Internal Revenue Service

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Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
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Date:
February 21, 2019

Re:

LEGEND

Parent =

Company =

Taxpayer =

Division =
Commission A =
Commission B =
State A =
State B =
State C =
a =
b =
c =
Bill 1 =
Bill 2 =
Bill 3 =
Section 1 =
Section 2 =
Section 3 =
Date =

Year 1 =
Year 2 =

Dear

This is in response to your request for a ruling, submitted by your authorized representative, concerning the federal income tax consequences of the transaction and facts you have described below.

Taxpayer, a corporation formed under the laws of State A, is a regulated electric utility that services retail electric customers in portions of State B and five other states. Division is a division of Taxpayer that provides electric service in State B. Division is subject to the regulatory jurisdiction of Commission A and Commission B as to the terms and conditions of service, including the rates it can charge for the provision of service. In general, both regulators establish Division's rates based on its costs to provide its regulated electric service (including a return on its investment in the regulated business). Taxpayer employs an accrual method of accounting and reports on a calendar year basis. Taxpayer is an indirect, wholly owned subsidiary of Company. Company is a State C corporation. It is a holding company that conducts various regulated and non-regulated energy-related businesses through subsidiaries and affiliates. Company is b% owned by Parent. Parent is the parent of an affiliated group of corporations that files a federal consolidated income tax return. This group includes Taxpayer.

In Year 1, State B enacted Bill 1. This legislation added Section 1 to the State B code. In Year 2, State B enacted Bill 2. This legislation added numerous sections to the State B code, most pertinent to this request is Section 2. In pertinent part, these provisions allow a utility customer to identify a renewable energy facility and negotiate the terms and conditions (including the price) under which it would be willing to purchase power from the facility. Assuming the quantity of energy involved meets the requirements of the statute, the customer may request that the utility that serves it enter into two "back-to-back" power purchase agreements (PPAs). The first PPA (Wholesale PPA) is an agreement between the utility and the owner of the facility whereby the owner agrees to provide the utility with (and the utility agrees to take) the quantity of energy from the facility agreed upon between the customer and the owner of the facility under the terms and conditions the customer and the resource negotiated. The second PPA (Retail PPA) is between the utility and the customer (Contract Customer) whereby the utility agrees to provide the customer with (and the customer agrees to take) the energy purchased by the utility pursuant to the Wholesale PPA at the utility's cost. The Retail PPA is subject to the jurisdiction of Commission A. The provisions added by Bill 1 and Bill 2 (the Bills) require that, if requested, the utility must enter into these two PPAs.

Additionally, the utility can charge the Contract Customer for all reasonable identifiable costs associated with the provision of the energy including transportation, billing, administrative and other services as determined by Commission A. The provisions of the Bills also require the Wholesale PPA to provide that, if the utility's Contract Customer defaults on its obligation to take energy under the Retail PPA, the utility ceases to be obligated to take power under the Wholesale PPA. The provisions of the Bills require Commission A to approve contracts that meet the requirements of the statute. A facility, the costs of which have been included in a utility's regulated rates, is excluded from the operation of these provisions.

On Date, the governor of State B signed into law Bill 3 which added Section 3. Section 3 specifically confirms that qualified utilities (utilities that service more than c retail customers in State B) are permitted to acquire and own solar resources referred to in the statutory provisions added by Bill 1. Specifically, Section 3 provides, in part, that a qualified utility may apply to Commission A to acquire a solar electric generating facility to service, a Contract Customer using rate recovery based on a competitive market price. The application shall include a proposed solicitation process for the energy resource and the criteria proposed to be used to evaluate the responses. Upon completion of an approved solicitation process, the utility may seek approval for acquisition of the energy resource that won the bid. Commission A may approve the acquisition with rate recovery based on a competitive market price only if it determines that the utility's bid for the resource is the lowest cost ownership option for the utility. If the utility acquires a facility, it must enter into a PPA with its Contract Customer that incorporates the terms and conditions the customer negotiated with the prior owner of the project. This PPA is subject to Commission A's jurisdiction.

Under the program established by statute, any of Division's large customers may identify a solar energy resource (resource) from which it is willing to purchase electricity. This resource may be identified through a request for proposal (RFP) process it conducts itself or which is conducted by Division at the behest of the customer, the results of which are meant to identify the lowest cost ownership option for the utility, after satisfying other non-price criteria enumerated by the customer and Division. Non-price criteria will include but not necessarily be limited to items such as credit quality of the resource owner, ability to deliver a completed resource in a timely manner, access to transmission without undue transmission upgrade costs, and ability to demonstrate that the resource owner has negotiated a purchase option with Division. Once the lowest cost ownership option has been verified, the terms and conditions for the sale and purchase of power are negotiated between the proposed customer and the owner of the resource. Under Section 3, Division is permitted to apply to Commission A to acquire the resource. The administrative steps in the acquisition process are those outlined above in the description of Bill 3. Once Division's application is approved, it must charge its Contract Customer for energy at the rate that was negotiated between that customer and the owner of the resource from whom Division acquired it (plus reasonable non-energy costs).

The Taxpayer has requested us to rule that that portion of any solar electric generating facility owned by Taxpayer, the electric output from which is charged to participating State B customers based on rates established under the Contract Customer program described above on a bilaterally negotiated in lieu of a cost of service basis, will not be public utility property within the meaning of § 46(f), § 168(i)(10) and the regulations promulgated thereunder.

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 § 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.

Thus, 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.

As indicated above, under normal circumstances, retail sales come within the pricing jurisdiction of Commission A. However, the provisions of the Bills over-ride the power of Division A to prescribe and/or alter the terms and conditions of the arrangement negotiated between the Contract Customer and the original resource owner. Thus, as to the Retail PPA, the third Public Utility Property qualification requirement, regulatory cost-based pricing jurisdiction, is lacking.

However, even if Commission A were construed to have pricing jurisdiction, it does not have the power to impose prices based on Division's costs in the exercise of that jurisdiction. The only ability it has is to consider the terms of the deal negotiated between the Contract Customer and the original resource owner. Thus, any pricing ultimately approved by Commission A will not be based on its authority to impose rates based on Division's cost of service.

Accordingly, we conclude that that portion of any solar electric generating facility owned by Taxpayer, the electric output from which is charged to participating State B customers based on rates established under the Contract Customer program described above on a bilaterally negotiated in lieu of a cost of service basis, will not be public utility property within the meaning of § 46(f), § 168(i)(10) and the regulations promulgated thereunder.

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: