposes
- Improvements standard
  - Betterment
  - Restoration
  - Adaptation
- Routine maintenance safe harbor
- Accounting method changes filed with 2014 tax returns
Depreciation
Depreciation

- Placed in service date
- Unit of account
Tax Depreciation

- Modified accelerated depreciation system
  - Methods and lives
- Bonus depreciation
- Modeling considerations
  - Short period tax returns
  - Transfers of assets
  - Placed-in-service date conventions
Accounting for Liquidated Damages
Liquidated Damages During Construction

- **Examples**
  - Missed Milestones/Project Completion Delays
  - Failed Specifications

- **ASC 605-50-25-1 through 2 and ASC 605-50-45-12 through 45-13**

- **Accounting** – Reduce PPE basis by liquidated damages amount
  
  Dr. Cash
  
  Cr. PPE
Liquidated Damages

• Treatment when contractor is not obligated to provide consideration?
• Treatment when consideration is additional equipment versus cash consideration?
Tax Treatment of Liquidated Damages

• Potential fact patterns and contingencies
  – Cash refunds
  – Discounts against future goods or services

• Potential tax treatment
  – Income
  – Reduction of tax deductions
  – Basis reduction

• Basis reduction contexts
  – Depreciation
  – Investment tax credit
Questions?
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