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Gainesville Regional Utilities

Accounting Treatment of GREC Power Purchase Agreement

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Gainesville Regional Utilities

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ISSUE

Gainesville Regional Utilities (GRU) has entered into a long-term power purchase agreement (PPA) with the Gainesville Renewable Energy Center (GREC) for the purchase of output from the GREC bio-mass facility. GRU retained Baker Tilly to evaluate whether the Power Purchase Agreement between GREC and GRU should be accounted for as a capital lease.

GREC PPA

GRU has a PPA with GREC for GRU to purchase all of the energy production from a 100 mW bio-mass fired power production facility located in Alachua County, Florida. The initial purchase term is 30-years from December 17, 2013, with potential contract extension of five-years. The PPA also includes the potential for GRU to purchase the facility at the fair market value in Year 29 of the agreement.

EVALUATION

Governmental Accounting Standards Board Guidance

Current Governmental Accounting Standards Board (GASB) guidance requires that proprietary funds follow Accounting Standards Codification (ASC 840) – *Leases.* GASB standards apply to GRU as a proprietary fund of the City of Gainesville (City).

Financial Accounting Standards Board Guidance

The Financial Accounting Standards Board (FASB) ASC-840 – *Leases* contains the following criteria to determine whether a transaction is a capital lease for reporting purposes. In general, a lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee and as a sale or financing by the lessor. A capital lease should also meet one of the four requirements below:

#	Section	Criteria	Present in PPA?
1	840-10-25	Transfer of ownership – the lease transfers ownership of the property to the lessee by the end of the lease term	Ownership is not transferred at the end of the PPA term
2	840-10-25	Bargain purchase option – the lease contains a bargain purchase option	PPA 27.2 – GRU can purchase the facility at Year 29 of the agreement at the fair market value of the facility – this does not constitute a bargain purchase option
3	840-10-25	Lease term – the lease term is equal to 75% or more of the estimated economic life of the leased property	Per GRU, as this is new technology it is not able to determine the estimated economic life of the facility, therefore this is not applicable

#	Section	Criteria	Present in PPA?
4	840-10-25	Minimum lease payments – the present value at the beginning of the lease term of the minimum lease payments…….equals or exceeds 90% of the excess of the fair value of the leased property to the lessor	As GRU is entitled to 100% of the facility's generating output, GRU's payments under the PPA are in excess of 90% of the fair value of the leased property using the income approach valuation

Minimum lease payments

Per GRU, the fair market value of the facility was determined to be in a range from an offer made by the City to the total of scheduled payments. GRU has elected to utilize the total of scheduled payments as the fair market value of the asset. Utilizing the total of scheduled payments as the fair market value is appropriate, as the income approach to valuation is one of the generally accepted methods used in valuations. As GRU is entitled to 100% of the facility's generating output, GRU's payments under the PPA are in excess of 90% of the fair value of the leased property using the income approach valuation.

Additional guidance

As the definition from ASC 840-10-20 states that a lease is "an agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time" power purchase agreements that are dependent on an identified power plant may contain a lease. In order to review this area, we utilized the PricewaterhouseCoopers (PWC) "Guide to Accounting for Utilities and Power Companies" for additional considerations.

Areas addressed by the PWC Guide to consider include:

#	Page	Criteria	Comment
1	1-3	(1) The unit of accounting should be considered to determine whether lease or derivative accounting should apply and whether there are separate deliverables	The unit of accounting contains one deliverable – energy delivery
2	1-6	(2) In accordance with ASC 840, a reporting entity should assess whether an arrangement contains a lease based on its substance. This is applicable if the contract explicitly or implicitly identifies specified property, plant or equipment	Based on the substance of the contract, lease accounting may apply
3	1-7	(3) It should be determined whether consolidation accounting applies	The PPA and the GRU/GREC governance structure does not meet the definition of a variable interest entity
4	2-2	Reporting entities should determine whether	1. The facility is specifically identified

