Internal Revenue Service

Number: **201825026**
Release Date: 6/22/2018

Index Number: 45.00-00

Department of the Treasury
Washington, DC 20224

[Third Party Communication:
Date of Communication: Month DD, YYYY]

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B06
PLR-135762-17

Date:
March 08, 2018

Re:

LEGEND

Company 1 =
Company 2 =

Taxpayer =

State A =
State B =
State C =
a =
b =
c =
d =
e =
f =
g =
h =
i =
j =
k =
Program =
Certificate =
Date 1 =
Date 2 =

Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =

Dear

This is in response to your request for rulings, submitted by your authorized representative, concerning the federal income tax consequences of the transaction described below.

Background and Facts

Taxpayer is wholly owned by Company 1 a State A corporation. For federal income tax purposes, Taxpayer is considered a division of Company 2. Company 2 is the common parent of an affiliated group of corporations that file a consolidated federal income tax return. Taxpayer is a regulated public utility engaged principally in the generation, transmission, distribution and sale of electric energy in portions of State A and State B. Taxpayer's service area covers approximately a square miles and supplies electric service to approximately b million residential, commercial and industrial customers. Taxpayer is subject to regulation as to rates and conditions of service by the State A Utilities Commission, the State B Public Service Commission and the Federal Energy Regulatory Commission (FERC) (collectively referred to as the (Commissions). The Commissions generally establish rates based on costs including a provision for a return on the capital employed by Taxpayer in its regulated business. Approximately c percent of Taxpayer's electricity generation is used to provide electricity to retail customers in State A subject to State A's Utility Commission jurisdiction, approximately d percent is used to serve retail customers in State B subject to its utility commission, and approximately e percent is used to serve wholesale customers subject to FERC jurisdiction.

On Date 1, the Governor of State A signed a bill into law (Act). The purpose of the Act was to reform State A's approach to integrating renewable electricity generation into State A's energy mix. Though the Act has a number of chapters, three chapters establish new programs for renewable energy generation resources. Since, under these three programs, Taxpayer is able to own and operate renewable generation facilities, the Act raises the issue of whether such facilities will qualify as public utility property (PUP), thereby becoming subject to the normalization rules of former Code §46(f), Code §167, Code §168(i)(9) and the regulations promulgated under each This private letter ruling request relates to the Program authorized by the Act.

The Program requires electric public utilities with f or more State A retail customers to issue requests for proposals (RFPs) in order to procure renewable energy and capacity in the aggregate amount of up to g megawatts. The public utilities will procure this cost-effective renewable energy resource capacity through one (or, more likely, a combination) of the three options provided for in State A Act): (1) Acquiring renewable energy facilities bid into the Program RFP solicitation by third parties for ownership by the public utility (EPC bids); (2) Self-developed projects bid in by the public utilities (self-developed bids); or (3) Third-party power purchase agreements for renewable energy facilities to be dispatched, operated and controlled in the same manner as the public utility's own generating resources (PPA bids).

The procurement process has the following relevant features with respect to facilities that will be owned by the public utility, which are the subject of this ruling request and present the question whether the facilities are PUP: (1) Electric utilities may satisfy their procurement obligations by acquiring or constructing (or having affiliates acquire or construct) renewable facilities; (2) No more than h% of a utility's procurement obligation can be satisfied through self-developed or affiliate-developed facilities with the exception of facilities acquired from third parties through the competitive procurement process; (3) An electric utility shall be authorized to recover the authorized revenue of any utility-owned assets outside of base rates; (4) The authorized revenue for any utility-owned facility may be calculated on a market basis in lieu of cost of service based recovery using data from the applicable competitive procurement in accordance with the methodology established by the State A utility commission; (5) The competitive procurement process, including the pricing, will be administered by an independent third-party entity to be approved by the State A utility commission. It is with respect to any utility-owned facility for which the authorized revenue is calculated on a market basis in lieu of cost of service under this procurement process for which it must be determined whether the facility is PUP.

On Date 2, State A utility commission issued an order initiating a rulemaking to adopt and modify the State A utility commission's rules to implement the Program in the State A Act. On Date 3, Taxpayer made a filing in the Program rulemaking proceeding to establish the Program. The Program is for competitive procurement of energy and capacity from renewable energy facilities with the purpose of adding renewable energy to the State A generation portfolio in a manner that allows the Taxpayer to continue to reliably and cost-effectively serve customers' future energy needs. This rulemaking addresses: (1) Oversight of the competitive procurement process; (2) Waiver of regulatory conditions and code of conduct requirements unreasonably restricting Taxpayer or its affiliates from participating in the Program; (3) Procedures for expedited review and approval of certificates of public convenience and necessity, or the transfer thereof, for renewable energy facilities owned by Taxpayer and procured under this section; (4) Methodology to allow

Taxpayer to recover on its investment through market-based rates; and (5) A procedure for the State A utility commission to modify or delay implementation of the provisions of the Program section in whole or in part if it is in the public interest to do so.

With respect to the methodology to allow Taxpayer to recover on its investment through market-based rates, Taxpayer will propose to offer programs that will establish revenues using market prices established in Program solicitations. Under the proposed methodology, Taxpayer will establish the market price based upon the evaluation of prices that third parties bid to provide renewable energy and capacity in the same Program solicitation under comparable terms. Only winning bids actually procured through the Program solicitations will be used in deriving the market prices. The authorized revenue from a facility will be calculated by multiplying the market price by the appropriate unit procured in terms of energy production made contractually available (e.g., MWh), forecasted over the equivalent term of the comparable arrangement.

Under the Program, the renewable energy (solar produced electricity) will be charged with other sources of energy on customers' bills as a single energy charge. The Program provides a source of electricity from renewable energy, the cost of which will be taken into account along with other sources of electricity in calculating the kilowatt per hour charge on the customers' bills. The renewable energy provided under the Program will not be identified as a separate charge on customers' bills, but the portion of the single energy charge related to the Program will be based on the market rates applicable to those renewable energy facilities.

On Date 4, Taxpayer filed reply comments in that docket further refining the details of the Program. Taxpayer incorporated three new subsections that: (1) Further clarify State A utility commission oversight of the Program as it relates to the process for selecting the independent third- party evaluator (IE); (2) Provide procedures to be followed by the Taxpayer and the IE in implementing Program RFP solicitations; and (3) Establish transparency requirements and limits on affiliate communications between the electric public utility's "evaluation team" managing the Program RFP solicitation and any Taxpayer affiliate acting as a market participant bidding into the Program solicitation. A timeline was also established identifying critical milestones up to the execution of the first competitive procurement solicitation.

On Date 5, Taxpayer filed additional reply comments in that docket further refining the details of the Program. The filing further addressed the assurance of fairness and integrity of the RFP process by which market rates will be established in the Program by State A utility commission oversight and independent third-party evaluation, including the role and selection of the third- party evaluator.

On Date 6, State A utility commission issued an order adopting and amending the rules under which Taxpayer will present the Program guidelines on the design of the RFP process used to establish market pricing. More specifically, by Date 7, Taxpayer expects to make a filing to establish the Program guidelines for competitive solicitations. As described above, the market price for electricity would be set based on prices at which Taxpayer or third parties competitively bid and offer to sell electricity to Taxpayer at comparable terms in response to an RFP issued by Taxpayer. The market price shall not exceed the electric public utility's "Avoided Cost Rates" established for the same Program RFP Solicitation. Taxpayer's Avoided Cost Rates will be used for purposes of determining the cost effectiveness of renewable energy resources procured through a Program RFP Solicitation. The State A utility commission will issue an order to approve, modify, or deny the program no later than i days after the submission of the program by Taxpayer. The authorized revenue of any utility-owned asset selected in the Program RFP Solicitation will be approved through an annual rider cost recovery mechanism based on the market price in lieu of a cost-of-service based recovery upon a finding by the State A utility commission that market-based recovery is in the public interest. Renewable energy facilities eligible to participate in the competitive procurement will be limited to facilities with a nameplate capacity rating of j megawatts or less that are placed in service after the date of the electric public utility's initial Program RFP Solicitation.

"Avoided Cost Rates" are Taxpayer's calculation of its long-term, levelized avoided costs utilizing the methodology most recently approved or established by the State A utility commission as of h days prior to the date of the electric public utility's upcoming Program RFP Solicitation for purchases of electricity from qualifying facilities. For each Program RFP Solicitation, the electric public utility's avoided costs shall be calculated over the time period of the utility's pro formal contract(s) approved by the State A utility commission. For example, where Taxpayer solicits a pro forma Program contract offering a term of k years, the Avoided Cost Rate applicable to that contract would be a k-year, levelized long-term rate calculated based upon the State A utility's commission approved avoided cost methodology in effect at the time the solicitation is held. The Avoided Cost Rate is not based on either the cost or the investment in the facility from which the energy being priced is produced nor is the cost of the facility included in Taxpayer's rate base for State A retail ratemaking purposes.

The above described methodology of market pricing is for State A retail customers only. While the portion of the facility allocable to State A retail customers will be recovered through market pricing as described above, the recovery of the cost of Taxpayer owned renewable energy facilities allocable to State B retail customers and wholesale customers will be recovered through normal State B and wholesale rate making procedures. Wholesale recovery will be determined under the FERC filed formula rates.

RULINGS REQUESTED

The Taxpayer has requested the following rulings:

1. That portion of any facility owned and operated by Taxpayer, the electric output from which is charged to State A customers based on rates established under the Program, as such program is described above on a market basis in lieu of cost of service based recovery using data from the applicable competitive procurement, will not constitute PUP.

2. That portion of the same facilities that will be charged to State B retail customers will constitute PUP.

3. That portion of the same facility that will be charged to wholesale customers will constitute PUP.

LAW AND ANALYSIS

Section 168(f)(2) of the Internal Revenue Code (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.

Section 168(i)(10) of the Code defines, in part, public utility property as property used predominantly in the trade or business of the furnishing or sale of electrical energy if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof.

Prior to the Revenue Reconciliation Act of 1990, the definition of public utility property was contained in § 167(l)(3)(A) and § 168(i)(10), which defined public utility property by means of a cross reference to § 167(l)(3)(A). The definition of public utility property is unchanged. Section 1.167(l)-1(b) provides that under § 167(l)(3)(A), property is public utility property during any period in which it is used predominantly in a § 167(l) public utility activity. The term “section 167(l) public utility activity” means, in part, the trade or business of the furnishing or sale of electrical energy if the rates for such furnishing or sale, as the case may be, are regulated, i.e., have been established or approved by a regulatory body described in § 167(l)(3)(A). The term “regulatory body described in section 167(l)(3)(A)” means a State (including the District of Columbia) or political subdivision thereof, any agency or instrumentality of the United States, or a public service or public utility commission or other body of any State or political subdivision thereof similar to such a commission. The term ““established or approved” includes the filing of a schedule of rates with a regulatory body which has the power to approve such rates, though such body has taken no action on the filed schedule or

generally leaves undisturbed rates filed by the taxpayer.

The definitions of public utility property contained in § 168(i)(10) and former § 46(f)(5) are essentially identical. Section 1.167(l)-1(b) restates the statutory definition providing that property will be considered public utility property if it is used predominantly in a public utility activity and the rates are regulated. Section 1.167(l)-1(b)(1) provides that rates are regulated for such purposes if they are established or approved by a regulatory body. The terms established or approved are further defined to include the filing of a schedule of rates with the regulatory body which has the power to approve such rates even though the body has taken no action on the filed schedule or generally leaves undisturbed rates filed.

The regulations under former § 46, specifically § 1.46-3(g)(2), contain an expanded definition of regulated rates. This expanded definition embodies the notion of rates established or approved on a rate of return basis. In addition, there is an expressed reference to rate of return in § 1.167(l)-1(h)(6)(i). The operative rules for normalizing timing differences relating to use of different methods and periods of depreciation are only logical in the context of rate of return regulation. The normalization method, which must be used for public utility property to be eligible for the depreciation allowance available under § 168, is defined in terms of the method the taxpayer uses in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account. Therefore, for purposes of application of the normalization rules, the definition of public utility property is the same for purposes of the investment tax credit and depreciation.

Accordingly, the key factors in determining whether property is public utility property are that (1) the property must be used predominantly in the trade or business of the furnishing or sale of, inter alia, electrical energy; (2) the rates for such furnishing or sale must be established or approved by a State or political subdivision thereof, any agency or instrumentality of the United States, or by a public service or public utility commission or similar body of any State or political subdivision thereof; and (3) the rates so established or approved must be determined on a rate-of-return basis.

Pursuant to Code §50(d)(2), rules similar to the rules of former Code §46(f) as in effect on November 5, 1990, continue to determine whether or not an asset is PUP for purposes of the investment tax credit normalization rules. As in effect at that time, former Code §46(f)(5) defined PUP by reference to former Code §46(c)(3)(B). Section 168(i)(l0) sets out the current definition of PUP for purposes of the depreciation normalization rules.

Under both the depreciation and investment tax credit normalization rule definitions, the property must be predominately used in one of a number of enumerated activities. Aside from the description of certain telecommunications services (which has no relevance to Taxpayer's situation), the list of activities in the

two definitions are virtually identical. One of these activities is the furnishing or sale of electric energy.

Under both definitions, in order to be classified as PUP, the rates for the electricity produced by the property must be "established or approved" by:

1. A State or political subdivision thereof;

2. Any agency or instrumentality of the United States; or

3. A public service or public utility commission or other similar body of any State or political subdivision thereof.

Finally, Treas. Reg. §1.46-3(g)(2)(ii) further requires that property used in one of the enumerated activities and subject to the jurisdiction of a governmental regulator must be furnished or sold at regulated rates. Treas. Reg. §1.46-3(g)(2)(iii) provides that rates are regulated if they are established or approved on a rate-of-return basis.

There are, therefore, three characteristics all of which a facility must possess in order to be characterized as PUP:

1. It must be predominately used in the trade or business of the furnishing or sale of electric energy;
2. The rates for such sale must be established or approved by one of the enumerated agencies or instrumentalities; and
3. The rates set by that agency or instrumentality must be established or approved on a rate-of-return basis.

