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Washington, DC 20224

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Date:
April 15, 2020

In Re:

LEGEND

Taxpayer =

Parent =

State A =

State B =

Commission 1 =

Commission 2 =

Rider =

Facility =

Operator =

Date =

a =

b =

Director =

Dear :

This letter responds to your request dated October 17, 2019, for a ruling regarding the application of Internal Revenue Code (Code) § 168(i)(10) and former § 46(f)(5) to the facts described below. The relevant facts as represented in your submission are set forth below.

FACTS

Taxpayer, a State A corporation, is a wholly-owned subsidiary of Parent. Parent, a State B corporation, is a public utility holding company that owns, directly or indirectly, all of the outstanding common stock of its public utility subsidiaries, the service areas of which are in a states. Parent files a consolidated federal income tax return with its affiliated companies, including Taxpayer, on a calendar year basis using an accrual method of accounting. Taxpayer is a public utility subject to regulation by Commission 1. Taxpayer provides electric service on an integrated basis to retail customers in State A. It also supplies and markets electric power to wholesale customers.

Taxpayer's sale of electricity to its customers is subject to the terms of its existing tariff (Tariff) approved by Commission 1. Taxpayer's retail electric rates under the Tariff are cost-based rates approved by Commission 1 and are a combination of base rates and separate cost recovery clauses for specific categories of costs. These separate cost recovery clauses address such items as fuel, purchased energy costs, and purchased power capacity costs. Costs not addressed through one of the specific cost recovery clauses are recovered through Taxpayer's base rates. Electric service rates in State A are determined using the bundled cost of service method, which requires a single bundled rate for the generation, transmission, and distribution components of the base rate. As part of the ratemaking process, Taxpayer separately calculates its generation, transmission, and distribution components of the base rate in determining the total rate. The Tariff includes the Rider, under which certain customers who wish to directly purchase the electric output and all associated environmental attributes from a renewable energy generator may contract bilaterally with Taxpayer. The Rider is optional and is generally available to certain commercial and industrial customers. All bilateral agreements that Taxpayer may enter into under the Rider must be approved by Commission 1.

As part of its plan to address demand from large commercial customers for renewable electricity, Taxpayer intends to purchase a Facility that is currently under construction by an independent third party (Developer). The Facility is expected to be completed before Date. Taxpayer intends to enter into a purchase and sale agreement with Developer pursuant to which Developer will develop the Facility and sell it to Taxpayer upon completion. Taxpayer must obtain a Certificate of Public Convenience

and Necessity from Commission 1 before acquiring the Facility, but the Facility will not be included in the Tariff rate base. Taxpayer intends to recover its costs of constructing and operating the Facility through charges under negotiated bilateral contracts (Special Contracts) with customers.

Taxpayer intends to enter into Special Contracts for retail electric service with up to four large commercial customers (each a Customer) for sale of the output from the Facility. Each Special Contract will include the following key terms:

- A portion of the Customer's total load for its accounts in Taxpayer's service territory will be served by output from the Facility (Facility Portion of Load). The remaining portion will continue to be served by a combination of generation from Taxpayer's other generation facilities that are included in its Tariff rate base and purchased power (Non-Facility Portion of Load). The Customer will continue to pay the standard Tariff rate for the Non-Facility Portion of Load.

- For the Facility Portion of Load, the Customer will pay a fixed, bilaterally negotiated rate for the generation component of its electricity service, which will replace the applicable rate-of-return based generation component of the standard Tariff.

- A charge will be added to the Customer's total bill equaling the product of the per kWh price for solar electricity under the Special Contract (Solar Price) multiplied by the total solar kWh generated by the Facility that are sold to the Customer in a month (Solar Charge) pursuant to the Special Contract. The Solar Price will be an all-in volumetric rate negotiated between Taxpayer and the Customer. Pricing will be fixed upfront and will not vary over the life of the Special Contract, the initial term of which will be b years from the beginning of commercial operation of the Facility.

Each Customer will continue to pay a rate-of-return based rate for generation serving the Non-Facility Portion of Load, as well as the transmission and distribution portion of its electric service. The Facility will not be used in generating the Non-Facility Portion of the Load or in transmission or distribution service. Unlike the general service rates under Taxpayer's Tariff, which were approved after Commission 1 had determined that the rates were fair, just, and reasonable, there is no requirement under the Rider for Commission 1 to make a similar determination in approving Special Contracts. Commission 1 will not have any authority to modify the Solar Price after approval of the Special Contracts. All of the power purchased under the Special Contracts will ultimately be sold to persons that are unrelated to Taxpayer or any of its affiliates. Taxpayer and its affiliates will not consume or use any of the electricity. None of the Customers will have any option to purchase the Facility or any portion thereof.

Taxpayer intends for all of the output of the Facility to be sold pursuant to the Special Contracts. Should any portion of the Facility's output not be covered by a

Special Contract, it will be sold in the wholesale market operated by Operator (such sales, the Wholesale Sales). Any Wholesale Sales would be subject to jurisdiction by Commission 2 and the price Taxpayer would receive for any such sales would be market-based rates established by the wholesale market and would not be determined on a rate-of-return basis. All electricity generated by the Facility will be sold either though the Special Contracts or as Wholesale Sales. No electricity generated by the Facility will be sold to Taxpayer's retail customers (other than parties to the Special Contracts).

No portion of the costs to construct or operate the Facility is included in Taxpayer's rates for the sale of electricity under the Tariff. None of Taxpayer's customers (other than the parties to the Special Contracts) will directly or indirectly subsidize Taxpayer's costs of acquiring and operating the facility.

RULING REQUESTED

A ruling has been requested that the Facility is not public utility property within the meaning of § 168(i)(10) and former § 46(f)(5) because none of the payments for electrical energy produced by the Facility at the Solar Price are a payment for the furnishing or sale of electrical energy at a price that reflects cost-based, rate-of-return ratemaking.

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 the same. 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)) contain an expanded definition of regulated rates in § 1.46-3(g)(2)(iii). 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 the 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 the 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.

The Facility will meet the first requirement as it will be used predominantly in the trade or business of the furnishing or sale of electrical energy. The Facility will also meet the second requirement as it will be subject to the jurisdiction of Commission 1 (or, to the extent that there are Wholesale Sales, Commission 2).

The Facility will not meet the third requirement because the electricity it will generate will not be sold at rates determined on a rate-of-return basis. The Special Contract Solar Price will be fixed and determined on a market basis, under bilateral contracts negotiated between unrelated parties with adverse interests. Thus, no portion of the rate paid for generation serving the Facility Portion of Load will be determined on a rate-of-return basis. Moreover, no portion of the costs to construct or operate the Facility is included in Taxpayer's rates for the sale of electricity under the Tariff. None of Taxpayer's customers (other than parties to the Special Contracts) will directly or indirectly subsidize Taxpayer's costs of acquiring and operating the Facility. To the extent there are Wholesale Sales, the price for such sales will also be market-based under the wholesale market for electricity, rather than rate-of-return based rates. Accordingly, we conclude that the Facility is not public utility property within the meaning of § 168(i)(10) and former § 46(f)(5) because none of the payments for electrical energy produced by the Facility at the Solar Price are a payment for the furnishing or sale of electrical energy at a price that reflects cost-based, rate-of-return ratemaking.

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 facility generating electricity for federal income tax purposes.

This letter 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 letter ruling is based upon information and representations submitted on behalf of 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 upon examination.

In accordance with the power of attorney on file with this office, copies of this letter ruling are being sent to your authorized representatives. We are also sending a copy of this letter ruling to the Director.

Sincerely,

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

cc: