Q. On page 27 of Schedule 1: Evidence of the Application Hydro notes that it is "investing approximately $13.3 million in capital in 2021 and is proposing to invest $8.8 million in 2022 to ensure the Holyrood TGS will continue to operate reliably until March 31, 2023, (i.e., for two winter seasons after the planned commissioning of the Project late in 2021). Depreciation on these investments is required to be calculated on an accelerated basis (i.e., monthly depreciation = capital investment divided by remaining months of service life). For example, $13.3 million in capital investment put in service in the quarter of 2021 would be depreciated over 18 months and impact costs by $2.2 million in 2021, $8.9 million in 2022 and $2.2 million in 2023. The projected $8.8 million of capital investments required in 2022 would typically need to be treated as an operating cost as the expected service life would be less than 12 months."

Please provide copy of Hydro's capital asset accounting policy, indicating the tests used to determine if a cost is capital or operating.

A. Please refer to IIC-NLH-017, Attachment 1.

Policy Title	**Capital Assets – Capitalization Policy**
Policy Group	Capital Assets
Policy Number	CA1
Accountable Division	Finance
Policy Owner	Assistant Corporate Controller

1. Policy Statement	This policy highlights the guidelines to be followed related to the recognition and measurement of capital assets in accordance with International Financial Reporting Standards (IFRS).
2. Purpose	The purpose of this policy is to provide guidance related to capitalization of costs in accordance with IFRS. The policy describes the conditions that must be met to capitalize a cost and the measurement of the capital assets at recognition. The policy also addresses the costs as they are incurred throughout the course of the capital project in work-in-progress and the subsequent treatment of the costs when projects are completed, closed and assets are placed in service.
3. Guiding Principles	Capital assets are a material item impacting Nalcor's financial position. It is therefore important that capital assets are presented accurately, completely, timely and in accordance with the agreed upon accounting principles in the records and financial statements of Nalcor. The recording of capital costs is based on the following principles: - Capital costs should be directly attributable to a capital project; - Capital costs should be reliably measurable; It is probable that the future economic benefits associated with the asset will flow to Nalcor for a period in excess of one year. Materiality Materiality limits are established related to capital assets to minimize the amount of administrative effort required to capitalize smaller dollar value assets. These limits permit the expensing of items that would normally meet the criteria for capitalization if costs are below a certain threshold. Any single or group purchase of the same asset below the limits does not require capitalization and related activities such as preparation of a capital budget. The materiality guidelines for each line of business will be determined and communicated by the appropriate Divisional Controller after consultation with the Corporate and Assistant Corporate Controllers.

4. Definitions and Terms	Capital assets: Property, plant and equipment which are tangible items that are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and are expected to have a useful life to Nalcor of more than one year. Capital spares: Major spare parts that meet the definition of capital assets that are kept on hand to be used in the event of an unexpected breakdown of failure of equipment, expediting the return of the assets to service. Maintaining capital spares is critically important in reducing periods of interruption in the generation, transmission and generation of electricity. Depreciation: The systematic allocation of the depreciable amount of an asset over its useful life. Depreciable amount: Depreciable amount represents the cost of an asset, including subsequent expenditures that have been capitalized within the scope of this policy, less its residual value. Front end engineering design (FEED): The engineering design for a capital project. FEED work commences with the project brief at the start of a project through to the visualization, conceptualization and definition stages and involves translating the project into a conceptual design and then a basic design. Incidental operations: Revenues earned and costs incurred during the construction of an asset that are not, in themselves, necessary to bring the asset itself to the location and condition necessary for it to be capable of operating in the manner intended by management. Costs related to incidental operations are not eligible for capitalization. International Financial Reporting Standards (IFRS): A set of accounting standards developed by an independent, not-for-profit organization called the International Accounting Standards Board (IASB). The goal of IFRS is to provide a global framework for how companies prepare and disclose their financial statements and has been adopted by Nalcor energy as the financial reporting framework. Major inspections: Activities performed during the life of the equipment and a frequency interval of longer than one year required to ensure the working order of the equipment. Major overhauls: Major overhauls involve upgrades or replacement of significant components (or a portion of) of equipment without replacing the equipment itself to maintain or improve the function of the equipment. In determining whether an overhaul is deemed to be major, the following criteria are used: - The overhaul would occur at regular predetermined intervals throughout the life of the asset; and,

