

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact: _____, ID No.

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Date:
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LEGEND:

Taxpayer =
Parent =
State =
Commission A =
Commission B =
Operator =
Date 1 =
Date 2 =
Form =
Rider A =

Rider B =
Rider C =
Year 1 =
Year 2 =
Director =

Dear _____ :

This letter responds to Parent’s request, made on behalf of Taxpayer, dated February 1, 2017, for a ruling on the application of the normalization rules of the Internal Revenue Code (Code) to certain accounting and regulatory procedures, as described below.

The representations set out in your letter follow.

Taxpayer, a wholly-owned subsidiary of Parent, is an investor-owned regulated utility incorporated in State. Taxpayer is a member of Parent’s consolidated group that files a consolidated federal income tax return on a calendar year basis using an accrual

method of accounting.

Taxpayer is engaged in the purchase, transmission, distribution, and sale of electric energy in State. It is subject to regulation by Commission A and Commission B, with respect to terms and conditions of services, including the rates it may charge for its services. Both Commissions establish Taxpayer's rates based on its costs, including a provision for a return on the capital employed by Taxpayer in its regulated business.

Taxpayer's electric transmission lines located in State are integrated into Operator, a regional transmission operator. As a transmission-owning member of Operator, Taxpayer is able to include in Operator's tariff a rate that allows it to recover the costs it incurs with respect to the transmission facilities it makes available to Operator. The rate-setting mechanism used by Taxpayer is a formula rate approved by Commission B. The formula rate is established in two parts: a basic rate and a true-up.

By Date 1 of each year, Taxpayer files with Commission B to update its formula rate. The new rate takes effect the following Date 2 and remains in effect for one year. The data used in calculating the basic rate portion of the updated rate is, for the most part, taken from the historical test year which ended on the last day of the immediately preceding calendar year (as reflected in Taxpayer's Form for that period). All elements of rate base, including plant in service, accumulated depreciation and accumulated deferred federal income taxes (ADFIT) use, at least initially, "end of historical calendar test year" balances. Depreciation expense (and all other operation and maintenance expenses) reflected in the calculation are also historical calendar test year expense amounts.

One element of the calculation is then modified. A projection is made of plant additions that will be placed in service during the calendar year in which the rates are being set. The cost of these additions is weighted to reflect the number of months each addition will be in service during the calendar year. This weighted amount is added to rate base. Thus, this component of the rate provides a return on the equity reflected in the projected plant additions being included in rate base. No modification is made to the balances of the depreciation expense or deferred taxes due to these projected plant additions. The basic rate is a revenue requirement calculated based on the historical calendar year test period data so modified.

The true-up component of Taxpayer's formula rate is calculated by comparing a revenue requirement computed based on Taxpayer's most recent Form to the revenue requirement originally calculated for the prior test period. Any difference, both over- or under-recoveries (plus interest), is incorporated into the formula rate as the true-up component of that rate. Among other things, this component corrects any over- or under-recovery of equity return arising from the prior year's projection of plant additions, based on actual plant additions during the year.

Taxpayer has claimed (and continues to claim) accelerated depreciation on all of its public utility property to the full extent those deductions are available under the Code. Taxpayer normalizes the federal income taxes deferred as a result of its claiming these deductions in accordance with the Normalization Rules. As a consequence, Taxpayer has a substantial balance of ADFIT that is attributable to the accelerated depreciation reflected on its regulated books of account. In its formula rate template, Taxpayer reflects its ADFIT balance (as appropriately allocated to the jurisdiction) as a reduction in its computation of rate base.

In calculating both its basic rate and its true-up, the ADFIT balance by which Taxpayer reduces rate base is the end of period balance (i.e. the ending balance as reflected in Taxpayer's Form for the calendar year immediately preceding the year in which rates are being updated). Because ADFIT is not projected in either component, Taxpayer neither averages nor applies the proration methodology to the ADFIT balance in either calculation.

Taxpayer also has three State riders: Rider A, Rider B, and Rider C. For each of the riders, Taxpayer files to update the rider for the subsequent calendar year ("Annual Filing") for each of the years for which the rider is authorized. Each rider consists of two components: the projected rate and the true-up.