Any facility in the Program, described above, will be predominantly used in the trade or business of the furnishing or sale of electric energy and therefore, it will possess the first of the three characteristics. Moreover, as a regulated public utility subject to the jurisdiction of federal or state law, including the ratemaking jurisdiction of the State A utility commission, the State B commission and FERC, a Program facility will possess the second of the three characteristics. However, as will be discussed below, the portion of any Program facility owned and operated by Taxpayer the price for the electric output which is charged to customers based on rates established under the Program, as such program is described above, on a market basis in lieu of cost of service based recovery using data from the applicable competitive procurement, will not possess the third characteristic. The following is an analysis of the third characteristic of PUP with respect to each customer base: (1) State A retail customers; (2) State B retail customers; and (3) Wholesale customers.

STATE A CUSTOMER

Treas. Reg. §1.46-3(g)(2)(iii) provides that rates regulated on a rate-of-return basis are an authorization to collect revenues that cover the taxpayer's cost of providing goods or services, including a fair return on the taxpayer's investment in providing such goods or services. It specifically states:

> A taxpayer's rates are not "regulated" if they are established or approved on the basis of...charging "reasonable" rates within an industry since the taxpayer is not authorized to collect revenues based on the taxpayer's cost of providing goods and services.

As described above, the rate charged State A retail customers under the Program will be determined by the Program RFP process, which is a market mechanism administered by a non-regulatory third-party entity. These rates are the only source of compensation to Taxpayer from State A retail customers. The only cash flow that actually involves Taxpayer's sale of electricity to State A retail customers is not computed by reference to the costs of the facility. The process by which the Taxpayer's rates are determined for State A retail customers has nothing whatsoever to do with the facility's costs and, therefore, cannot be characterized as rate-of-return based. Moreover, any difference between Taxpayer's revenue from this charge and its facility cost will be borne entirely by Taxpayer's shareholders. There will be no "safety net" by which the State A utility commission will ensure or support Taxpayer's recovery of its costs.

Although the projected costs of a facility will be an element of the information submitted to the State A utility commission in the process of procuring a Certificate, the State A utility commission will not have the authority under the Program to establish rates based on those costs. This mere availability of cost data is not dispositive. Instead, the portion of any facility owned and operated by Taxpayer, the electric output from which is charged to State A customers based on rates established under the Program, which as described above is on a market basis in lieu of cost of service based recovery using data from the applicable competitive procurement, will not constitute PUP.

STATE B CUSTOMERS

The recovery of the cost of Taxpayer owned renewable energy facilities allocable to State B retail customers will be recovered through normal State B rate making procedures. Taxpayer will recover the portion of the facility allocable to State B retail customers through normal cost recovery rate making principles (including a return on investment). Thus, the portion of a facility owned and

operated by Taxpayer the electric output from which is charged to retail customers in State B will be PUP.

WHOLESALE CUSTOMERS

Taxpayer has applied for and received Market Based Ratemaking Authority (MBRA) from FERC for wholesale power sales outside of the areas in which Corporation has been determined to have market power. Pursuant to this authority, it makes sales through the wholesale market at rates established by the market. However, the recovery of the cost of Taxpayer owned renewable energy facilities allocable to wholesale customers will be recovered through normal wholesale rate making procedures. Wholesale recovery will be determined under the FERC filed formula rates, which currently recover an assets cost through depreciation and allow a return on rate base. As a result, that portion of the same facility that will be charged to wholesale customers will constitute PUP.

Accordingly, we conclude that:

1. That portion of any facility owned and operated by Taxpayer, the electric output from which is charged to State A customers based on rates established under the Program, as such program is described above on a market basis in lieu of cost of service based recovery using data from the applicable competitive procurement, will not constitute PUP.

2. That portion of the same facilities that will be charged to State B retail customers will constitute PUP.

3. That portion of the same facility that will be charged to wholesale customers will constitute PUP.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above under any other provisions of the Code (including other subsections of § 168). Specifically, no opinion is expressed concerning whether the contract to sell electricity constitutes a service contract under § 7701(e). In addition, no opinion is expressed concerning whether the Taxpayer is the owner of the Facility generating electricity for federal income tax purposes. Further, no opinion is expressed or implied on the classification of the property under § 168(e). Except as provided in § 168(e)(3), section 5.03 of Rev. Proc. 87-56, 1987-2 C.B. 674, provides, however, that asset classes in Rev. Proc. 87-56 include property described in such asset classes without regard to whether a taxpayer is a regulated public utility or an unregulated company.

Sincerely,

Peter C. Friedman
Senior Technician Reviewer, Branch 6
Office of Associate Chief Counsel (Passthroughs & Special Industries)

cc: