CAPITAL VERSUS EXPENSE CRITERIA

Note: Terms defined in Appendix A are initially italicized.

Introduction

This policy provides guidelines surrounding the decision to capitalize or expense expenditures for plant. Charging *maintenance* expense and repairs accounts requires the Company to record the expense as incurred, while charging the utility plant accounts (capital) requires the Company to record the cost of the expenditure over the life of the asset through *depreciation*. Questions regarding this determination should be directed to Plant Accounting Manager.

Generally Accepted Accounting Principles (GAAP) provide a framework for determining whether expenditures should be capitalized or expensed. For Eversource's regulated companies, the determination is also impacted by FERC regulation, the rate making process, and the GAAP guidance specific to regulated operations in Accounting Standards Codification (ASC) Section 980. The Plant Accounts and Retirement Units Manual and this policy are established to address the regulated electric and gas businesses.

There are certain expenditures that are capitalized for the regulated businesses that are not permitted to be capitalized for the non-regulated businesses, such as certain overhead costs and the cost of equity. Questions regarding the capitalization of expenditures for the unregulated businesses should be directed to Plant Accounting.

General Information

Plant assets represent capitalized expenditures. Plant assets must meet the definition of an asset in accordance with FASB Statement of Concepts No. 6:

> Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
>
> *Characteristics of Assets*
> An asset has three essential characteristics:
> (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows,
> (b) a particular entity can obtain the benefit and control others' access to it, and
> (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred.

In accordance with FERC guidelines found in Electric Plant Instruction 10 of the Uniform System of Accounts, *retirement units* are the basis for determining whether transactions are capitalized or expensed. Plant Accounting further classifies retirement units into *units of property* and maintains a listing of retirement units and units of property in the Plant Accounts and Retirement Units Manual. When retirement units or units of property are an addition to plant, a replacement, or a retirement, the expenditure is either charged or credited to a utility plant account. Items that comprise a retirement unit or unit of property are called *minor items of property*.

All plant assets, including additions, replacements and improvements, should be analyzed to determine if there is an asset retirement obligation (ARO) associated with them. An ARO is a current legal obligation to remove or retire property, plant or equipment at some point in the future. This obligation may arise as a result of an existing law, statute or ordinance or as a result of a written or oral contract. An ARO may also arise through statements or comments made by management or officials of the Company that someone would or could rely upon. AROs require timely identification and are subject to complex accounting requirements and treatment. Individuals responsible for developing or purchasing property, plant and equipment must consider whether there is a legal retirement obligation associated with the property. Any such potential AROs must be identified and discussed with the Plant Accounting Manager to ensure that they are accounted for on a timely basis using appropriate accounting. New ARO's or changes to existing ARO's are required to be reported to Plant Accounting quarterly.

Expenditures to Be Expensed

The following categories of expenditures shall be expensed:

- Certain Start-up Costs:

The stage of the project when expenditures are incurred influences the decision on whether or not to begin capitalization. A definite plan to perform work on an approved project must be in place prior to capitalization. Plant Accounting should be consulted prior to beginning any major projects to ensure appropriate and timely accounting.

- Repairs and Maintenance:

Repairs and maintenance charges are defined as expenditures that are required to keep existing assets in a condition to adequately and efficiently perform the services for which the unit was designed or assure that the original expected useful life will be attained. These expenditures shall be charged to appropriate expense accounts in the accounting period incurred.

Expenditures to be Capitalized

- Expenditures that meet the definition of a retirement unit or unit of property and are included in the Plant Accounts and Retirement Units Manual shall be capitalized.

- Capital projects (e.g., transmission, distribution and generation)

Once a project has been approved by management, a work order is established by the project management team. Generally, all expenditures directly related to the project incurred after this point are capitalized.

- General Plant

Expenditures associated with the purchase of certain equipment such as office furniture, equipment and tools shall be capitalized if individual units exceed $500. This criterion pertains to equipment included in the following FERC Plant Accounts:

  - 391 - Office Furniture and Equipment
  - 393 - Stores Equipment
  - 394 - Tools, Shop and Garage Equipment

- 395 - Laboratory Equipment
- 398 - Miscellaneous Equipment

Also included are those items identified as Production General Equipment such as office furniture, equipment and tools in the Plant Accounts and Retirement Units Manual for the following Plant Accounts:

- 316 - Misc. Power Plant Equipment - Fossil Production
- 335 - Misc. Power Plant Equipment – Hydro Production
- 346 - Misc. Power Plant Equipment – Other Production

Exceptions to this $500 threshold include items which are purchased “in bulk”, such as office furniture and fixtures used for the initial setup of a facility or department, where although the individual assets may fall below the threshold, in aggregate such assets are significant and shall be capitalized. For this policy, the total cost of the “bulk” equipment must exceed $100,000 to qualify for an exception to the $500 capitalization threshold.

- Replacements and Improvements

When a retirement unit or unit of property is replaced, the cost of the replacement is capitalized and the existing retirement unit or unit of property is retired.

When a retirement unit or unit of property is to be substantially replaced or rebuilt, the cost of the replacement may be capitalized and the existing retirement unit or unit of property retired. The retirement unit must be returned to substantially new condition and the substantial replacement/rebuild must be a minimum of $25,000. If the equipment being rebuilt is being replaced and salvaged to inventory, contact Plant Accounting for accounting guidance.

When a minor item of property that did not previously exist (i.e., it is not a replacement) is added to an existing property unit, the cost of the addition is capitalized if the total cost (installed cost) is greater than $25,000.

When a minor item of property is replaced, the cost of the replacement is expensed, except for “betterments” which are treated as follows.

