Benchmarking Capitalization Best Practices

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AGENDA

• Background and Scope of Study
• General Capital Policy
• Survey Results
  – Property and retirement units
  – Minor items
  – Policy thresholds
  – Work order close-out timeframe
  – Post in-service date charges
  – Rebuilds and overhauls
  – Cloud computing
  – Temporary facilities
  – Activities related to poles in-service
  – Training costs
• Conclusion
BACKGROUND AND SCOPE OF STUDY
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• Engaged Ernst & Young to conduct independent review of capitalization policies

• Purpose
  – Determine consistency with industry peers
  – Identify areas not aligned to capture realities of our business
  – Ensure consistent application of policy

• 23 peer companies participated
GENERAL CAPITAL POLICY

- 53% of respondents update or review capitalization guidelines only as requested

- 30% of respondents indicated that it had been 1-2 years since a policy review led to substantial updates to the capitalization policy, 26% indicated it had been 3-5 years

- 78% of respondents indicated that different operating units did not have separate and identifiable capitalization policies
SURVEY RESULTS
PROPERTY AND RETIREMENT UNITS

• Most participants have identified a hierarchical relationship between property and retirement units; some identify units without designating property or retirement classification

• Generally, for property units, the cost to replace is capital

• For retirement units, the decision to capitalize is based on a threshold
MINOR ITEMS

- The associated parts or items of which retirement units are composed
- 61% of respondents use betterment accounting
- Benefits of expanding retirement unit catalog
  - Reduce the application of minor item policy
  - Reduce confusion when determining classification
POLICY THRESHOLDS

Cost Threshold for Capitalizing Retirement Units

- None
- Multiple
- $20,000+
- $10,000-$19,999
- $5,000-$9,999
- $1,000-$4,999
- $500-$999
- Less than $500

Cost Threshold
POLICY THRESHOLDS

Costs Included in Thresholds for Retirement Units

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Materials only</td>
<td>10%</td>
</tr>
<tr>
<td>Labor only</td>
<td>50%</td>
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<tr>
<td>Materials and labor</td>
<td>20%</td>
</tr>
<tr>
<td>Labor and other</td>
<td>10%</td>
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<tr>
<td>Materials, labor and other</td>
<td>10%</td>
</tr>
<tr>
<td>N/A</td>
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WORK ORDER CLOSE-OUT TIMEFRAME

- Most participants have general timeframe to close work orders. Many do not have defined number of days.
- Methods for management of work order closeout
  - Provide open status reports to field service employees
  - Monitor activity posted to old work orders
  - Understand the nature of late charges
POST IN-SERVICE DATE CHARGES

- Questions focused on treatment of charges incurred following the in-service date of an asset
  - System-wide program to move gas meters (39% O&M)
  - Animal safety programs (44% O&M)
  - Engineering design documents
    - 7 months after in-service date (78% O&M)
    - 3 years after in-service date (96% O&M)
  - Restoration of local environment
    - 2 months after in-service date (78% capital)
    - 8 months after in-service date (61% capital)
REBUILD AND OVERHAULS

- Focused on the participant's policy related to rebuilds and overhauls
- Broad approach
  - General definition for what qualifies for capitalization and relies more on judgment
  - Descriptions such as “substantial” or “nearly complete”
- Standardized approach (most common)
  - Uniform criteria defined by organization
  - Utilize tools such as road maps or decision trees
- Specific approach
  - Explicit criteria defined for specific property or retirement units
CLOUD COMPUTING

• Focused on license arrangements for cloud computing, internal development of software and service fees associated with third-party providers

• Majority of respondents would only capitalize license costs if:
  – the arrangement could be treated as a capital lease
  – the company had the contractual right to take possession of the software at any time during the hosting without significant penalty and it was feasible for the software to be run on another entity’s hardware
TEMPORARY FACILITIES

- Costs for operating temporary facilities used to continue delivery of energy for less than one year, or greater than one year

<table>
<thead>
<tr>
<th></th>
<th>Less than one year</th>
<th>Greater than one year</th>
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<tbody>
<tr>
<td>Capital</td>
<td>30%</td>
<td>70%</td>
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<tr>
<td>O&amp;M</td>
<td>48%</td>
<td>17%</td>
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<tr>
<td>Both</td>
<td>22%</td>
<td>13%</td>
</tr>
</tbody>
</table>
ACTIVITIES RELATED TO POLES IN-SERVICE

- Restoring and extending the useful life of poles in service (i.e., pole painting, fiber glass protection, pole inspections)
- Majority only capitalize pole treatments the first time it is performed
- Majority consider costs to perform inspections as O&M
TRAINING COSTS

- Training costs associated with training for new capital assets or improvements to capital assets, safety training for nuclear facilities, development of training materials and costs to train the trainers.
- Typically, ongoing training is expensed and training incurred to train employees to operate or construct new assets is capitalized.
CONCLUSION

- Companies can continue to benchmark against industry peers to promote consistency of policy
- Companies can identify and improve areas not aligned with the realities of their business
- Companies can seek continuous improvement of overall policy structure, as well as specific capitalization topics
QUESTIONS?