Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
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PLR-112037-17
Date: October 2, 2017

In Re: Request on consequences under the normalization provisions

Legend:

Taxpayer =

Parent =

Commission A =
Commission B =
State =
Incident =

Decision =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
a =
b =
c =
d =
e =
f =

Director =

Dear :

This letter responds to the request, dated April 10, 2017, submitted on behalf of Taxpayer for a ruling on the application of the depreciation normalization rules of § 168(i)(9) of the Internal Revenue Code ("Code") and § 1.167(l)-1 of the Federal Income Tax Regulations ("Regulations") (together, the "Normalization Rules") to the rate base offset procedure used by Commission A in a recent rate proceeding to implement its prior determination that $a of Taxpayer's otherwise allowable capital expenditures must be funded by shareholders and not by ratepayers.

The representations set out in your letter follow.

Taxpayer is an investor-owned regulated public utility incorporated under the laws of State. Taxpayer generates electricity and provides electric transmission and distribution services in State. Taxpayer also owns and operates a natural gas transmission, storage, and distribution system in parts of State.

Taxpayer is wholly owned by Parent. Taxpayer is included in a consolidated U.S. corporation income tax return filed by an affiliated group of which Parent is the common parent. The return is under the audit jurisdiction of the Large Business and International Division of the Internal Revenue Service. For federal income tax purposes, Taxpayer uses the accrual method of accounting and reports on a calendar year basis.

Taxpayer's rates for utility services are subject to the jurisdiction of Commission A and Commission B (the Commissions). Both Commissions set rates at levels that are intended to allow Taxpayer an opportunity to recover its costs of providing service including a return on invested capital ("rate of return" or "cost-of-service" ratemaking.) Before setting rates, Commissions conduct proceedings to determine the amounts that Taxpayer will be authorized to collect from its customers (Taxpayer's "revenue requirements"). This ruling request involves Commission A's decision in Taxpayer's most recent natural gas transmission and storage rate case.

On Date 1, Incident occurred. Following the Incident, Commission A initiated investigations related to the Incident and to Taxpayer's transmission practices. On Date 2, Commission A issued its final decisions in the investigations. On Date 2, Commission A also issued Decision to be imposed on Taxpayer as a result of its findings in the investigations.

Decision required that shareholders fund future, post-Year 1 safety-related programs and projects to be identified by Commission A in the amount of $b. Of the $b in mandated shareholder funded future safety enhancement costs, Commission A determined that up to $c could be for expenditures that would otherwise be expensed and the remainder (at least $a) would be required to fund expenditures that would otherwise represent capital expenditures for regulatory purposes. To track expenditures and to ensure that its objectives of shareholder funding would be achieved, Commission A required Taxpayer to establish two subaccounts: one to track expenses that would be shareholder funded and another to track capital expenditures that would be shareholder funded ("Capital Sub-Account"). Commission A imposed additional conditions to ensure that only capital expenditure amounts that otherwise would have been allowable for ratemaking purposes could count against the $a. Commission A also set forth very specific requirements to ensure that amounts to be paid by shareholders would not be recovered in rates. Commission A was clear as to its intended ratemaking impact for the shareholder funded costs. Commission A's purpose was to deny Taxpayer a return of and a return on $a of safety-related capital investments. Commission A sent a letter to the IRS to make very clear its view is that the proposed accounting treatment is necessary to ensure that shareholders bear the full cost of the penalties and cannot shift any of these costs to customers. Beyond the intent of Commission A that the actual costs of the safety-related assets be borne by Taxpayer's shareholders, Commission A intended that Taxpayer (and thus its shareholders) not be able to realize the accelerated depreciation-related tax benefits related to these assets.

On Date 3, Taxpayer filed an application to set revenue requirements for its natural gas transmission and storage business for the period Year 2 through Year 3 (Rate Case). Rates in this proceeding were intended to be effective for the three-year period beginning Date 4. The Decision was issued after the close of evidentiary hearings in the Year 2 Rate Case and shortly before opening briefs were to be filed. Because of this timing, an issue arose whether the final Rate Case revenue requirement decision should implement the Decision disallowance or whether the process should be divided into two phases: a Phase 1 to set the revenue requirement without regard to any disallowance and a Phase 2 to then reduce the Phase 1 revenue requirement to reflect the disallowed expense and capital costs. A Commission A ruling dated Date 5 adopted the second (two-phase) alternative.

A final decision in Phase 1 of the Rate Case ("Phase 1 Decision") was issued by Commission A on Date 6 and established revenue requirements for a four year period beginning Date 4. In this phase, the revenue requirements for the relevant years were calculated without regard to the $b shareholder funded component of the Decision.