- Betterment

A replacement of a minor item of property during the life of the property unit is capitalized if it is greater than $500,000 or at least $25,000 and 25% of the book value of the unit of property and it meets one of the following criteria:

  - It increases productive value by raising the capacity or usefulness; ***or***
  - It increases durability or economic life; ***or***
  - It reduces the operating cost or increases efficiency of the existing property.

In FERC terminology, a replacement that meets these criteria is referred to as a betterment. Betterments often involve upgrades through the use of improved materials or updated technology. The amount of the betterment that is to be capitalized is the

excess cost of the replacement over the estimated cost at current prices of replacing the asset with no upgrade or improvement in materials, technology, etc. Any remaining costs of the betterment are required to be expensed. The estimated cost at current prices must be documented (e.g., with a third party estimate) and reviewed with Plant Accounting.

Following are examples of betterments:

Example 1:

The cooling fan on a power transformer has failed and must be replaced. The transformer is the unit of property and the fan is a minor item of property. The recorded cost of the transformer is $470,000. Typically, this replacement would be considered maintenance work. In this case, however, a new fan is available at a cost of $175k that has the capability of increasing the kilovolt-amperes (KVA) the transformer can produce. The fan meets the criteria of a betterment because it increases the transformer's productive value by raising the capacity or usefulness of the transformer and the cost is greater than $25,000 and 37% (more than 25%) of the cost of the power transformer. It would cost $100k to replace the old fan with a like unit. The amount to be capitalized as a betterment would be $75k ($175k - $100k). The remaining $100k would be expensed as maintenance.

Example 2:

The supports (minor item of property) for a pier in the waterway at a hydro station must be replaced. The unit of property is the pier, including the supports. Typically, this replacement would be considered maintenance work. In this case, however, there are new supports available at a cost of $520,000 that will extend the useful life of the pier from 30 years to 40 years because of the materials used for these supports. The supports meet the criteria of a betterment because they extend the life of the pier and the cost is greater than $500,000. It would cost $270,000 to replace the old supports without the improved/bettered materials. The amount to be capitalized as a betterment would be $250k ($520k - $270k). The remaining $270k would be expensed as maintenance.

Other substantial improvement costs incurred that do not take the form of a retirement unit, unit of property or minor item of property may occasionally be capitalized if they meet the criteria above related to enhancing the value, life or capacity of an asset. Capitalization in these infrequent situations must be reviewed with Plant Accounting prior to work order approval.

Retirements

Retirement is the removal of property from service due to the end of its productive life. The item may be sold, abandoned or otherwise disposed of. Retirement accounting may also be applied when property is substantially replaced or rebuilt to substantially new condition. When a retirement unit or unit of property is retired from utility plant, the retired property is deducted from the plant account, and the related accumulated provision for depreciation is adjusted, as follows:

- The original cost is subtracted from the appropriate plant account, through the Unit of Property code, found in the company's property records and
- The original cost, *cost of removal*, and *salvage* are recorded to the accumulated provision for depreciation accounts.

Generally, when a minor item of property is retired, no separate accounting entry is required. The item's original cost will be subtracted from utility plant when the retirement unit, of which it is a part, is retired.

Spare Parts

Spare parts kept on hand in a centralized materials and supplies inventory storage location and available for general company use for replacement or maintenance purposes shall not be classified as plant assets prior to being placed in service. For such spare parts, those to be used within one year are classified as materials and supplies and those expected to be used over a longer period are classified as other noncurrent assets.

Under limited circumstances, certain spare parts that are retirement units and are not available for general company use may be capitalized as plant assets. Review with Plant Accounting is required. For a spare part to be capitalized as a plant asset, it must meet all of the following criteria:

1. The part is a retirement unit listed in the Plant Accounts and Retirement Units Manual.
2. The part is unique or of special design, custom manufactured for a specific piece of equipment because it is needed to ensure continuous operation of a facility or to minimize downtime costs that would be caused by lack of an available replacement.
3. The part is vital to the continuous operation of the facility.
4. The part will be used for emergency replacement purposes, not for routine or periodic maintenance or replacement.
5. The part is stored at or near the facility where it will be used for replacement purposes.

Installation costs are capitalized when the capitalized spare part is physically installed.

Exceptions to this capitalization policy must be discussed with and approved by Plant Accounting.

Appendix A

1. ***Cost of Removal***

   The cost of demolishing, dismantling, tearing down or otherwise removing plant, including the cost of incidental transportation and handling. This cost is included in rates and, when collected, is credited to accumulated depreciation.

2. ***Depreciation***

   Depreciation is the loss in service value not restored by current maintenance, incurred in connection with the use of plant and against which the utility is not protected by insurance. Causes of depreciation include wear and tear, inadequacy, obsolescence, changes in the art, changes in demand and requirements of public authorities.

3. ***Maintenance***

   The cost, throughout the life of an asset, required to keep it in efficient operating condition. Among these are, but not limited to, expenditures for painting, lubricating, and adjusting equipment. Characteristically, such expenditures neither add significantly to the value of the property, nor materially prolong its useful life.

4. ***Minor Items of Property***

   The associated parts or items which comprise a retirement unit.

5. ***Retirement Units***

   As defined by FERC and in the *Plant Accounts & Retirement Units* manual, retirement units are the accounting unit for implementing the company's policy for charging the cost of work performed.

7. ***Salvage Value***

   Compensation received for property retired, less any expenses incurred in connection with the sale or in preparing the property for sale; or, if retained, the amount at which the material recovered is chargeable to materials and supplies, or other appropriate account.

8. ***Units of Property***

   An expansion of retirement units into the items which are actually reported and recorded in the company's property records system