LOS ALAMOS

Finance

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Memorandum

To: Alvin Leaphart, County Attorney
Kevin Powers, Assistant County Attorney

Fr: Helen Perraglio, CPA, Chief Financial Officer

Cc: Harry Burgess, County Manager
Steven Lynne, Deputy County Manager
Timothy Glasco, Utilities Manager
Steve Cummins, Deputy Utilities Manager
Robert Westervelt, Deputy Utilities Manager

Date: April 4, 2018

Re: Accounting Review of Proposed Carbon Free Power Project (CFPP) Power Sales Contract

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As requested, I have performed a condensed review of certain sections of the proposed CFPP Power Sales Contract (contract) in relation to proper accounting and financial reporting treatment, if executed. Given the short time-frame to analyze, I have also sought the subject matter expertise of Russ Hissom, CPA and Senior Partner of Baker Tilly Virchow Krause, LLP. Mr. Hissom has provided a Professional Position Paper to support my overall assessment of how to account for the proposed contract, and is included as Attachment A to this Memorandum.

To summarize, there are three main components to consider on how to account for this contract as it relates to financial statement reporting, budgetary reporting, and the potential impact to the LAC Utilities System bond rating.

Financial Statement Reporting

From the review of ARTICLE VIII, BUDGET, BILLING AND PAYMENT, the Electric Subfund would capitalize all costs and record an intangible capital asset represented by the County's "entitlement share" for the

1000 Central Avenue, Suite 300
Los Alamos, NM 87544
P 505.662.8060 F 505.662.8069
losalamosnm.us

ATTACHMENT D

timeframe of the initial licensing and development period, up to the commercial operation date, and amortize the amounts paid over the life of the contract. This intangible plant asset would be recorded on the balance sheet of the Electric Subfund and in the Joint Utilities Fund in the Comprehensive Annual Financial Report (CAFR).

Amortization expense would be recorded on a full-accrual basis of accounting which would reduce net income by only the amortization expense respective to each fiscal year. Capitalizing these costs essentially spreads the cost of investing in the intangible plant asset over the life of the contract and is in accordance with Generally Accepted Accounting Principles (GAAP), and provided for in the Governmental Accounting Standards Board (GASB) Statement No. 51.

After the commercial operation date, costs would be captured as operating expenses in the financial statements and no longer subject to capitalization. These would directly reduce net income for the total amount paid in a fiscal year and would be captured under contractual services. No liabilities or debt would be recorded in the CAFR.

Budgetary Reporting

Regardless of the phase of the project, any obligated outflows of cash would have to be appropriated as uses of funds and would be reported as actual budgetary expenditures in the contractual services line item of the Electric Subfund of the Joint Utilities Fund.

Prior to the commercial operation date, a full-accrual GAAP-Basis adjustment to reduce contractual services for capital outlay capitalized would be performed and shown in the SCHEDULE OF REVENUES, EXPENSES, ENCUMBRANCES, AND CHANGES IN NET POSITION - BUDGET AND ACTUAL (BUDGET BASIS) for the Electric Subfund in the CAFR.

It should be noted that per Section 801., paragraphs (a) and (b) of the contract, depending on the timing of the adopted UAMPS Annual Budget, the County may not meet the deadline for inclusion of its share of costs in the normal annual budgeting cycle and may have to bring budget revisions for Board of Public Utility and County Council review and approval accordingly. It is also noteworthy to point out that per paragraph (b), the UAMPS Annual Budget may be superseded, “in the event such review indicates that the Annual Budget does not or will not substantially correspond with actual receipts or expenditures, or if at any time during such Contract Year there are or are expected to be extraordinary [items]…”, therefore consideration for this potential should be planned for accordingly by the Utilities Department.

Bond Rating & Imputed Debt

In general, it is becoming more common for utilities nationwide to enter into purchase power agreements and recover the costs of such participation in these long term obligations through rates, rather than financing and building their own generation facilities[1]. As described in the Financial Reporting section above, the County would not report the obligations of this contract as debt, however certain credit-rating agencies may take such obligations into consideration when evaluating the Utilities System bond rating. This is referred to as "imputing debt" and participation in this contract could be referred to as "debt equivalency" for credit analysis purposes. This may have more of an indirect impact today, but may impact future potential borrowings and is therefore noteworthy.

<u>Summary</u>

In summary, if the proposed CFPP Power Sales Contract is adopted, the accounting and financial reporting is straight-forward and allowed for under Generally Accepted Accounting Principles as described above.

It is my recommendation that a more in-depth financial projection inclusive of potential imputed debt or potential debt equivalency be performed by a more qualified consultant or subject matter expert than what I can provide in my analysis at this time. Such projection should be taken into consideration prior to the expiration of the Licensing Period when the County shall have the right to withdraw as referenced in Section 204., of the contract and referred to in prior discussions as an "off-ramp". This is mainly due to the fact that such imputed debt may impact the financial ratios taken into consideration by potential credit analysts regarding the County's default risk and creditworthiness, and impact the overall bond rating. This may have more of a long-term impact on the County's costs associated with the issuance of future debt.

Finally, a more in-depth financial projection and analysis from the Utilities Department or other professional subject matter expert/consultant to determine the adequacy of the present value of future rates pledged for cost recovery under the terms referenced in Section 903, and once more concrete long-term estimates can be provided, would be prudent for continued consideration in the long term obligation of the contract.

[1] California Public Utilities Commission Policy & Planning Division, An Introduction to Debt Equivalency, August 4, 2017

Baker Tilly Virchow Krause, LLP
Ten Terrace Ct, PO Box 7398
Madison, WI 53707-7398
tel 608 249 6622
fax 608 249 8532
bakertilly.com

To: Ms. Helen Perraglio, CPA; Chief Financial Officer, Los Alamos County

From: Russ Hissom, Baker Tilly Virchow Krause, LLP

Date: April 4, 2018

Re: Accounting treatment of UAMPS purchased power agreement

Dear Ms. Perraglio:

Baker Tilly Virchow Krause, LLP ("Baker Tilly") has performed a review of the following sections of the proposed Carbon Free Power Project Power Sales Contract (contract), dated April 1, 2018 between UAMPS and Los Alamos County.

Background

Los Alamos County (LAC) is considering entering into a Power Sales Contract with UAMPS to participate in a Carbon Free Power Project (the project). The agreement details the obligations of LAC in connection with potential construction costs and the take of energy and capacity output from the project. Los Alamos County (LAC) sought Baker Tilly's services to analyze the Power Sales Contract to determine the proper accounting for the contract under generally accepted accounting principles. As directed by LAC, our review focused on Section 805 (c) and Section 903 of the contract. Under this contract, LAC is referred to as the Participant.

Section 805 – *Participant's Payment Obligations*

Background

Section 805 addresses the participant's payment obligations. Section 805 ('c) specifically addresses the obligation of the participant to make the payments for Development costs, Operation and Maintenance Costs, Transmission Costs, Debt Service Costs and other amounts.

This section discusses the prior to the Commercial Operation Date[1] of the project, the obligation of the participant to make these payments are a cost of the development of a new power supply resource. After the Commercial Operation Date, these payments are stated to be an operating expense of participant's electric system and a cost of purchased power.

Accounting treatment of the costs in Section 805

As this power supply resource is in the construction phase until the Commercial Operation Date, the recording of costs as directed by Section 805 ('c) is appropriate. The costs should be recorded as follows:

1. **Prior to the Commercial Operation Date, the costs should be recorded as an intangible asset of LAC**. LAC has certain rights from its contributed capital to the project during this period that the asset is being constructed. Thus, an investment must be recorded and that investment will decline in value over the remaining life of the asset as LAC's right to use that asset will come to an end at the conclusion of the contract. This accounting is in accordance with the requirements of Governmental Accounting Standards Board (GASB) Statement No. 51 – *Accounting and Reporting for Intangible Assets.* GASB 51 defines an intangible asset as:
   i. An asset having a lack of physical substance – *LAC contributions to the project do not give it ownership in the project*
   ii. An asset that is nonfinancial in nature – *the LAC's contributions does not give it a claim to rights to assets in a monetary form*
   iii. The asset has an initial useful life extending beyond a single report period – *the LAC's contributions apply to the life of the project*

   GASB 51 states that the asset must also be identifiable, which consists of either of the following:
   i. The asset is separable, or
   ii. The asset arises from a contractual or other legal rights

   Our interpretation of these contributions is that they are separable, as they are not part of the physical asset to LAC and they arise from a contractual or other legal right. GASB 51 para 80 states that intangible assets should be amortized if the life of the asset is known. In the case of the project, the life is based on the contract life and is known. Thus, the contract life should be the amortization period.

2. **On and after the Commercial Operation Date, the costs should be treated as operating expenses** – i.e. purchased power expense, as LAC now is receiving ongoing services as part of a long-term contract. This is in keeping with the *economic resources* concept of accounting required of organizations that follow the standards of Governmental Accounting Standards Board (GASB) under

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[1] *"Commercial Operation"* means, with respect to the Initial Facilities, the date on which the Initial Facilities (i) have been substantially completed pursuant to the EPC Contract and any other Construction Agreements, including the satisfaction of all required performance tests thereunder, (ii) are capable of continuous firm operation, (iii) are interconnected and synchronized with, and capable of delivering Electric Energy to, the transmission grid, (iv) have received all Permits and Approvals required for their operation,

GASB Statement No. 34 – *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments*, the government-wide statement of net position and statement of activities are required to be reported using the economic resources measurement focus and the accrual basis of accounting. Under the accrual basis of accounting, revenues are recognized when earned and expenses are recorded when the liability is incurred or economic asset used. Revenues, expenses, gains, losses, assets, and liabilities resulting from exchange and exchange-like transactions are recognized when the exchange takes place. The exchange takes place when LAC takes power from the project through UAMPS and delivers it to its end users, who then in turn pay LAC for the delivery of power. Then LAC pays UAMPS.

3. While LAC has a long-term obligation to pay UAMPS for the right to take power from the project and it has the right of use of the asset through its UAMPS contract, this does not result in the recording of a long-term asset or liability by LAC. Under GASB Statement No. 87 *Leases*, power purchase agreements such as the Power Sales Contract are exempt from the recording of long-term capital assets and liabilities and are to be recorded as an operating expense.

Section 903 – *Covenants and Agreements of the Participant*

Background

Section 903 addresses particular covenants and agreements of the participant. These include:

a. *Maintenance of rates*
    i. This requires LAC to set rates to its customers that will provide revenues that will meet its obligations to UAMPS under the contract, pay for LAC's operating expenses and any other bond obligations.
b. *Maintenance of revenues*
    i. LAC shall collect revenues when due from customers
c. *Sale or assignment of electric system of power sales contract*
    i. LAC cannot assign, sell, lease or dispose of its electric system or the contract (unless on complying with Sections 303 or 304 – which are not examined in this memo)
d. *Prudent Utility Practice*
    i. LAC shall operate its system using the industry standard of Prudent Utility Practice, which is described in this section of the contract
e. *Operating expenses*
    i. LAC shall record any payments made prior to the Commercial Operation Date as a cost of the development of a new long-term power supply resource. This would require the treatment described under Section 805 above, i.e. recording the payments as an intangible asset.
    ii. LAC shall record the expense of the contract after the commercial operation date as purchased power expense
f. *Tax status*
    i. This describes that LAC will take all actions to maintain the tax status of the UAMPS bonds issued for the project

LAC budgeting impacts

The costs will have the following impacts on LAC's budget:

1. Costs recorded before the Commercial Operation Date should be budgeted as capital expenditures. These amounts can be charged to FERC Account 303 – Miscellaneous Intangible Plant.
2. Costs recorded after the Commercial Operation Date are purchased power expenses and should be budgeted in that category and charged to FERC Account 555 – Purchased Power.

Summary/Conclusion

Our interpretation of the accounting treatment and requirements of the contract are discussed in Section 805 of this memo. The items in Section 903 of the contract do not alter any of that interpretation, but are obligations of LAC under the contract. Even though this contract does not result in the recognition of a long-term liability by LAC, bond rating agencies often view these types of contracts as adding to the debt of the entity when the agency performs its analysis in developing a bond rating.