In the Phase 1 Decision, all of the costs that are to be recorded in Taxpayer's Capital Sub-Account were treated as though they were no different from any other allowed capital costs. These costs were included in rate base and depreciated through cost of service. Moreover, to the extent that these assets produce deferred federal income taxes ("Capital Sub-Account-Related ADFIT"), those accumulated deferred federal income taxes ("ADFIT") were incorporated into the rate base calculation as an incremental rate base reduction, just as they would have been absent the Decision. In accordance with the earlier ruling, the Phase 1 Decision deferred until Phase 2 the determination of the projects and programs that were subject to the $b disallowance.

Commission A issued a final decision in Phase 2 of the Rate Case ("Phase 2 Decision") on Date 7. It calculated the adjustments to the Phase 1 revenue requirements to reflect the implementation of the $b shareholder funded component of the Decision. The Phase 2 Decision affirmed that the portion of the penalty applied to disallowed capital expenditures should equal $a.

The Phase 2 Decision implemented the $a capital cost shareholder funding in the following way. The Phase 2 Decision did not directly adjust or alter anything relating to the Capital Sub-Account costs. They remained in rate base, they produced depreciation expense which was included in cost of service, and the Capital Sub-Account-Related ADFIT reduced rate base. However, the Phase 2 Decision created a regulatory liability in the total amount of $a ($d relating to capital costs incurred in Year 2 and $e relating to capital costs incurred in Year 4). This regulatory liability was included as an offset to Taxpayer's rate base. This effectively neutralized the impact of including the Capital Sub-Account balance in rate base. The regulatory liability was amortized as a reduction in cost of service over f years, the weighted average life of Taxpayer's assets. The amortization was included as a credit to expense in the cost of service calculation. This essentially offset the annual depreciation expense relating to the assets recorded in the Capital Sub-Account. No adjustment was made to ADFIT balances (which reflected accelerated depreciation calculated in Phase 1 on all capital costs) on account of the creation or amortization of the regulatory liability. Consequently, the reduction in rate base attributable to the Capital Sub-Account-Related ADFIT balance remained in place and was not counteracted.

Before issuance of the final Phase 2 Decision, the judge issued a proposed decision ("PD"). Taxpayer filed comments on the PD expressing its view that the IRS could likely find that implementation as proposed would violate the Normalization rules. Commission A adopted the PD essentially unchanged. However, Commission A expressed its intent to comply with the Normalization Rules and to avoid the potential adverse consequences associated with the finding of a normalization violation by the IRS. In its final decision, Commission A stated that Taxpayer may seek adjustments if Taxpayer receives a ruling from the IRS contradicting the PD. This ruling request is made in connection with this directive.

Taxpayer requests that the Service issue one of the following two rulings:

1. The Phase 2 Decision rate base offset procedure described, including the reduction of Taxpayer's rate base by the Capital Sub-Account-Related ADFIT as

described, is consistent with (and, hence, will not violate) the requirements of § 168(i)(9) of the Code and § 1.167(l)-1 of the Regulations.

2. The Phase 2 Decision rate base offset procedure described, including the reduction of Taxpayer's rate base by the Capital Sub-Account-Related ADFIT as described, is inconsistent with (and, hence, will violate) the requirements of § 168(i)(9) of the Code and § 1.167(l)-1 of the Regulations.

Law and Analysis

Former § 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 § 167(l)(3)(G) in a manner consistent with that found in § 168(i)(9)(A). Section 1.167(l)-1(a)(1) of the 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) of the Code 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) of the Code 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, 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) of the Code 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 (hereinafter referred to as the "Consistency Rule").

Therefore, in order to satisfy the requirements of § 168(i)(9)(B) of the Code, there must be consistency in the treatment of costs for rate base, regulated depreciation expense, tax expense, and deferred tax revenue purposes. Consequently, those consistency rules would be violated if, as described in the proposed decision, $a of capital additions are removed from rate base (and from future depreciation expense) while retaining the deferred taxes associated with those same capital additions as a rate base reduction. This implementation would result in reduction of rate base by ADFIT produced by depreciable assets for which Commission A has disallowed recovery. Under § 168(i)(9)(B)(ii), the proposed treatment of the reserve for deferred taxes is inconsistent with respect to the depreciation expense and with respect to the rate base and thus violates the Consistency Rule. The Normalization Rules apply mechanically and the intent of Commission A to ensure that Taxpayer's shareholders (and not ratepayers) bear the burden of paying for certain assets does not permit Commission A to shift the depreciation-related tax benefits arising from these assets from Taxpayer to ratepayers.

We rule that:

2. The Phase 2 Decision rate base offset procedure described, including the reduction of Taxpayer's rate base by the Capital Sub-Account-Related ADFIT as described, is inconsistent with (and, hence, will violate) the requirements of § 168(i)(9) of the Code and § 1.167(l)-1 of the Regulations.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

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 Associate Chief Counsel
(Passthroughs & Special Industries)