#	Page	Criteria	Comment
		the contract meets the following criteria: • It depends on an identified power plant, i.e. is the plant explicitly identified • It conveys the purchaser the right to control the use of the power plant • The purchaser has the right to control physical access to the plant while obtaining or controlling more than a minor amount of the output • If the ability to purchase replacement power is limited to outage periods, the agreement contains an identified asset	as the GREC facility 2. Section 10.1 states GRU is responsible for scheduling daily production 3. Section 10 discusses purchase of offset capacity or energy and GREC's responsibility to match its outage duration to GRU's replacement energy term (10.4.3 (C)) so this requirement is met
5	2-9	It is remote that parties other than the purchaser will take more than a minor amount of the output during the agreement and the pricing in the contract is neither fixed per unit of output, nor equal to the market price per unit of the output at the time of delivery	1. Appendix III – 100% of the output is sold to GRU 2. Appendix III – see pricing discussion in #6 below
6	2-13	The pricing criterion is met (i.e. a lease may exist) if pricing is neither a fixed price per unit of output nor equal to the current market price per unit of output at the time of delivery • A contract with pricing that has a fixed element and a market component is neither fixed per unit of output nor equal to the current market price per unit of output at the time of delivery • If the pricing of the contract is either fixed per unit of output or market price per unit of output at the time of delivery, control of the use of the facility is not conveyed • Any variability due to factors other than time (such as volume or cost) would not qualify	1. Appendix III – pricing components are as follows: • Fixed and variable O&M – variable component increases by CPI • Fuel – Base charge plus fuel price adjuster • These pricing components meet the criteria for a lease under ASC 840-10-15-6(C)

Conclusion

Based on the analysis in this report, in our opinion the GREC PPA meets the requirements of a capital lease for GRU.

Additional analysis is shown in this report:

1. Appendix A - Proposed changes to GASB and FASB lease standards
2. Appendix B - Proposed GRU journal entries. We concur with the proposed GRU recording of the lease.
3. Appendix C – Calculation of minimum lease payments and depreciation (prepared by GRU)

Appendix A
Proposed Changes to GASB and FASB Lease Standards

Potential changes to current lease accounting guidance

In performing this evaluation, we evaluated the potential changes to lease accounting guidance being proposed by the standard setting bodies. This report takes into account potential GASB issues involved with lease accounting, so that GRU may not need to unnecessarily unwind the accounting for the GREC contract or report on it in an inconsistent manner. These potential changes are:

Governmental Accounting Standards Board Guidance potential changes

The Governmental Accounting Standards Board (GASB) current guidance requires that proprietary funds follow Accounting Standards Codification (ASC 840) – *Leases.* This guidance is discussed below. On November 20, 2014 GASB issued for public comment through March 6, 2015, a *Preliminary Views, Leases*, which includes proposals for lease accounting for state and local governments from both a lessee and lessor perspective. This is a precursor to GASB issuing an exposure draft and eventual standard. When GASB does issue a standard, GRU will be required to follow it.

The GASB's preliminary views, which can be viewed at http://www.gasb.org/jsp/GASB/Document_C/GASBDocumentPage?cid=1176164579648&acceptedDisclaimer=true are:

- Lessee governments would use a single approach to accounting for leases, i.e. leases would not be classified as operating or capital
- Lease assets would be amortized in a systematic manner over the shorter of the lease term or the useful life of the underlying asset
- Amortization would represent the use of the service capacity of the right to use the underlying asset

Financial Accounting Standards Board potential changes

The Financial Accounting Standards Board (FASB) has issued an exposure draft on proposed changes to lease accounting. This can be viewed at: http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176162613656&acceptedDisclaimer=true

The FASB exposure draft would require an entity to recognize assets and liabilities arising from a lease. This would involve the following:

- For Type A leases (which would apply to the GREC PPA) the lessee would subsequently measure the lease liability on an amortized cost basis and amortize the right-of-use asset on a systematic basis that reflects the pattern in which the lessee expects to consume the right-of-use asset's future economic benefits

FERC Guidance

Applicability of FERC Guidance

With the issuance of GASB Statement No. 55,*The Hierarchy of Generally Accepted Accounting Principles for State and Local Government, GASB* incorporated the hierarchy of generally accepted accounting principles (GAAP) for state and local governments into the GASB's authoritative literature. This standard was effective in 2009.

This statement lists the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of state and local governmental entities that are presented in conformity with generally accepted accounting principles (the GAAP hierarchy). The statement states that "If the accounting treatment for a transaction or other event is not specified by a pronouncement or established in practice ….. a governmental entity should consider accounting principles for similar transactions…. and may consider other accounting literature."

This means that if GASB does not have a statement that addresses a particular accounting issue then industry or other alternative guidance may be followed. Current GASB guidance requires that proprietary funds follow Accounting Standards Codification (ASC 840) – *Lease* - so FERC guidance does not apply.

Baker Tilly conclusion on impact of proposed GASB and FASB changes to lease accounting

We conclude that potential changes to lease accounting by GASB and FASB would not have a material impact on the recorded substance of this transaction as proposed in this report. There may be changes in labeling of the transaction under proposed GASB guidance.

As the lease payments are recovered from customers through GRU rates, GRU can also record this transaction as a regulatory asset under GASB 62 – *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements.*

Appendix B
Proposed Journal Entries

Proposed journal entries for capital lease

The proposed journal entries for the PPA follow. This transaction qualifies for treatment under GASB 62 - *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements.* GRU collects the lease payments in the PPA through rates to its customers. As this is a capital lease, GRU must also record depreciation expense on the facility which it does not recover through customer rates. This leads to a timing difference between the principal/fixed portion of the lease payment and depreciation expense. GRU will recognize these future recoverable costs of this difference in its Statement of Net Position and Statement of Revenues, Expenses and Changes in Net Position.

GRU's journal entries in Year 1 of the transaction are as follows:

1				
	101105	Capital lease asset	1,006,808,754	
	243005	Capital lease liability - current		12,700,476
	227005	Capital lease liability - noncurrent		994,108,278
		To record initial lease liability and asset (as if recorded 12/17/2013)		
2				
	243005	Capital lease liability - current	12,700,476	
	570370	Interest expense (fuel cost)	35,515,528	
		Cash		48,216,004
		To record lease payments for 2014		
3				
	500805	PP GREC Biomass Fixed	12,700,476	
	186202	Misc Deferred Debits - Future Recoverable Costs		12,700,476
		To record capital lease portion of payment recovered in rates - Year 1		
4				
	570100	Depreciation expense	26,433,241	
	108010	Accumulated depreciation		26,433,241
		To record depreciation on GREC - Year 1		
5				
	186202	Misc Deferred Debits - Future Recoverable Costs	26,433,241	
	418xxx	Costs to be Recovered in Future Rates		26,433,241
		To record regulatory costs to be recovered in future rates		
6				
	227005	Capital lease liability - noncurrent	16,828,193	
	243005	Capital lease liability - current		16,828,193
		To reclassify long and short term portions of lease liability		

Appendix C
Present Value of Minimum Lease Payments

Gainesville Regional Utilities

Accounting Treatment of GREC Power Purchase Agreement

Gainesville Regional Utilities
Gainesville Renewable Energy Center Power Purchase Agreement Evaluation for Capital Lease Treatment
September 30, 2014

	Price per MWH for Available Energy	Projected Usage (1)	Total Hours	Lease Term	Per Year	Total	Capital Lease Per Month	Depreciation Per Month
Non-fuel energy charge	56.15	88.29	8,760	30	43,427,555	1,302,826,664	3,618,962.96	
Fixed capacity charge	23.00	88.29	8,760	30	17,788,669	533,660,076	1,482,389.10	
					61,216,225	1,836,486,740	5,101,352	2,796,691

Capital lease asset	($1,006,808,754.09)	
Capital lease liability		(1,006,808,754)

Note 1: Projected usage is based on actuals from fiscal year 2014	88.29%
Note 2: Assumed discount rate	4.50%
Note 3: FMV as determined by cash flow/income approach	$ 1,836,486,740
Note 4: Lease inception - date biomass plant was placed into service	12/17/2013