Internal Revenue Service

Number: **201743009**
Release Date: 10/27/2017

Index Number: 167.22-01

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

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Refer Reply To:
CC:PSI:B06
PLR-104580-17

Date:
August 02, 2017

LEGEND:

Taxpayer	=
X	=
Y	=
Parent	=
State A	=
State B	=
Commission A	=
Commission B	=
Rider 1	=
Rider 2	=
Rider 3	=
Month	=
Report	=
Order	=
Date	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Director	=

Dear :

This letter responds to Taxpayer's request dated January 31, 2017, for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, as described below.

The representations set out in your letter follow.

Taxpayer, a State A limited liability company disregarded for federal income tax purposes, is wholly owned by X, which is also a State A limited liability company disregarded for federal income tax purposes. X is wholly owned by Y. Y is a State B corporation that is wholly owned by Parent. For federal tax purposes, Taxpayer is deemed to be owned by Y. Parent is the common parent of an affiliated group of corporations that files a consolidated federal income tax return on a calendar year basis using an accrual method of accounting. Y and therefore Taxpayer are included in this return.

Taxpayer is a regulated public utility engaged in the generation, transmission, distribution, and sale of electric energy in State A. It is subject to regulation by Commission A and Commission B, with respect to terms and conditions of 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. Commission A sets Taxpayer's rates at a level that is intended to allow Taxpayer the opportunity to collect from retail customers its total revenues equal to its cost of providing service, including a reasonable rate of return on invested capital. To accomplish this, Commission A uses base rates and cost recovery clauses ("Riders").

Taxpayer has claimed (and continues to claim) accelerated depreciation on all of its public utility property to the full extent those deductions are available. 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 accumulated deferred federal income tax (ADFIT) that is attributable to accelerated depreciation reflected on its regulated books of account.

In its base rate-setting, ADFIT is treated as a component of Taxpayer's capital structure and is assigned a zero cost rate. In computing its weighted average cost of capital ("WACC"), Taxpayer projects its capital structure and its costs for the various elements of its capital structure (including ADFIT) by using a 13-month average. Taxpayer has not applied the Proration Methodology to its ADFIT in determining the amount to which to apply the 13-month averaging convention in its base rate cases.

In addition to base rates, Taxpayer also has three main Riders (Riders 1 - 3) that are re-calculated at least annually and are each comprised of three components: (1) a basic amount that is computed using projected costs and customer usage for the current calendar year, (2) a preliminary true-up amount for the prior year, and (3) a final true-up amount from two years prior. In each Rider case, all elements of Taxpayer's rate base (for those Riders having a rate base component) are computed using a simple monthly average (beginning plus ending divided by two for each month).

As with base rates, ADFIT is treated as a component of Taxpayer's capital structure and is assigned a zero cost rate. However, unlike with base rates, in its Rider cases Taxpayer does not project it's WACC. Instead, in all three Rider cases it uses the more recent of (1) the WACC approved in Taxpayer's last base rate case, or (2) the WACC reflected in Taxpayer's most recently filed Month Report.

Reports are prepared and filed with Commission A monthly to reflect a "rolling" 13-month average WACC. This methodology was approved by Commission A in Order issued on Date. Reports are based on actual, historical results and Taxpayer did not apply the Proration Methodology to its ADFIT in determining the WACC for purposes of its Reports. Consequently, the WACC used in its Rider cases has not reflected the application of the Proration Methodology either.

In its Rider cases, Taxpayer does not explicitly compute income tax expense. Instead, it merely "grosses up" the equity return at the statutory rate to derive the revenue requirement necessary to fund that return after-tax. Thus, in its Rider cases, Taxpayer makes no distinction between current and deferred income tax expense.

In Year 2, Taxpayer's tax department personnel reviewed Taxpayer's treatment of its ADFIT in its base rate filings and concluded that Taxpayer was obliged to employ the Proration Methodology in calculating the ADFIT balance that it used as a component of its capital structure.

Under the Year 1 Agreement that it entered into in its last base rate case, Taxpayer does not expect to be able to change its base rates until Year 4. Therefore, it does not anticipate filing another base rate case until, at the earliest, sometime in Year 3. Taxpayer will implement the Proration Methodology as required and will propose to alter its use of disparate conventions in computing rate base and its WACC if the Service rules that such alterations are necessary to remain compliant with the Normalization Rules.

Taxpayer requests that we rule as follows:

1. To the extent that, in computing Taxpayer's base rates and its cost recovery clauses ("Riders"), Taxpayer's inclusion in its capital structure of an amount of depreciation-related ADFIT computed without applying the Proration Methodology was inconsistent with the Normalization Rules, any such action by Taxpayer in any year prior to taking the necessary corrective action as described above was not a violation of the Normalization Rules;

2. In computing the projected component of its Riders, Taxpayer's use of projected costs, including the projection of all elements of rate base, in conjunction with the use of historical deprecation-related ADFIT balance which is a component of the historical WACC does not conflict with the Consistency Rule of § 168(i)(9)(B) in any year in which the depreciation-related ADFIT balance used to compute Taxpayer's WACC is equal to or less than the maximum depreciation-related ADFIT balance Taxpayer could have used under the Limitation of Treas. Reg. § 1.167(l)-1(h)(6)(i);

3. In computing the true-up components of its Riders, Taxpayer's use of a simple monthly average applied to all elements of rate base in conjunction with the use of the depreciation-related ADFIT balance that is a component of the WACC reflected in the Report from Month of the year to which that historical data relates or from a combination of that Report and the Report from Month of the prior year does not conflict with the Consistency Rule of § 168(i)(9)(B); and

4. In the event that Requested Ruling 2 and/or Requested Ruling 3 is negative, Taxpayer's use of regulatory conventions for determining all elements of rate base which differed from the convention it used to derive the depreciation-related ADFIT balance which is a component of the WACC it applied to that rate base in any year prior to taking the necessary corrective action as described above was not a violation of the Normalization Rules.

Law and Analysis

In General

Former § 167(l) 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), which provides that if a utility uses anything but regulatory depreciation for tax purposes, it must make an adjustment to a reserve to reflect the deferral of taxes resulting from the difference. Similarly, § 1.167(l)-1(h)(1)(b) provides that any tax deferral attributable to accelerated depreciation must be reflected in a reserve account.

Section 168(i)(9)(B) provides that one way the Normalization Rules are not satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which uses an estimate or projection of tax expense, depreciation expense, or a reserve for deferred taxes unless such estimate or projection is also used with respect to the other two items and with respect to rate base. This prohibition is generally referred to as "the Consistency Rule".

Section § 1.167(l)-1(h)(6)(i) provides that 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 (ADFIT), or treated as cost-free capital, exceeds the amount of the ADFIT reserve for the period used in determining the taxpayer's ratemaking tax expense. This is generally referred to as "the Limitation".

Requested Ruling 1

Section 1.167(l)-1(h)(6)(ii) provides that for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under § 1.167(l)-1(h)(6)(i), if solely an historical period is used to determine depreciation for federal income tax expense for ratemaking purposes, then the amount of the reserve account for the period is the amount of the reserve (determined under § 1.167(l)-1(h)(2)) at the end of the historical period. Section 1.167(l)-1(h)(6)(ii) provides that if solely a future period is used for such determination, the amount of the reserve account for the period is the amount of the reserve at the beginning of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during such period. This calculation of the portion of the amount of any projected increase or decrease to be charged in the future period (or the future portion of a part historical and part future period) is done by application of the "Proration Formula", described below.

Section 1.167(l)-1(h)(6)(ii) provides if, in determining depreciation for ratemaking tax expense, a 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. Therefore, a taxpayer may use either historical data or projected data in calculating these two amounts, but they 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 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. The Proration 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 Proration 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 the same as that of the Consistency Rule discussed above: 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 limited 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 test period for determining depreciation for ratemaking tax expense. How are these time periods to be measured? 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) 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 truly projected (future estimated) data is computed according to the Proration Formula, 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.

But 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).

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 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.

Both Commission A and Commission B have, at all times, required that utilities under their respective jurisdictions use normalization methods of accounting. Taxpayer also intended at all times to comply with the Normalization Rules.

Taxpayer is required to follow the Proration Requirement applicable to future test periods for the projected revenue requirement for Taxpayer's base rate and Rider cases. Prospectively adhering to the Service's interpretation of § 1.167(l)-1(h)(6)(ii) by using the Proration Formula requires adjustments to conform to this ruling.

Any rates that have been calculated using procedures inconsistent with this ruling ("nonconforming rates") which are or 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.

Taxpayer requests that any such failure to use the Proration Formula in any year prior to taking the necessary corrective action not be considered to be a violation of the Normalization Rules. Taxpayer has represented that it will initiate the measures necessary to conform to the Normalization Rules for its base rate and Rider cases. Taxpayer also stated that it will initiate those measures at the earliest available opportunity.

Taxpayer's failure to comply with the Normalization Rules in its prior base rate and Rider cases was inadvertent. It was not an inconsistency with the Normalization Rules that Taxpayer, any participant in any of the proceedings, or the regulator in any of the proceedings recognized. No potential proration-related normalization issue was ever identified. Thus, there was clearly no required treatment that was inconsistent with the Normalization Rules. Therefore, there was no determination made with respect to Taxpayer's calculation of its ADFIT balance by either Commission. Because the Commissions, as well as Taxpayer, at all times sought to comply, and because Taxpayer will take corrective actions at the earliest available opportunity, it is not appropriate to conclude that the failure to use the Proration Formula constituted a normalization violation and apply the sanction of denial of accelerated depreciation to Taxpayer.

<u>Requested Rulings 2, 3, and 4</u>

As explained in § 1.167(l)-1(h)(6)(i), the Limitation applies to ensure that the amount of the ADFIT reserve that can be excluded from rate base (or, as here, treated as zero-cost capital) does not exceed "the amount of such reserve for deferred taxes for the period used in determining the taxpayer's tax expense in computing cost of service in such ratemaking." Thus, the Normalization Rules do not permit rate base to be reduced by an ADFIT balance in excess of the amount reflected in cost of service.

If the Consistency Rule is, in whole or in part, integrated with the Limitation then the outcome of any technical violation of the Consistency Rule may be mitigated by a mathematical analysis showing that, despite the lack of consistency, the Limitation has not been exceeded and, therefore, the Normalization Rules have not been violated.

In this case, Taxpayer relies on projected costs for its determination of rate base to compute the projected component of its Riders. However, its ADFIT is not similarly projected. With regard to Taxpayer's two true-up Rider calculations, while Taxpayer applies a simple monthly average to historical test period data, for its ADFIT, Taxpayer does not rely on data from the same period. Accordingly, in Taxpayer's computation of both the basic amount and the true-up components of its Rider cases, a facial inconsistency exists between the convention applied to ADFIT and to depreciation expense, tax expense, and rate base that does not satisfy the mechanical application of the Consistency Rule.

Importantly, the ADFIT balance Taxpayer actually incorporates into its WACC for any given Rider case is likely to be significantly less than what the ADFIT balance would be if Taxpayer projected the ADFIT balance changes for the test period. If a failure to comply with the Consistency Rule is a per se violation of the Normalization Rules, then Taxpayer's procedure constitutes a violation of these rules without regard to compliance with the Limitation. However, proper consideration of this issue arguably involves the interaction between the Consistency Rule and the Limitation found in § 1.167(l)-1(h)(6)(i).

We believe that the Limitation and Consistency Rule should be read together where the purposes of the Normalization Rules are achieved thereby. Under this approach, compliance with the Consistency Rule can be achieved by calculating the ADFIT balance by which rate base would be reduced using the same conventions used for the other aspects of rate base (i.e., by adhering to the Consistency Rule). Provided that the amount of ADFIT actually used in Taxpayer's present method does not exceed the Limitation, the purpose of the Normalization Rules has been vindicated because no benefits that belong to the utility are being "flowed through" to ratepayers.

Accordingly, we conclude that, under the facts presented here, with regard to Requested Rulings 2 and 3, Taxpayer has not violated the Normalization Rules by virtue of using a computational methodology that is inconsistent with the Consistency Rule of § 168(i)(9)(B) because the ADFIT used in such methodology does not exceed that allowed by the Limitation in § 1.167(l)-1(h)(6)(i). Because of these conclusions, Request Ruling 4 is moot and will not be considered further.

<u>Conclusions</u>

1. To the extent that, in computing Taxpayer's base rates and its Rider cases, Taxpayer's inclusion in its capital structure of an amount of depreciation-related ADFIT computed without applying the Proration Methodology was inconsistent with the Normalization Rules, any actions taken by Taxpayer in any year prior to taking the necessary corrective action as described above was not a violation of the Normalization Rules.

2. In computing the projected component of its Riders, Taxpayer's use of projected costs, including the projection of all elements of rate base, in conjunction with the use of historical deprecation-related ADFIT balance which is a component of the historical WACC does not conflict with the Consistency Rule of § 168(i)(9)(B) in any year in which the depreciation-related ADFIT balance used to compute Taxpayer's WACC is equal to or less than the maximum depreciation-related ADFIT balance Taxpayer could have used under the Limitation of Treas. Reg. § 1.167(l)-1(h)(6)(i).

3. Similarly, in computing the true-up components of its Riders, Taxpayer's use of monthly averages for the historical test period for all elements of rate base in conjunction with the use of an historical depreciation-related ADFIT balance which is a component of the WACC from a different period does not conflict with the Consistency Rule of § 168(i)(9)(B) in any year in which the depreciation-related ADFIT balance used to compute Taxpayer's WACC is equal to or less than the maximum depreciation-related ADFIT balance Taxpayer could have used under the Limitation of Treas. Reg. § 1.167(l)-1(h)(6)(i).

4. Because we have found no violation of the Consistency Rule of § 168(i)(9)(B) in either Requested Rulings 2 or 3, this issue is moot.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above. We note that the calculations described above to determine the Limitation in the ratemaking processes related to its Riders, and thus whether Taxpayer's ADFIT exceeds that amount, should be retained by Taxpayer as part of their normal retention of records under § 6001.

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)