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December 04, 2007

LEGEND:

Taxpayer	=
Parent	=
State A	=
State B	=
Commission A	=
Commission B	=
Commission C	=
Plant	=
x	=
X	=
Y	=
Z	=
Order	=
N	=
Director	=

Dear :

This letter responds to the request, dated June 5, 2007, of Taxpayer for a ruling on the consequences of Taxpayer's accounting and regulatory treatment of depreciation and the Investment Tax Credit (ITC).

The representations set out in your letter follow.

Taxpayer is a regulated electric utility, incorporated under the laws of State A. Taxpayer provides rate-regulated electric generation, transmission, and distribution services to customers in State A and State B. It is owned by and files a consolidated return with, Parent, a holding company incorporated under the laws of State A. Taxpayer is subject to the regulatory jurisdiction of Commission A, Commission B, and Commission C with regard to its retail rates and certain conditions of service. Taxpayer's rates are established on a "rate of return" basis in each of the regulatory jurisdictions.

Taxpayer, among other assets, owns a x percent interest in Plant, a nuclear generating facility. Plant was placed in service for tax and regulatory purposes in with a 40-year operating license. Prior to , Taxpayer's investment in the Plant was included in its regulated rate base and depreciated for regulatory purposes over a 40-year life. The accumulated deferred investment tax credit (ADITC) associated with the Plant was amortized ratably over that same life. During that period, Taxpayer computed the reversal of the excess deferred income taxes (EDFIT) associated with the Plant using the average rate assumption method (ARAM), also calculated by reference to the same 40 year life.

In , a co-owner of the Plant filed an application for a rate increase with Commission B. In this proceeding, Commission B issued an order on , extending the depreciable life of the Plant from 40 years to 60 years and adjusting the depreciation rates and deferred income tax accounts to reflect this extension. On , Taxpayer entered into a Stipulation and Agreement with Commission B staff to conform Taxpayer's treatment of the Plant with that approved for the co-owner in the , order. The Stipulation and Agreement provided that, effective , Taxpayer would reduce rates by no less than $X and no more than $Y. Taxpayer calculated that the actual rate reduction was to be $Z. Because the recent rate case involving the co-owner had been fully contested and the numerical range of the rate reduction were based on those conclusions, the actual calculations used by Taxpayer to arrive at the actual numbers were not reviewed by Commission B. Commission B approved the Stipulation and Agreement by Order. Included in Order was a requirement that Taxpayer file a general rate case on or before .

For the years , Taxpayer depreciated the Plant over the new, longer life. However, it erroneously failed to consider the impact of the life extension on the amount of ADITC amortized and the ARAM computation (and thus, the amount of EDFIT reversal). In addition, the Taxpayer failed to consider the effect of the life extension on the reversal of the Allowance for Funds Used During Construction (AFUDC). The impact of the failure to consider the impact of the life extension on the first two (ADITC and the EDFIT ARAM calculation) was to understate tax expense and thus increase the rate reduction, while the impact of the failure to consider the effect of the reversal on AFUDC was to overstate tax expense and thus reduce the rate reduction. The net effect of these errors for the years was $N.

On , Taxpayer filed an application with Commission B to change its rates effective . In preparing this filing, Taxpayer discovered the errors described above and recalculated the items in question by using the extended 60 year life. In December , Taxpayer made adjustments to its financial and regulatory records to recapture the prior excessive ADITC amortization and EDFIT reversal as well as the excessive AFUDC tax effect. These adjustments increased the ADITC, EDFIT, and regulatory asset balance sheet accounts to where those accounts would have been if Taxpayer had not made the computational errors. In addition, the aggregate tax expense since reflects the amount that would have been reported if the AFUDC had been correctly calculated during that period.

Law and Analysis

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

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code 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 section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that-would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 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) of the Code provides that one way the requirements of section 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 section 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 section 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 section 167(l) of the Code 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 section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(1)-1(a)(1) of the Income Tax Regulations 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 section 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) of the regulations 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(1)-1(h)(1)(iii) of the regulations 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(1)-1(h)(2)(i) of the regulations 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 may be reduced 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 section 1.167(1)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under section 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.

According to section 203(e)(1) of the Act, a normalization method of accounting shall not be treated as being used with respect to any public utility property for purposes of section 167 or 168 of the Code 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 that this reserve would be reduced under the average rate assumption method (ARAM).

The term "excess tax reserve" is defined in section 203(e)(2)(A) of the Act as the excess of:

(i) the reserve for deferred taxes as described in former section 167 (1)(3)(G)(ii) or 168(e)(3)(B) (ii) of the Code 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 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 section 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 section 203(e) of the Act does not modify the normalization requirements of former section 167(l) or section 168(i) of the Code.

For a public utility to use accelerated depreciation in determining its federal income tax liability, section 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 section 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, section 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.

Former section 46(f)(2) of the Code 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 section 38. Also, under former section 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 section 38.

Former section 46(f)(6) of the Code provides that for purposes of determining ratable portions under former section 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 section 1.46-6(g)(2) of the regulations, "ratable" for purposes of former section 46(f)(2) of the Code 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.

Section 1.46-6(f)(4) provides that the ITC is disallowed for any section 46(f) property placed in service by a taxpayer before the date a final decision of a regulatory body that is inconsistent with section 1.46-6(f)(2) is put into effect on or after such date and before the date a subsequent decision consistent with section 1.46-6(f)(2) is put into effect.

Section 1.46-6(f)(2) provides that there is no disallowance of a credit before the first final inconsistent determination is put into effect for the taxpayer’s § 46(f) property.

Section 1.46-6(f)(8)(1) provides that “inconsistent” refers to a determination that is inconsistent with § 46(f)(1) or (2). For example, a determination to reduce the taxpayer’s cost of service by more than a ratable portion of the credit would be a determination that is inconsistent with § 46(f)(2).

Senate Report No. 94-36, 94th Cong., 1st Sess. 44-45 (1975), 1975-1 C.B. 590, 610, provides, in its explanation of the ratemaking treatment to be accorded the additional ITC allowed public utilities under the 1975 Act, explains that the additional ITC is to be disallowed if the regulatory agency requires the flowing-through of a company's additional ITC at a rate faster than permitted, or insists upon a greater rate base adjustment than is permitted, but only after a final determination is put into effect. That report further provides that the rules provided under existing law with respect to determinations made by a regulatory body and the finality of its orders would apply to this provision.

Senate Report No. 92-437, 92nd Cong., 1st Sess. 40-41 (1971), 1972-2 C.B. 559, 581, provides, in its explanation of amendments to the Revenue Act of 1971 dealing with the limitations on the ratemaking treatment of the ITC under section 46(e)(1) and (e)(2), that the Committee hopes that the sanctions of disallowance of the ITC will not have to be imposed.

For the periods during which Taxpayer erroneously failed to use the extended life of the Plant in calculating ADITC, EDFIT, and AFUDC, the practical effect of those actions was to reduce the tax expense element of cost of service by $N. This translated into a rate reduction of less than % of Taxpayer's revenues from operations in State B for this period, according to calculations by Taxpayer. This reduction was not the intent of either the Taxpayer or Commission B. Further, Taxpayer has acted upon discovery of these errors and adjusted its account balances so that they now reflect the same amounts as if no errors had occurred. We conclude that Taxpayer's actions as described above are not inconsistent with the requirements of §168(i)(9) and former §§ 167(l) and 46(f). Finally, Commission B never specifically addressed these matters in a rate case involving Taxpayer and so did not issue and order on these matters during this period. In accord with the Senate Reports quoted above, disallowance or recapture of the ITC should be imposed only after a regulatory body has required or insisted upon such treatment by a utility. Because Commission B did not insist on the errors discussed above, no disallowance or recapture is required in this case.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above. In particular, orders concerning this matter finalized by either of the Commissions after the date of this ruling are not necessarily subject to the same analysis as those considered above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely,

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

cc: