Utilities

In pursuit of government grants

The economic stimulus package offers utility and power companies an opportunity to jump-start smart grid and other clean energy projects

PricewaterhouseCoopers

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The heart of the matter

Federal funding for clean energy programs entices utility companies

Utility companies eye federal grant incentives

It's no wonder utility companies are enticed by the *American Recovery and Reinvestment Act of 2009* and its billions of economic stimulus dollars waiting to be spent on renewable energy projects, smart grid technologies, and clean energy initiatives.

Signed into law on February 17, 2009, the federal legislation, also known as ARRA, provides about $83 billion in tax incentives, loan guarantees, and government grants for investments in energy-efficient technologies and renewable energy programs. These incentives may be a precursor to a more comprehensive US energy policy, with renewable energy and a cap-and-trade climate change proposal featured as prominent components.

As the legislative debate continues on how best to cut carbon emissions, utility companies are looking at federal tax incentives and grants to offset investments in costly infrastructure projects that are mostly optional today but could soon become mandatory. Rather than delay, many utility companies see federal stimulus grants as an opportunity to jump-start their energy initiatives. There is also a presumption that regulators expect utilities to access these incentives to mitigate raising customer rates to pay for the improvements.

The stimulus package earmarks $4.5 billion for smart grid projects to help utilities retool the electrical grid and in the process save power and reduce congestion that can result in blackouts. And as wind, solar, and geothermal sources of energy evolve, smart grid technology becomes essential to making renewable sources of energy available to customers with evolving plug-in needs—from new electronic devices to electric cars.

Because the energy efficiency advantages of a smarter electrical grid are critical and the projects are expensive to build, the Department of Energy recently raised the grant cap from $20 million to $200 million. Further, the Federal Energy Regulatory Commission issued a policy statement and action plan to accelerate the development of smart-grid technologies.

But it's not easy money. Along with significant financial and regulatory incentives to apply for stimulus grant funding come federal oversight provisions that might require some utility companies to implement new procedures or tailor policies to ensure their compliance.

The government anticipates spending $74.5 million to conduct federal and state audits of approved stimulus projects. An additional $84 million[1] of the ARRA money will be spent on the oversight activities of the Recovery Accountability and Transparency Board, created to prevent fraud, waste, and abuse.

To know whether pursuing a federal stimulus grant will be advantageous, utility companies need to understand the government grant process and be knowledgeable about the compliance, accounting, and tax implications involved.

1 *The Wall Street Journal Online:* What's in the Stimulus: A breakdown, February 2009

An in-depth discussion

To capitalize on federal funding takes knowledge of compliance rules

Getting the most from a federal grant requires knowledge and preparation

At $787 billion, ARRA is by far the largest combined spending and tax bill in US history. Understandably, accountability and transparency are of primary importance to the US government. Even companies with experience and knowledge about federal grants may need a refresher to understand and comply with ARRA's new reporting measures.

Without the proper compliance structure in place, a utility could be excluded from receiving ARRA grants or risk having grant payments suspended before a project is complete. Failure to meet any of the complex reporting, accounting, and compliance requirements could cause an award to be terminated and result in unwanted publicity.

Compliance and reporting depend on whose rules are in force

Compliance requirements may vary depending on the type of award (contract or grant) and whether the grant is federal or state. Differences may also exist among each of the states, making it difficult to identify the regulations and laws that apply. It is important to have this kind of information before the grant is awarded because compliance requirements begin with the proposal and application process and generally end three years after final payment.

Compliance begins with the pricing included in the proposal or budget submitted to the funding agency. If the compliance requirements associated with the cost proposal or budget are not fully understood, it could result in future disallowance of costs by the government or findings of defective pricing associated with contracts subject to the Truth in Negotiations Act (TINA). Such findings can have a severe impact because they reduce the costs that can be recovered by the company and may result in fines and penalties if certain laws, such as TINA, are violated.

Key elements associated with proposal pricing include the allowability of costs, the methods used to estimate cost categories such as labor, ensuring proposed cost sharing conforms to the rules, and indirect costs calculated using the appropriate causal/beneficial relationships. Also, ensuring the pricing is properly supported by basis of estimates, historical data and other corroborating information can help companies mitigate findings associated with pre-award audits of the proposal or budget and also reduce the risk of defective pricing allegations. The proposal process also gives organizations an opportunity to understand the compliance requirements that will be applied during the performance of the contract.

Compliance during the life of an award involves many systems and may require developing additional policies, procedures, and internal controls. The compliance requirements involve the accounting system and related subsystems including, but not limited to:

- Time and expense reporting
- Procurement
- Billing
- Contract/subcontract administration
- Labor distribution
- Materials management
- Government property

For example, the government may take an ownership interest in equipment and real property purchased under an award. This often results in seeking disposition instructions from the government at the end of the project, which may have a negative cash flow impact on the company. Understanding this up front helps companies make the bid/no bid decision by considering potential pricing and negotiation techniques that reduce the risks associated with government property.

Understanding the various requirements associated with the regulations is important to developing a negotiating position and also to mitigating risk of fraud, waste, abuse, adverse pre-award findings that may preclude an award, and adverse findings during performance of an award. For companies new to government-funded awards, this requires early planning to assess the current systems and compare them with the award requirements so that risks are understood and action can be taken to remediate deficiencies prior to accepting an award. Failure to plan may lead to significant government fines and penalties and negative media coverage if fraud, waste, or abuse exist or negative audit findings result.

In addition to core system requirements, companies are subject to other equally important laws and regulations. For example, ARRA funding opportunities may require the application of the provisions of the Buy American Act as well as the concept of prevailing wages of the Davis-Bacon Act. The Buy American Act could have implications on procurement methods, and the prevailing wage provisions can affect reporting, record retention requirements, and labor costs. Also applicable to Recovery Act funds is the False Claims Act, which imposes significant criminal and civil penalties, fines, and possible prosecution if invoices include improper amounts. Having the proper project reporting process and billing controls in place is critical to mitigate risk.

Reporting

Recovery Act awards include the normal reporting requirements associated with government funding including, but not limited to, progress reports, financial reports, and annual incurred cost submissions. However, the Recovery Act requires substantially more reporting and transparency than is normally expected with government funding, including the reporting of data and information in public forums for review by all interested parties. Specifically, recipients may be required to report on the following items:

- Job creation/retention
- Total ARRA funds awarded, amount of money received and expended, and the funding amount not yet committed as a project expense
- Details of the project, including a description of the activity and the evaluation of the completion status
- Detailed information on sub-awards, including names and locations of sub-awardees, primary place of performance of the work, a description of the sub-awards and unique identifiers (i.e., name or code) for the sub-awardees and their parents

In addition, under an interim rule published by the Federal Acquisition Regulation (FAR) council, entities receiving funding that includes the FAR clause must report the total compensation of the five highest-paid individuals employed by the contractor and the first-tier subcontractor.

> Before proposing on or accepting an award, it is important for companies to have the proper systems and methods in place to stay current on state and federal reporting requirements and to be able to identify and capture the right data to meet the reporting requirements.

Companies also must be aware that federal government regulations may change and the states may implement their own reporting requirements. Therefore, before proposing on or accepting an award, it is important for companies to have the proper systems and methods in place to stay current on state and federal reporting requirements and to be able to identify and capture the right data to meet the reporting requirements.

Companies also should be aware that the information provided to the government may include data that can be obtained through the Freedom of Information Act. Therefore, protection of sensitive and proprietary data must be a top priority.

Accounting and financial reporting

The specific facts and circumstances surrounding the type of funding received under the Recovery Act will have a significant impact on the accounting for those funds. The recognition and classification of amounts received will be dependent on the terms of the funding received. Although many companies will be familiar with accounting for either investment tax credits or production tax credits, they are probably less familiar with the accounting and reporting for government grants. Furthermore, utility companies will need to consider the implications of government grant regulations on their existing accounting practices.

US generally accepted accounting principles (GAAP) provides limited guidance on the accounting for government grants received by for-profit companies. As such, there may be more than one acceptable alternative for the accounting for government grants. Companies should understand the conditions and restrictions (e.g., repayment conditions) of the government grant and match accounting decisions with the economics and substance of the government grant.

We believe it would be acceptable for companies to apply the guidance in the International Accounting Standard IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance* (IAS 20), by analogy. It should be noted that the AICPA issues paper *Accounting for Grants Received from Governments*, dated October 16, 1979, currently indicates that it has been superseded by IAS 20.

IAS 20 states that economic benefits of government grants shall not be recognized until there is reasonable assurance that: (a) the entity will comply with the conditions attaching to them; and (b) the grants will be received. Therefore, a recipient of government grants would be able to recognize the grant as expenditures are made if it can conclude it is reasonably assured that it will be able to comply with the conditions specified in the grant agreement and the government will have ability to pay the amounts due under the grant.

IAS 20 also describes accounting for the grant as either:

1. A reduction of costs (either reduction of expense or reduction of capitalized cost of an asset)
2. A deferred credit (amortized over life of related asset or period of grant)
3. Revenue
4. Other income

Alternatively, there may be situations in which the grant recipient believes the underlying economics of the arrangement support analogizing to revenue recognition guidance. Specifically, the recipient must demonstrate that all four criteria of revenue recognition are met prior to recognizing revenue:

1. Persuasive evidence of an arrangement exists
2. Fulfillment of the obligation has occurred or services have been rendered
3. The amount of the grant is fixed or determinable
4. Collectability is reasonably assured

Use of the revenue recognition criteria is also acceptable.

Companies should choose the alternative that best represents the economics of the arrangement and apply that accounting to all similar transactions. Companies should also provide appropriate disclosures on its accounting for government grants if such amounts are material.

Tax considerations

The Recovery Act touches on more than 142 sections of the tax code by adding to the code, changing the code, or removing entire sections. To keep pace with how these changes impact finance and tax departments, utility company accounting and tax personnel are encouraged to become familiar with the following tax considerations:

The Recovery Act touches on more than 142 sections of the tax code by adding to the code, changing the code, or removing entire sections.

Stimulus Acts: The *Emergency Economic Stabilization Act of 2008* and the *American Recovery and Reinvestment Tax Act of 2009* contain tax provisions designed to provide jobs, encourage growth, and ensure accountability by those entities that participate in the incentives. Energy and environmental concerns play a key role in both acts, and the utilities and energy industries are most heavily affected.

For the renewable energy credit program, these acts provide a longer term for investment, (generally 2013 for most facilities, with wind terminating in 2012) which provides some stability and rationale to the construction costs of these investments. Hydropower, including marine renewables, combined heat and power, wind, turbines and geothermal pumps, also are recognized as qualified facilities for tax credits. The most significant change for this industry is to make utilities a qualified taxpayer for tax credits.

Both acts offer utilities carbon dioxide capture and sequestration provision opportunities that will require a partnership type relationship between the utilities and other industries with geological resources. Transactions between utilities and others also require careful consideration of the business arrangements between the parties, accounting procedures, and sharing of tax benefits.

Among the more interesting provisions in the Recovery Act is the ability to convert tax credits into cash grants from the government. The grants will be treated as excluded taxable income but cause an adjustment in basis equal to 50 percent of the amount of the grant.

The Treasury grant provisions are allowed for the construction of facilities that begins in calendar years 2009 and 2010; however, the facility does not need to be placed into service until expiration date under the tax law (e.g., wind before 2013, biomass before 2014, solar before 2017). Thus, the claimant may preserve the right to claim the grant at a later date by starting construction in 2009 or 2010 even if the property is not placed in service until later. However, it should be noted that the Treasury has not issued guidance for this provision and is working with the IRS and the Department of Energy to develop this program's policies and procedures, including application forms and instructions, program guidance, reporting and monitoring requirements, and any related agreements. The program was expected to begin in July 2009.

Separately, the IRS recently issued guidance for a new provision that allows for the conversion of "production tax credits" into "investment tax credits." This procedure calls for a formal irrevocable election to be filed with the income tax return in the tax year in which the facility or renewable asset is placed-in-service.

Investments in clean or renewable facilities: The definition of a renewable facility continues to be debated. The IRS has indicated that regulations will not be issued for these incentives due to the short time period that these provisions will be in the law. Moreover, some energy recovery processes (such as recovery of waste heat, gas from bio-matter, and use of commercial wastes by the facility generating them) are not covered by the current law. Thus, businesses will need to address these matters on their own, with assistance from advisers, or reach out to the IRS for a ruling. The IRS has indicated that it will not issue rulings on every facility. With concerns over privacy and technologies protections, some within the renewable energy industry have been hesitant to provide their peers with insight into their projects and will not seek a ruling.

Investments in energy efficiencies and saving assets: Although energy efficiency enticements are not covered in great detail for utilities, the stimulus act provides for significant tax benefits associated with smart meters, smart grid and commercial building energy savings. The act also provides credits for the capture of waste heat when efficiently employed in electrical or mechanical activities, and the use of coal waste for steam generation processes. By far, the most dollars for energy efficiency will come from providing customer benefits and from deductions and credits.

Tax effects associated with governmental or public utility grants: As a general rule, most grants are considered taxable income unless special guidance is provided. As an example, Congress declared that the conversion of tax credits into Treasury grants is not subject to income tax. Other specific examples of guidance have been provided for some state and local grants. In the IRS' view, funding allocated to the biomass industry should be treated as gross income because the money is used to compensate the bioindustry for the cost of grain. Further, the IRS has ruled that treatment as a nonshareholder contribution will not be available to noncorporate entities. Recipients of grants will need to review the terms of the grants and the relationships between the parties to determine what treatments are available. Because the terms for the grants are subject to negotiation, businesses wanting to have nonshareholder contributions should seek to have that provision included within the grant agreement.

Climate change payments and the treatment of allowances and penalties: As the Obama administration reconsiders the Kyoto protocol, legislative proposals to reduce carbon dioxide and other greenhouse gases are being debated. The House approved a cap-and-trade approach to reduce the nation's emissions in late June 2009. Under the terms of the Waxman-Markey bill, which needs Senate approval before becoming law, businesses may be required to purchase allowances for the right to emit carbon or carbon-equivalent gases. The legislation requires a reduction in emissions of CO_2 and other greenhouse gases (GhGs) of 17 percent against the 2005 baseline by 2020 and a reduction of 83 percent by 2050. Further, the legislation requires that 20 percent of the nation's energy be derived from renewable resources by 2020, with incremental improvements required starting with a requirement of 6 percent renewable energy by 2012.

Under the terms of the Waxman-Markey bill, which needs Senate approval before becoming law, businesses may be required to purchase allowances for the right to emit carbon or carbon-equivalent gases.

Although the terms of this legislation continue to be debated, earlier guidance provided by the IRS should be considered as instructive on emission-type allowances. In an earlier ruling, the IRS stated that air emission allowances will not be gross income to the party being granted the allowance. If the allowance is to be purchased, the ruling provides that the "emission right" would be treated as a capital asset to be recovered when the allowance is remitted, exchanged, or sold.

The staff of the Joint Committee on Taxation recently issued its review of the income tax issues raised by cap-and-trade proposals. Although they have recognized past guidance by the IRS, the staff requests clear guidance from Congress on:

- How and when any *gratis* allocations of emission allowances will be taxed
- How the tax basis of emission allowances will be determined
- Whether the cost of acquiring an emission allowance should be capitalized or deducted
- When and how any capitalized costs are to be recovered
- How the character of any gains and losses recognized on sale or exchange of allowances should be determined

Utilities should be cognizant of these discussions as the climate bill moves through Congress.

On penalties, the origin and character of the claim of an expense will determine its tax treatment. To the extent that a penalty is paid for failure to comply with the provisions of this act, it is believed that the IRS will treat it as a nondeductible penalty.

What this means for your business

Economic stimulus money helps advance utilities, clean energy strategy

The utilities and power generation industry takes steps to secure economic stimulus funding

Utility company leaders who understand the compliance, accounting, and tax implications of the federal grant process are able to apply for and secure funding to advance the strategic direction of their companies.

Although deadlines are approaching for companies to submit certain grant applications, there is ample time to take advantage of available federal funding by acting now to:

- Prioritize projects by developing a list of viable ventures
- Conduct an early assessment of each project to understand the objectives of each opportunity and the evaluation factors to use for calculating an effective bid and the costs involved to submit the proposal or application
- Develop and manage the application process by assessing the costing techniques to facilitate compliance
- Develop application strategies that strive for competitive advantage while being mindful of the economic consequences
- Evaluate accounting and compliance systems by:
- Assessing the compliance gaps in the organization and developing and implementing actions to remediate any weaknesses and enhance the organization's competitive position. The goal is to convince the government that the organization is ready to accept and perform under an award.
- Understanding compliance risks and also public perception risks and developing methods to mitigate any risks that may arise because of the transparency requirements of the economic stimulus package.

The federal stimulus grants may not be easy money, but the ARRA funding is available now, and it can provide utilities a crucial boost to implement smart grid technology and other energy initiatives, such as renewables and core infrastructure. It can also help the utility industry enhance its public image and put a spotlight on the many areas where the industry is engaged in clean energy programs.

Contacts

PricewaterhouseCoopers professionals have significant experience dealing with these and many other issues unique to the utilities industry. Our perspectives on these issues, including practical insights, have been gained from years of experience assisting clients to navigate the challenges they face. We offer these perspectives as a framework to help your business successfully manage in a complex world.

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