	- would occur on a frequency greater than 1 year. Materiality: In the context of this policy, materiality is the concept of the relative importance of a capital cost expenditure. A capital expenditure is material if the amount significantly changes the value of the capital assets, affects decision making, or distorts the capital asset position of Nalcor. Materiality levels will also differ for various parties, for example, materiality at the consolidated Nalcor level will be higher when compared to the materiality levels of an individual division. Nalcor: includes Nalcor Energy and all lines of business including Newfoundland and Labrador Hydro, Churchill Falls, Energy Marketing, Bull Arm Fabrication, Oil and Gas and the Lower Churchill Project. Net book value: the value at which a company carries an asset on its balance sheet. It is equal to the cost of the asset minus accumulated depreciation. Relocation costs: costs that are incurred to move the asset from one location to the other and then bringing back to operational state as intended by the management Residual value: The expected value of an asset at the end of its useful life.
5. Scope of Application	The policy applies to property, plant and equipment for Nalcor but excludes the following: - Exploration and evaluation assets; refer to *CA18 – Exploration and Evaluation Costs*. - Mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources. - Intangible assets; refer to *CA14 – Intangible Assets*. - Incidental operations; refer to *CA7 – Incidental Operations.* - Asset Retirement obligations; refer to *CA15 – Asset Retirement Obligations*. - Property, plant and equipment classified as held for sale.
6. Standards and Requirements	In order to be capitalized, costs must fulfill the criteria listed in the processes and procedures section below. These processes and procedures are in accordance with IFRS IAS 16 – Property, Plant and Equipment.
7. Process/ Procedure	The following section describes the guidelines and policies regarding capitalization. For instances where the accounting treatment of transactions is unclear, the Assistant Corporate Controller will confirm the appropriate accounting treatment, in consultation with the Divisional Controller.

Eligible Capital Costs

In order to be considered eligible for capitalization, costs must be considered to be directly attributable to a capital project. The following examples are types of costs that are considered to be directly attributable costs eligible for capitalization:

- Costs of Nalcor salaries and wages and other employee benefits arising directly from the construction or acquisition of specific items of property, plant and equipment. Therefore, hours worked by staff, including managers and supervisors, that are directly attributable and incremental to a project should be recorded through the timesheet process to the appropriate capital work order. Capital work orders should be assigned to the appropriate capital business unit and cost type.
- Costs of onsite preparation;
- Initial delivery and handling costs, specifically identifiable for an asset;
- Installation and assembly costs; and
- Professional fees (ie consultants, contractors, lawyers etc.).

General overhead and administrative costs are not to be capitalized. These activities are generally not directly attributable and incremental to a project. Examples of these activities include legal, finance and administration activities, supply chain activities (such as the handling of inventory), general administrative supervision of staff and general management time. There are exceptions when an employee performing these functions is considered directly attributable and incremental to a specific project. In these situations when it is felt that this is the case, the Assistant Corporate Controller should be consulted to verify the appropriate accounting treatment for the related labour costs.

Relocation costs are not recognized in the cost of the asset and should be **expensed.** Once the asset is in the location and condition intended by management, costs related to redeploying or relocating the asset must be expensed.

Expenditures – Categories

The capitalized cost of an item of property, plant and equipment is comprised of:

- its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates;
- any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management; and

- the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located (Refer to *CA15 – Asset Retirement Obligations);*

There are different types of expenditures related to capital projects that are often incurred by Nalcor. These have been further described below along with the appropriate accounting treatment associated with these costs.

1) <u>Replacement Parts</u>

Costs related to the day-to-day servicing of property, plant and equipment **should not be capitalized**. Costs of day-to-day servicing generally relate to labour and consumables and the cost of small parts and are generally expensed as System Equipment Maintenance costs (operating).

Parts of some items of property, plant and equipment requiring replacement at regular intervals (e.g. a furnace requiring a relining after a certain number of hours of use) **can be capitalized** if there is a benefit exceeding a one year period. In these situations, the Asset Owners should prepare a capital budget proposal, Asset Assignment Form and required retirement and removal forms. These documents must specify the specific asset numbers and the related costs of the assets being replaced (or percentage of the total asset, if applicable) to allow the replaced assets to be retired. Further details on retirements of assets can be found in *CA10 – Capital Asset Disposals*.

Items such as spare parts, servicing equipment and stand-by equipment should be recognized as property, plant and equipment as long as they are tangible items that:

- Are held for use in the production or supply of goods and services, for rental to others or for administrative purposes; and,
- Are expected to be used during more than one year.

Otherwise, these spares are classified as inventory.

2) <u>FEED Costs</u>

Assessment phase

The assessment phase of a project is defined as the planned investigation, inspection, engineering review or prioritization determination, all of which may be used to gain knowledge on the "if or how" work should proceed. Such activities are performed before it becomes probable that future economic benefits associated with the item will flow to Nalcor and therefore costs incurred for assessment phase activities are **expensed as operating costs**.

The following are examples of assessment activities to determine "if or how" work should proceed:

- Determining the requirements of a particular location, area, or department;
- Research and analysis to determine the best approach to development;
- Assessment of the prioritization for upgrade of existing assets.

Design phase

The design phase of a project is defined as the application of the findings or knowledge gained during the assessment phase to a plan and design of an existing asset or the construction of a new asset. Therefore, the costs incurred related to FEED work and other design activities during the design phase should be **capitalized**.

The engineering/labour costs can be capitalized and should be tracked through the work order process by coding to separately identifiable capital work orders, as opposed to operating work orders for general budgets and estimating.

If it is not possible to distinguish between the assessment and the design phase of a study, the project is treated as relating only to the assessment phase and is to be expensed accordingly.