The projected rate employs a revenue requirement calculation based on Taxpayer's projection of the qualified rider plan costs to be incurred during the year for which rates are being set. Earnings are calculated upon a simple average of the beginning of the period and end of the period net plant.

The true-up is calculated by computing a revenue requirement for the last three months of the prior calendar year and the first nine months of the current calendar year based on actual results for those periods and comparing that amount to the actual revenues collected through the rider during that same twelve-month period. Any imbalance is charged or credited to the subsequent year's rider charge along with interest on the amount.

Changes in ADFIT balances are not prorated in the calculation of either component. Rather, they are calculated using a simple average of the beginning and the end of the period ADFIT.

Taxpayer requests that we rule as follows:

1. Taxpayer's projection of plant additions for inclusion in rate base in conjunction with the use of historical ADFIT and depreciation expense in computing its basic rate is not a violation of the Consistency Rule;
2. If the Service rules adversely with respect to Requested Ruling 1, provided that

Taxpayer takes the necessary corrective action at the next Form filing following the effective date of any related tariff changes approved by Commission B, any failure by Taxpayer to comply with the Consistency Rule in connection with its formula rate at any time prior to the Taxpayer taking the necessary corrective action was not a violation of the Normalization Rules;

3. If the Service rules adversely with respect to Requested Ruling 1, incorporating projected ADFIT (on a prorated basis), depreciation expense, and tax expense relating to the projected additions included in the formula rate calculation going forward will satisfy the Consistency Rule;

4. Taxpayer's Rider A, Rider B, and Rider C projected rates employ a future test period and, therefore, are subject to the Proration Requirement;

5. If the Service rules affirmatively with respect to Requested Ruling 4, provided that Taxpayer takes the necessary corrective action at the next Annual Filing, any failure by Taxpayer to comply with the Proration Requirement in connection with its Rider A, Rider B, and Rider C projected rates at any time prior to the Taxpayer taking the necessary corrective action was not a violation of the Normalization Rules; and

6. Taxpayer's Rider A, Rider B, and Rider C true-ups employ an historical test period and, therefore, are not subject to the Proration Requirement.

Law and Analysis

Requested Rulings 1, 2 and 3

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(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 § 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 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) requires that a 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, 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.

In order to satisfy the requirements of § 168(i)(9)(B), there must be consistency in the treatment of costs for rate base, regulated depreciation expense, tax expense, and deferred tax revenue purposes. In this case, all elements of rate base, including plant in service, accumulated depreciation, and ADFIT use, at least initially, "end of historical calendar test year" balances. Depreciation expense (and all other operation and maintenance expenses) reflected in the calculation are also historical calendar year test year expense amounts.

Taxpayer uses a projection of plant additions that will be placed in service during the calendar year in which rates are being set to compute a weighted amount that is added to rate base. The addition of the projected plant additions to rate base provides a return on the equity reflected in these projected plant additions. No modification is made to depreciation expense or deferred taxes as a result of these expected additions to Taxpayer's equity. Taxpayer's tax expense, depreciation expense, and ADFIT are all calculated in a consistent fashion. Therefore, Taxpayer is not in violation of the Consistency Rule.

Because of the conclusion reached above, Taxpayer is also not in violation of the Normalization Rules. Accordingly, Taxpayer's Requested Issues 2 and 3 are moot and will not be considered further.

Requested Ruling 4

Section 1.167(l)-1(h)(6) sets forth additional normalization requirements with respect to

public utility property. Under § 1.167(l)-1(h)(6)(i), a taxpayer does not use a normalization method of accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes excluded from the rate base, or treated as cost-free capital, exceeds the amount of the reserve for the period used in determining the taxpayer's ratemaking tax expense. Section 1.167(l)-1(h)(6)(ii) also provides the procedure for determining the amount of the reserve for deferred taxes to be excluded from rate base or to be included as no-cost capital. If, in determining depreciation for ratemaking tax expense, a period (the "test period") is used which is part historical and part future, then the amount of the reserve account for this period is the amount of the reserve at the end of the historical portion of the period and a pro rata amount of any projected increase to be credited to the account during the future portion of the period. The pro rata amount of any increase during the future portion of the period is determined by multiplying the increase by a fraction, the numerator of which is the number of days remaining in the period at the time the increase is to accrue, and the denominator of which is the total number of days in the future portion of the period.

Section 1.167(l)-1(h)(6)(i) makes it clear that the reserve excluded from rate base must be determined by reference to the same period as is used in determining ratemaking tax expense. A taxpayer may use either historical data or projected data in calculating these two amounts, but it must be consistent. As explained in § 1.167(l)-1(a)(1), the rules provided in § 1.167(l)-1(h)(6)(i) are to insure that the same time period is used to determine the deferred tax reserve amount resulting from the use of an accelerated method of depreciation for cost of service purposes and the reserve amount that may be excluded from the rate base or included in no-cost capital in determining such cost of services.

If a taxpayer chooses to compute its ratemaking tax expense and rate base exclusion amount using projected data then it must use the formula provided in § 1.167(l)-1(h)(6)(ii) to calculate the amount of deferred taxes subject to exclusion from the rate base. This formula prorates the projected accruals to the reserve so as to account for the actual time these amounts are expected to be in the reserve. As explained in § 1.167(l)-1(a)(1), the formula in § 1.167(l)-1(h)(6)(ii) provides a method to determine the period of time during which the taxpayer will be treated as having received amounts credited or charged to the reserve account so that the disallowance of earnings with respect to such amounts through rate base exclusion or treatment as no-cost capital will take into account the factor of time for which such amounts are held by the taxpayer.

The purpose of the proration formula is to prevent the immediate flow-through of the benefits of accelerated depreciation to ratepayers. The proration formula stops flow-through by limiting the deferred tax reserve accruals that may be excluded from rate base, and thus the earnings on rate base that may be disallowed, according to the length of time these accruals are actually in the reserve account.

The effectiveness of § 1.167(l)-1(h)(6)(ii) in resolving the timing issue has been

questioned by its failure to define some key terms. Nowhere does this provision state what is meant by the terms “historical” and “future” in relation to the period for determining depreciation for ratemaking tax expense (the “test period”). One interpretation focuses on the type or quality of the data used in the ratemaking process. According to this interpretation, the historical period is that portion of the test period for which actual data is used, while the portion of the period for which data is estimated is the future period. The second interpretation focuses on when the utility rates become effective. Under this interpretation, the historical period is that portion of the test period before rates go into effect, while the portion of the test period after the effective date of the rate order is the future period.

The first interpretation, which focuses on the quality of the ratemaking data, is an attractive one. It proposes a simple rule, easy to follow and to enforce: any portion of the reserve for deferred taxes based on estimated data must be prorated in determining the amount to be deducted from rate base. The actual passage of time between the date ratemaking data is submitted and the date rates become effective is of no importance. But this interpretation of the regulations achieves simplicity at the expense of precision; in other words, it is overbroad. The proration of all estimated deferred tax data does serve to magnify the benefits of accelerated depreciation to the utility, but this is not the purpose of normalization. Congress was explicit: normalization “in no way diminishes whatever power the [utility regulatory] agency may have to require that the deferred taxes reserve be excluded from the base upon which the utility’s permitted rate of return is calculated.” H.R. Rep. No. 413, 91st Cong., 1st Sess. 133 (1969).

In contrast, the second interpretation of § 1.167(l)-1(h)(6)(ii) of the regulations is consistent with the purpose of normalization, which is to preserve for regulated utilities the benefits of accelerated depreciation as a source of cost-free capital. The availability of this capital is ensured by prohibiting flow-through. But whether or not flow-through can even be accomplished by means of rate base exclusions depends primarily on whether, at the time rates become effective, the amounts originally projected to accrue to the deferred tax reserve have actually accrued.

If rates go into effect before the end of the test period, and the rate base reduction is not prorated, the utility commission is denying a current return for accelerated depreciation benefits the utility is only projected to have. This procedure is a form of flow-through, for current rates are reduced to reflect the capital cost savings of accelerated depreciation deductions not yet claimed or accrued by the utility. Yet projected data is often necessary in determining rates, since historical data by itself is rarely an accurate indication of future utility operating results. Thus, the regulations provide that as long as the portion of the deferred tax reserve based on projected (future estimated) data is prorated according to the formula in § 1.167(l)-1(h)(6)(ii), a regulator may deduct this reserve from rate base in determining a utility’s allowable return. In other words, a utility regulator using projected data in computing ratemaking tax expense and rate base exclusion must account for the passage of time if it is to avoid flow-through.

However, if rates go into effect after the end of the test period, the opportunity to flow through the benefits of future accelerated depreciation to current ratepayers is gone, and so too is the need to apply the proration formula. In this situation, the only question that is important for the purpose of rate base exclusion is the amount in the deferred tax reserve, whether actual or estimated. Once the future period, the period over which accruals to the reserve were projected, is no longer future, the question of when the amounts in the reserve accrued is no longer relevant (at the time the new rate order takes effect, the projected increases have accrued, and the amounts to be excluded from rate base are no longer projected but historical, even though based on estimates).

In this case, for Rider A, Rider B, and Rider C, Taxpayer uses a projected rate to calculate Taxpayer's revenue requirement based on a projection of the qualified rider plan costs to be incurred during the year for which rates are being set. Therefore, because Taxpayer's Rider A, Rider B, and Rider C projected rates employ a future test period, they are subject to the Proration Requirement under § 1.167(l)-1(h)(6)(ii).

Requested Ruling 5

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. However, in the legislative history to the enactment of the normalization requirements of the Investment Tax Credit (ITC), Congress has stated that it hopes that sanctions will not have to be imposed and that disallowance of the tax benefit (there, the ITC) should be imposed only after a regulatory body has required or insisted upon such treatment by a utility. See Senate Report No. 92-437, 92nd Cong., 1st Sess. 40-41 (1971), 1972-2 C.B. 559, 581.

Because the Service has ruled affirmatively with respect to Requested Ruling 4 that Taxpayer was required to use the proration formula applicable to future test periods for the projected rate for Rider A, Rider B and Rider C, prospectively adhering to the Service's interpretation of § 1.167(l)-1(h)(6)(ii) may require adjustments to conform to this ruling. Any rates that have been calculated using procedures inconsistent with this ruling ("nonconforming rates") which are or which have been in effect and which, under applicable state or federal regulatory law, can be adjusted or corrected to conform to the requirements of this ruling, must be so adjusted or corrected. Where nonconforming rates cannot be adjusted or corrected to conform to the requirements of this ruling due to the operation of state or federal regulatory law, then such correction must be made in the next regulatory filing or proceeding in which Taxpayer's rates are considered.

Specifically, Taxpayer has represented that it will submit rate filings to Commission A within six months of receipt of this ruling letter and that Taxpayer's Year 1 rate filings have or will conform the Rider A, Rider B, and Rider C projected rates to the Normalization Rules with rates becoming effective for calendar Year 2.

Requested Ruling 6

As discussed above, where a taxpayer computes its ratemaking tax expense and rate base exclusion amount using projected data then it must use the proration formula provided in § 1.167(l)-1(h)(6)(ii) to calculate the amount of deferred taxes subject to exclusion from the rate base.

In contrast to the projected rate component of Rider A, Rider B, and Rider C as discussed above, Taxpayer's Rider A, Rider B, and Rider C true-ups are determined by reference to a purely historical period. Accordingly, there is no need to use the proration formula to calculate the differences between Taxpayer's projected ADFIT balance and the actual ADFIT balance during the period. As a result, Taxpayer's Rider A, Rider B, and Rider C true-ups are not subject to the Proration Requirement.

Conclusions

1. Taxpayer's projection of plant additions for inclusion in rate base in conjunction with the use of historical ADFIT and depreciation expense in computing its basic rate is not a violation of the Consistency Rule.
2. This issue is moot as discussed above.
3. This issue is moot as discussed above.
4. Taxpayer's Rider A, Rider B, and Rider C projected rates employ a future test period and, therefore, are subject to the Proration Requirement;
5. Any failure by Taxpayer to comply with the Proration Requirement in connection with its Rider A, Rider B, and Rider C projected rates at any time prior to the Taxpayer taking the necessary corrective action does not constitute a violation of the Normalization Rules, provided that Taxpayer takes the necessary corrective action at the next Form filing; and
6. Taxpayer's Rider A, Rider B, and Rider C true-ups employ an historical test period and, therefore, are not subject to the Proration Requirement.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described 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,

Patrick S. Kirwan
Chief, Branch 6
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

CC: