Internal Revenue Service

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Person To Contact:
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Refer Reply To:
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Date:
March 20, 2020

Re:

LEGEND:

Parent =

Taxpayer =

Subsidiary 1 =

Subsidiary 2 =

Company =

Commission A =

Commission B =

State A =

State B =

State C =

a =

b =

c =

d =

e =

Bill =

Facility A =

Facility B =

Location A =

Location B =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Year =

Department =

Director =

Dear :

This letter responds to your request, dated September 18, 2019, for a ruling regarding certain federal income tax consequences under § 168(i)(10) and former § 46(f) of the Internal Revenue Code of the proposed transactions described below. The relevant facts as represented in your submission are set forth below.

FACTS

Taxpayer, a State A corporation, is a public utility serving retail electric customers in State A. Taxpayer is a wholly-owned subsidiary of Subsidiary 1, a State A energy holding company. Subsidiary 1 is wholly-owned by Company, a State B limited liability company that is disregarded for federal income tax purposes and wholly-owned by Subsidiary 2, a State C corporation. Subsidiary 2 is a percent owned by Parent. Parent and its affiliated group of corporations, including Taxpayer, Subsidiary 1, and Subsidiary 2, file a consolidated federal income tax return on a calendar year basis using the accrual method of accounting.

Taxpayer is subject to regulation by Commission A and Commission B (Commissions) for ratemaking purposes. The Commissions generally establish Taxpayer's rates based on the costs to provide regulated electric service, including a return on investment. Taxpayer's rates include two basic rate elements. The first, is a base tariff general rate determined on a cost-of-service basis. The base tariff general rate revenue requirement includes, among other costs, a return on the value of property dedicated to servicing the public. The second, is a base tariff energy rate that reflects the actual cost of purchased fuel, purchased power, and related expenses.

State A law requires Taxpayer to procure renewable energy to meet State A's renewable energy portfolio standard. Taxpayer has achieved this renewable energy portfolio standard through both Taxpayer-owned rate-based facilities and power purchase agreements (PPAs) secured using a competitive solicitation process. With respect to PPAs, Taxpayer issues requests for renewable energy proposals and presents the bids to Commission A for approval as part of an integrated resource plan filing. Commission A determines if the price terms of the PPA are "just and reasonable." As part of the consideration for approval, Commission A considers which projects offer the best value to the customer that can be delivered as scheduled and compares the prices to other bids. Commission A does not compare the costs under a PPA to the cost-of-service based revenue requirement of a renewable energy facility (REF), including the facility producing the electricity sold under the PPA, to determine if the proposed contract is "just and reasonable."

On Date 1, the Governor of State A signed into law Bill. In addition to increasing State A's renewable energy portfolio standard, Bill created a new program that allows Taxpayer to meet this standard by owning renewable energy facilities without general rate approval for such ownership from Commission A.

With respect to self-developed projects, Section 6 of Bill has the following key provisions: 1) Commission A may establish a "just and reasonable" price for the energy produced by a REF owned by a utility by reference to a competitive market price, without regard or reference to the principles of cost of service or rate of return price setting; and 2) any capital investment associated with the REF must be excluded from the rate base of the utility and expenses associated with such facility must be excluded from the revenue requirement.

With respect to property that is acquired (either existing or being developed), Section 7 of Bill provides the following key provisions: 1) a utility may, without additional approval of Commission A, acquire an existing REF or a REF that is being developed if Commission A has approved the purchase of electricity generated by the REF pursuant to a PPA (under the competitive market-based process described above); and 2) a utility must submit notice to Commission A that (a) the utility will not include the REF in its rate base or expenses associated with the facility in its revenue requirement, (b) the utility will charge the "just and reasonable" contract price for electricity originally approved by Commission A with respect to the PPA approved by Commission A, and

(c) the utility acknowledges that following the conclusion of the term of the agreement, the utility must not include any capital investment associated with the REF in the utility's rate base or expenses associated with the REF in the utility's revenue requirement.

Pursuant to the requirements of Bill, Taxpayer intends to (1) self-develop Facility A (Section 6 of Bill) and (2) acquire Facility B (Section 7 of Bill). Taxpayer represents that Facility A and Facility B will satisfy the requirements of Bill, including that Facility A's and Facility B's capital investment and costs associated with the facilities were never included in (and will be permanently excluded from) Taxpayer's rate base and revenue requirements.

Taxpayer is self-developing Facility A, which will be located in Location A. Taxpayer is finalizing the construction process of Facility A under the terms of an engineering, procurement, and construction contract that is expected to be executed by Date 2. Facility A is a b-megawatt solar facility with c-megawatts of battery storage. Taxpayer finalized the Right of Way Grants from Department on Date 3. Taxpayer expects to place the property in service at the end of Year. Facility A will produce electricity that Taxpayer will sell to its retail customers in State A.

Facility B involves the development of a d-megawatt solar facility with approximately e-megawatts of battery storage in Location B. Facility B is expected to begin commercial operation by Date 4. An unrelated third party will develop the facility and transfer it to Taxpayer upon completion and prior to mechanical operation. A definitive Build Transfer Agreement is expected to be signed on Date 5. Facility B will produce electricity that Taxpayer will sell to its retail customers in State A.

RULINGS REQUESTED

Taxpayer requested the following rulings:

(1) Facility A, as a REF that satisfies the requirements of Section 6 of Bill, will not be public utility property within the meaning of former § 46(f) (of continuing applicability by virtue of § 50(d)(2), § 168(i)(10) and the regulations promulgated thereunder.

(2) Facility B, as a REF that satisfies the requirements of Section 7 of Bill, will not be public utility property within the meaning of former § 46(f) (of continuing applicability by virtue § 50(d)(2), § 168(i)(10) and the regulations promulgated thereunder.

LAW AND ANALYSIS

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.

Section 168(i)(10) 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, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof.

Prior to the Revenue Reconciliation Act of 1990, § 168(i)(10) defined public utility property by means of a cross reference to § 167(l)(3)(A). Section 167(l)(3)(A) as then in effect contained the same definition of public utility property that is currently in § 168(i)(10). 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. Pursuant to § 50(d)(2), rules similar to the rules of former § 46(f), as in effect on November 5, 1990, continue to determine whether an asset is public utility property for purposes of the investment tax credit normalization rules. As in effect at that time, former § 46(f)(5) defined public utility property by reference to former § 46(c)(3)(B).

The regulations under former § 46 (of continuing applicability by virtue of § 50(d)(2)), specifically § 1.46-3(g)(2)(iii), contains an expanded definition of regulated rates. This expanded definition embodies the notion of rates established or approved on a rate of return basis; where rate of return includes a fair return on the taxpayer's investment in providing such goods and services. Furthermore, rates are not "regulated" if they are established or approved on the basis of maintaining competition within an industry, insuring adequate service to customers of an industry, or charging "reasonable" rates within an industry. In addition to the definition in the § 46 regulations, 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, under both the depreciation and investment tax credit normalization rule definitions, a facility must meet three requirements to be considered public utility property:

(1) It 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.

Taxpayer will predominantly use Facility A and Facility B in the trade or business of the furnishing or sale of electric energy. Therefore, Facility A and Facility B will meet the first requirement. In addition, Taxpayer is a regulated public utility company subject to the jurisdiction of federal and state law, including the ratemaking jurisdiction of Commission A. Therefore, Facility A and Facility B will also meet the second requirement.

However, as described above, the rates Taxpayer charges for electricity to be produced by Facility A and Facility B will be the rates determined to be “just and reasonable” by reference to competitive market prices through the program established under Bill. These rates will be the only source of compensation to Taxpayer for electricity produced by Facility A and Facility B. The process outlined in Bill by which Taxpayer can charge rates to State A customers does not include recovery of Taxpayer’s costs on a cost-of-service basis, and all costs, including any cost of capital and capital investments, of Facility A and Facility B will be permanently excluded from Taxpayer’s rate base and revenue requirements. Thus, the program provided under Bill cannot be characterized as rate-of-return price setting. Therefore, Facility A and Facility B will not meet the third requirement.

Accordingly, we conclude that:

(1) Facility A, as a REF that Taxpayer represents satisfies the requirements of Section 6 of Bill, will not be public utility property within the meaning of former

§ 46(f) (of continuing applicability by virtue of § 50(d)(2), § 168(i)(10) and the regulations promulgated thereunder.

(2) Facility B, as a REF that Taxpayer represents satisfies the requirements of Section 7 of Bill, will not be public utility property within the meaning of former § 46(f) (of continuing applicability by virtue § 50(d)(2), § 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). In addition, no opinion is expressed concerning whether Taxpayer is the owner of the facilities generating electricity for federal income tax purposes.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent. This ruling is based upon information and representations submitted by Taxpayer and accompanied by penalty of perjury statements executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for a ruling, it is subject to verification on examination.

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 to the Director.

Sincerely,

Jennifer A. Records
Senior Technician Reviewer, Branch 6
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

cc: