Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: May 31, 2006

to: Industry Director, Natural Resources and Construction
(LM:NRC)

from: Branch Chief, Branch 6
(Passthroughs & Special Industries)

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subject: Withdrawal of PLR

This advice may not be used or cited as precedent.

This memo is to advise you that (Taxpayer), a subsidiary of has withdrawn its request for a private letter ruling regarding the treatment of normalization reserves upon disposition of electric generation facilities. Specifically, Taxpayer's requested 2 rulings that the normalization rules applicable to investment tax credits under former section 46(f) of the Code, and the normalization rules applicable to depreciation under former section 167(l), section 168 and section 203(e) of the Tax Reform Act of 1986, will not be violated if ADITC and EDIT balances attributable to the Taxpayer's generating facilities as of the date of the closing of sale are: (1) flowed through to customers ratably over a period of time, or (2) are applied to reduce stranded costs the Taxpayer is otherwise entitled to recover from its customers, or, if no stranded costs remain to be collected, they are otherwise applied for the benefit of the Taxpayer's customers as the may direct.

Taxpayer was advised the Service was tentatively adverse and a conference of right was held on April 10, 2006. Consequently, Taxpayer withdrew its request for a ruling when informed the Service was still adverse. Set out below is a brief statement of underlying facts and this offices analysis.

FACTS

Taxpayer elected under former Code section 46(f)(2) to amortize its ADITC in reduction of the tax expense component of its cost of service no faster than ratably, and its regulated rate base is not reduced by its ADITC balance. Taxpayer also uses a normalization method of accounting for purposes of claiming accelerated depreciation with respect to public utility property in accordance with former §§ 167(l) and 168(f), and with § 168(i)(9). Moreover, Taxpayer has normalized its EDFIT in accordance with § 203(e) of the Act and Rev. Proc. 88-12, 1988-1 C.B. 637.

In enacted deregulation of electric generation, providing that all retail electric customers in State must be given the opportunity to purchase electricity from electric power suppliers of their choosing and that to implement retail choice, each utility must "unbundled" its rates so as to provide separate charges on its bills to customers for its generation services, for its transmission and distribution services, and for other discrete services it provides to customers. However, electric utilities' transmission and distribution services were not deregulated under the Act, and the Taxpayer's rates for these services continue to be subject to cost of service regulation by the . The Act recognized that the movement to a competitive market for electric generation would leave utilities with "stranded costs," i.e., generation-related (and other supply-related) costs which traditionally would have been recoverable in a regulated environment but which might no longer be recoverable after deregulation when the utilities' rates for electric generation must be set at levels competitive with the rates charged by other generation suppliers not burdened with similar costs.

The deregulation act authorized to determine, in a stranded costs recovery order, the amount of a utility's stranded costs that are eligible for recovery, and to provide the utility with an opportunity to recover those costs through the mechanism of a non-bypassable market transition charge (MTC) that the utility may collect from all of its customers throughout a limited period. Taxpayer decided to exit the generation business and adopted a plan to divest itself of its generation facilities.

The issued a Recovery Order, permitting Taxpayer to include as a component of the MTC a ratable recovery of Taxpayer's net investment in one of its generating facilities, together with interest on the Taxpayer's net investment, adjusted for this purpose to eliminate ADFIT attributable to the facility. The Recovery Order also provided that in the event of a sale of its other generating facilities, any net proceeds realized from the sale had to be applied to reduce the amount of stranded costs otherwise recoverable or, if no such costs remain to be recovered, applied to the benefit of Taxpayer's customers as directed by the . has proposed, subject to Taxpayer's ruling request, that the ADITC and EDFIT balances attributable to these other generating facilities be treated as additional net divestiture proceeds. As such, they would be applied to offset any remaining plant-related stranded costs or, in the

event such costs were fully offset, applied for the benefit of the Taxpayer's customers as directed by the .

LAW AND ANALYSIS

The first determination involves the proper normalization treatment by Taxpayer, an elector under former § 46(f)(2), of its ADITC relating to sales of its generating assets.

Former § 46(f) provides an election for ratable flow through under which an elector may flow through the investment tax credit to cost of service. However, former § 46(f)(2)(A) provides that no investment tax credit is available if the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the credit determined under former § 46(a) and allowable by § 38. Also, under former § 46(f)(2)(B), no investment tax credit is available if the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit determined under former § 46(a) and allowable by § 38.

Former § 46(f)(6) provides that for purposes of determining ratable portions under former § 46(f)(2)(A), the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account shall be used.

Under § 1.46-6(g)(2) of the Income Tax Regulations, "ratable" for purposes of former § 46(f)(2) is determined by considering the period of time actually used in computing the taxpayer's regulated depreciation expense for the property for which a credit is allowed. Regulated depreciation expense is the depreciation expense for the property used by a regulatory body for purposes of establishing the taxpayer's cost of service for ratemaking purposes. Such period of time shall be expressed in units of years (or shorter periods), units of production, or machine hours and shall be determined in accordance with the individual useful life or composite (or other group asset) account system actually used in computing the taxpayer's regulated depreciation expense. A method of reducing is ratable if the amount to reduce cost of service is allocated ratably in proportion to the number of such units. Thus, for example, assume that the regulated depreciation expense is computed under the straight line method by applying a composite annual percentage rate to original cost (as defined for purposes of computing depreciation expense). If cost of service is reduced annually by an amount computed by applying a composite annual percentage rate to the amount of the credit, cost of service is reduced by a ratable portion. If such composite annual percentage rate were revised for purposes of computing depreciation expense beginning with a particular accounting period, the computation of ratable portion must also be revised beginning with such period. A composite annual percentage rate is determined solely by reference to the period of time actually used by the taxpayer in computing its regulated depreciation expense without reduction for salvage or other items such as over and under accruals.

The method prescribed by § 1.46-6(g)(2) for determining whether the taxpayer's cost of service for ratemaking is reduced by more than a ratable portion of the investment tax credit depends upon correlating the credit with the regulatory depreciable useful life actually used for the property that generated the credit. That the correlation must remain constant and current is illustrated by the requirement that the ratable portion must be adjusted to reflect correspondingly any revision to the composite annual percentage rate applied for purposes of computing regulated depreciation expense.

Should the property for which the ADITC is allowed become no longer available for computing the regulated depreciation expense, there could no longer be any correlation between the property and the credit. In that event, the requirements of former § 46(f)(2) are violated if any portion of the credit is used to reduce the taxpayer's cost of service.

In this case, Taxpayer has sold the assets that generated the ADITC and, as a result, the asset for which regulated depreciation expense is computed is no longer available. Consequently, no portion of the related unamortized ADITC remaining at the date of sale may be returned to ratepayers by amortizing those ADITC amounts over the period Taxpayer recovers stranded costs from its ratepayers.

The second determination involves the proper normalization treatment by Taxpayer of its EDFIT relating to the sale of its generating assets.

Section 168(f)(2) provides that the depreciation deduction determined under § 168 shall not apply to any public utility property (within the meaning of § 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, § 168(i)(9)(A)(i) requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes.

Under § 168(i)(9)(A)(ii), if the amount allowable as a deduction under § 168 differs from the amount that would be allowable as a deduction under § 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under § 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) provides that one way the requirements of § 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under § 168(i)(9)(B)(ii), such

inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under § 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

Former § 167(l) generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former § 167(l)(3)(G) in a manner consistent with that found in § 168(i)(9)(A). Section 1.167(l)-1(a)(1) provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under § 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

Section 1.167(l)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used.

Section 1.167(l)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that the aggregate amount allocable to deferred taxes shall not be reduced except to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under § 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period of depreciation used in determining the allowance for depreciation under § 167(a).

Section 203(e) of the Act provides another way in which a normalization method of accounting is not being used for public utility property.

Section 203(e)(1) of the Act provides that a normalization method of accounting shall not be treated as being used with respect to any public utility property for purposes of § 167 or § 168 if the taxpayer, in computing its cost of service for ratemaking

purposes and reflecting operating results in its regulated books of account, reduces the excess tax reserve more rapidly or to a greater extent than this reserve would be reduced under the average rate assumption method (“ARAM”).

The term “excess tax reserve” is defined in § 203(e)(2)(A) of the Act as the excess of:

> (i) the reserve for deferred taxes as described in former § 167(l)(3)(G)(ii) or § 168(e)(3)(B)(ii) as in effect on the day before the date of the enactment of the Act, over;
>
> (ii) the amount that would be the balance in this reserve if the amount of the reserve were determined by assuming that the corporate rate reductions provided in the Act were in effect for all prior periods.

Section 203(e)(2)(B) of the Act defines the ARAM and explains the calculations under this method. ARAM is the method under which the excess in the reserve for deferred taxes is reduced over the remaining lives of the property as used in its regulated books of account that gave rise to the reserve for deferred taxes. Under the ARAM, if timing differences for the property reverse, the amount of the adjustment to the reserve for the deferred taxes is calculated by multiplying:

> (i) the ratio of the aggregate deferred taxes for the property to the aggregate timing differences for the property as of the beginning of the period in question, by;
>
> (ii) the amount of the timing differences that reverse during this period.

Rev. Proc. 88-12, 1988-1 C.B. 637, provides further guidance as to the application of the ARAM to the excess tax reserve. Section 2.04 of Rev. Proc. 88-12 provides that under the ARAM, excess tax reserves pertaining to a particular vintage or vintage account are not flowed through to ratepayers until such time as the timing differences in the particular vintage account reverse. Moreover, it is a violation of § 203(e) of the Act for taxpayers to adopt any accounting treatment that, directly or indirectly, circumvents the rule set forth in the previous sentence. Section 2.04 also provides that § 203(e) of the Act does not modify the normalization requirements of former § 167(l) or of § 168(i).

Sections 3 and 4.01 of Rev. Proc. 88-12 provide that a taxpayer who lacks sufficient vintage account data necessary to apply the ARAM, can use the "Reverse South Georgia Method." In general, a taxpayer uses that method if it (a) computes the excess tax reserve on all public utility property included in the plant account on the basis of the weighted average life or composite rate used to compute depreciation for regulatory purposes, and (b) reduces the excess tax reserve ratably over the remaining regulatory life of the property.

For a public utility to use accelerated depreciation in determining its federal income tax liability, § 203(e) of the Act requires that normalization accounting be used to reduce the excess tax reserve in calculating the rates to be charged the utility's customers and in maintaining the regulated books of account. Under § 203(e) of the Act, the immediate flow through of the excess tax reserve to the utility's customers is prohibited. Instead, the excess tax reserve is to be reduced and flowed through to cost of service no more rapidly that this reserve would be reduced under the ARAM, or, where appropriate, the Reverse South Georgia Method.

Section 203(e) of the Act limits the rate at which the excess tax reserve may be reduced and flowed through to the utility's customers in setting rates. It does not require the utility to flow through the excess tax reserve to its customers, but permits the utility to do so provided the reduction to cost of service is not more rapidly than would be under the ARAM. Thus, § 203(e) of the Act imposes a limitation on when the excess tax reserve may be returned to the utility's customers in the form of reduced rates.

In the present case, Taxpayer has sold the aforementioned public utility property. Retirements of public utility property subject to the normalization requirements of § 168 are reflected in adjustments to Taxpayer's deferred tax reserve as well as its excess tax reserve (see § 1.167(l)-1(h)(2)(i) and Rev. Proc. 88-12, 1988-1 C.B. at 639). As a result of the sale, these reserves cease to exist. A violation of the depreciation normalization rules will occur if there is any return to ratepayers, after the sale date, of the unamortized EDFIT attributable to accelerated depreciation on public utility property that is sold. Further, both ARAM and the Reverse South Georgia Method rely on mechanisms requiring a regulatory life. Once the asset is sold, the regulatory life ceases to exist.

CONCLUSIONS

Hence, in each of the two rulings requested by Taxpayer, there would be a normalization violation if the remaining unamortized ADITC and EDFIT balances (or a proportionate part thereof) existing at the date of sale are returned to ratepayers by amortizing those amounts over the period Taxpayer recovers stranded costs from its ratepayers. Because Taxpayer has sold the assets that generated the ADITC, the asset for which regulated depreciation expense is computed is no longer available. Consequently, no portion of the related unamortized ADITC remaining at the date of sale may be returned to ratepayers by amortizing those ADITC amounts over the period Taxpayer recovers stranded costs from its ratepayers. Additionally, the unamortized EDFIT associated with the sold generating assets ceases to exist at the date of sale. Consequently, a violation of the depreciation normalization rules will occur if there is any return to ratepayers, after the sale date, of those unamortized EDFIT amounts attributable to accelerated depreciation on public utility property.

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Please call if you have any further questions.

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Charles B. Ramsey
Branch Chief, Branch 6
(Passthroughs & Special Industries)