FEED - other

FEED may result in the capitalization of costs on Nalcor's records in advance of specific budget approval for the capital jobs. Should the Board of Directors (or the Board of Commissioner of Public Utilities for Hydro) subsequently disallow or reject any of the capital projects, the costs associated with the FEED work will be **expensed** to operating costs immediately.

FEED expenditures will be reviewed on a periodic basis, with the following documentation prepared for any costs that are capitalized spanning multiple reporting periods (depending on materiality):

- A measurement of intention, evidenced by approvals, plans, etc.
- Likelihood of pursuit, evidenced by priority of the project in question relative to other projects.

3) <u>Other Administrative Costs related to Capital Projects</u>

Costs associated with compiling, copying and reporting the capital budget, related regulatory filings including any Capital Carryover and Variance Reporting and responses to requests for information from various parties should be considered **operating expenses**.

Project Managers are responsible for reviewing the detailed costs recorded to their capital jobs to ensure that these costs meet the criteria for capitalization.

Clarification should be sought from the Divisional Controller if there are any questions.

4) Studies

Costs associated with pre-engineering studies considered to be directly attributable to a project can be **capitalized**. These study costs include work performed after an alternative has been selected and the study is focused on how best to proceed with the work. If a study cannot be directly attributed to a capital asset, the study costs must be expensed. These study costs would be recorded in work-in-progress until work on the related project was completed and the related asset was set up in the capital asset records. These costs would be amortized over the same period as the related asset. If Nalcor decided not to proceed with the project after the pre-engineering study was completed, the related costs would then be **expensed as operating costs** at that time.

5) Training Costs

Training costs are not included in the cost of the capital asset and must be **recognized as an operating expense** when incurred.

6) Major Overhauls and Inspections

A condition of continuing to operate an item of property, plant and equipment may be performing regular major overhauls or inspections for faults regardless of whether parts are replaced.

When each major overhaul or inspection is performed, its cost is recognized in the carrying amount of the item of property, plant and equipment as a replacement if the following recognition criteria are satisfied:

- It is probable that there will be future economic benefits for Nalcor associated with the costs for a period of greater than one year; and
- The cost of the item can be measured reliably.

Major overhauls and inspections are **capitalized** where they are required for the continued operation of an asset and meet the above criteria. Any remaining net book value of the previous inspection or overhaul should be removed from the accounting records. If unknown, the estimated cost of a similar current inspection or overhaul may be used to estimate the cost of the previously capitalized inspection and related net book value of components to be retired, factoring in the time value of money.

Major Inspections

As a guideline for capitalization, inspection activities are evaluated as either Level 1 or 2 and assessed in conjunction with the materiality of the activity to determine whether such activities are to be capitalized:

Level 1 **(generally not capitalized)**

A level 1 Condition Assessment is a walk through, visual, external inspection providing sufficient detail by the assessor to clearly define the work required to address identified deficiencies, to enable an accurate cost estimate to be made, and a clear description to be provided of the scope of the restoration/repairs/replacement/ removal for the work to be done. Where the assessor does not have the ability to clearly define the repair, it would indicate that the deficiencies require more rigorous assessment or specialist knowledge, and would be flagged by the Level 1 Assessor for a Level 2 Assessment to be undertaken. Level 1 inspection activities are **generally not capitalized.**

Level 2 **(generally capitalized)**

A Level 2 Condition Assessment is an assessment undertaken by a professional or certified specialist having the knowledge, skill and experience in the design, construction and operation of the facility type and may require knowledge and use of specialized equipment in the assessment of the facility. Level 2 Condition Assessments are a much more thorough assessment than a Level 1 Assessment and often involve the dismantling of the equipment. Level 2 inspection activities are **generally capitalized.**

Materiality is a factor that may be used by Nalcor to determine if an overhaul or inspection is considered to be major. Inspection and major overhaul materiality is evaluated on a group basis if multiple inspections or major overhauls occur as part of a single initiative (i.e. within the same year).

7) Incidental Operations

Incidental Operations are **not to be capitalized**. Please refer to *CA7 – Incidental Operations.*

Cessation of Capitalization

Cost recognition on a capital project is suspended once an item of property, plant and equipment is in the location and condition necessary for it to be capable of operating in the manner intended by management. Therefore, costs incurred in using or redeploying an item are not included in the carrying

	amount of that item. For example, the following costs are not included in the carrying amount of an item of property, plant and equipment: (a) costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity; (b) initial operating losses, such as those incurred while demand for the item's output builds up; and (c) costs of relocating or reorganising part or all of an entity's operations.
8. Responsibilities	Corporate Controller: Responsible for the preparation of the consolidated capitalized expenditures for Nalcor Divisional Controller: Responsible for the review of overall capitalized expenditures for the division and to ensure they are in accordance with the policies and procedures. Team Leads in charge of Capital Assets: Responsible for the administration of the capitalization policy and the effective operation of the capital asset accounting policies and procedures. This includes ensuring that appropriate work orders are prepared and capitalized costs are coded correctly within the financial systems.
9. Supporting and Related Documents	IAS 16 – Property, Plant, and Equipment (International Financial Reporting Standards)