**Internal Revenue Service**

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Department of the Treasury
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February 15, 2008

LEGEND:

Taxpayer =

Parent =

State =
Commission A =

Commission B =
Director =

Dear :

This letter responds to the request, dated October 24, 2006, of Taxpayer for a ruling on whether the procedure used by the Taxpayer to quantify its gross rate base and the balance of its accumulated deferred federal income tax (ADFIT) account is consistent with the normalization provisions of section 168(i)(9) of the Internal Revenue Code and former § 167(l), as well as the regulations thereunder.

The representations set out in your letter follow.

Taxpayer, wholly owned by Parent, is an electric and natural gas utility headquartered in State. It is engaged in the generation, transmission, and distribution of electric power as well as the distribution of natural gas in State. It is subject to the

regulatory jurisdiction of Commission with regard to its retail rates and certain conditions of service.

Taxpayer's rates are established by Commission on a "rate of return" basis. In determining rates, the convention in State with respect to rate base is that a utility's accumulated deferred federal income tax (ADFIT) offsets gross rate base. Both gross rate base and the balance of Taxpayer's ADFIT are measured by the results of a 12-month historical test period.

This procedure for determining rate base has been used since the early 1980's and Commission, during a general rate case with an unrelated utility, stated that the procedure did not have a purpose inconsistent with the normalization rules, did not violate such rules, and, as a general matter, that Commission intended to comply with the normalization rules.

Taxpayer filed a general rate case in in which it no longer calculated the gross rate base differently from the ADFIT amount to be subtracted from the gross rate base. In the case, Taxpayer uses the for quantifying both numbers. Here, Taxpayer requests that the Service rule that its prior use of the procedure described above was consistent with the requirements of § 168(i)(9) and former § 167(l), and, if such prior use was not consistent with those requirements, that the prior use of the procedure described above will not violate the normalization requirements so long as future ratemaking procedures are consistent with the normalization rules.

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 rate making 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).

Thus, public utilities cannot use accelerated depreciation unless they use a normalization method of accounting. For the periods during which Taxpayer used the to calculate gross rate base and offset that amount by the amount of the ADFIT balance, such a procedure is not in accord with the consistency requirement of § 168(i)(9)(B). However, Congress intended that the harsh sanctions of disallowance of a public utility's use of accelerated depreciation and recapture of the tax benefits of the past use of such accelerated depreciation to be imposed only, it at all, after a regulatory body has required or insisted upon such treatment by a utility. See generally, Senate Report No. 92-437, 92nd Cong., 1st Sess. 40-41 (1971), 1972-2 C.B. 559, 581 (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), the Committee states that it hopes that the sanctions of disallowance of the ITC will not have to be imposed.) Because both Taxpayer and Commission at all times intended that Taxpayer comply with the normalization tax rules and because the specific matter of the Taxpayer's use of the procedure described above to calculate gross rate base and ADFIT has never been directly considered by the Commission, no disallowance or recapture is required in this case.

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)