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Department of the Treasury
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Person To Contact:
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Date:
July 17, 2020

Re:

LEGEND:

Taxpayer	=
Parent	=
Commission A	=
Commission B	=
State A	=
State B	=
Organization A	=
Organization B	=
Facility	=
Contractor	=
Company	=
Order A	=
Order B	=
a	=
b	=
c	=
d	=
e	=
f	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=

Date 8 =
Date 9 =
Date 10 =
Director =

Dear :

This letter responds to your request, dated December 5, 2019, for a ruling regarding certain federal income tax consequences under § 168(i)(10) and former § 46(f)(5) of the Internal Revenue Code of the proposed transaction described below. The relevant facts as represented in your submission are set forth below.

FACTS

Taxpayer, a State A corporation, is a public utility engaged in the generation, transmission, and sale of electrical energy to State A retail customers. Taxpayer is an indirectly wholly owned subsidiary of Parent. Parent, a State B corporation, and its affiliated group of corporations, including Taxpayer, 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. Commission A generally establishes Taxpayer's retail electric rates on a cost-based, rate-of-return basis, and such rates are generally a combination of base rates and several separate cost recovery clauses for specific categories of costs. Taxpayer also has approved capital investment mechanisms, such as the
mechanism, which capture, outside of base rates, the recovery of certain utility investments related to transmission, distribution, and generation resources. The combination of Taxpayer's base rates, cost recovery clauses, and capital investment mechanisms comprise the total rates and charges applied to State A customers.

On Date 1, Taxpayer filed a Verified Petition with Commission A seeking an order (1) authorizing Taxpayer to construct, own, and operate the Facility and finding that the Facility is a clean energy project under State A law; (2) issuing a Certificate of Public Convenience and Necessity (CPCN) for the Facility under State A law; and (3) authorizing Taxpayer to timely recover costs incurred in the construction and operation of the Facility using traditional cost-of service, rate-of-return ratemaking. The Facility is a a megawatt AC solar energy facility. Within Date 2 and Date 3, several organizations filed Petitions to Intervene in the regulatory proceedings, including Organization A and Organization B.

On Date 4, Taxpayer, Organization A, and Organization B jointly submitted to Commission A a Stipulation and Settlement Agreement (Settlement Agreement) resolving all matters raised in the proceeding between the parties. Under the Settlement Agreement, Taxpayer agreed to forego traditional ratemaking for the Facility and agreed to a fixed rate of $b per KWh for electrical energy generated and sold from

the Facility (before a gross-up for State A utility receipts tax). The fixed rate was (1) the result of negotiations between Taxpayer, Organization A, and Organization B, (2) derived from market rates for solar energy sold pursuant to long-term power purchase agreements from comparable facilities, and (3) based upon an estimated capital cost of the Facility of $c, which the parties to the Settlement Agreement agreed was a reasonable estimate of the construction costs of the Facility. Actual costs of the Facility, whether higher or lower, would not change the fixed rate. Furthermore, future changes in anticipated costs of owning and operating the Facility would not change the fixed rate. Finally, the Settlement Agreement specified that the Facility and its associated costs would be excluded from Taxpayer's Commission A-approved base rates throughout the life of the project.

During negotiations and prior to entering into the Settlement Agreement, Taxpayer used a revenue requirement model to determine whether the negotiated market-based rate met Taxpayer's economic return requirements for a capital investment. The model initially used traditional cost-of-service, rate-of-return ratemaking, and, as such, the model includes all costs associated with engineering, procurement, construction, ownership, operation, and maintenance of the Facility. After developing the model, Taxpayer then levelized the resulting annual revenue requirement using Taxpayer's weighted average cost of capital. The levelized rate ensured that the costs to customers would be relatively fixed over the life of the project, as opposed to the traditional cost-of-service, rate-of-return ratemaking. The levelized annual revenue requirement was then divided by the expected production from the Facility to determine a levelized revenue requirement per kWh of electrical energy expected to be generated by the Facility. Taxpayer then compared this amount to the negotiated, market-based fixed rate discussed above to determine the economic viability of the Facility using the alternative ratemaking procedure proposed under the Settlement Agreement.

While the rate determined under the Settlement Agreement is generally fixed over the life of the Facility, the parties agreed that the rate could be adjusted in three distinct circumstances: (1) a change in Taxpayer's approved rate of return on equity as determined by a final order of Commission A in a future base rate proceeding (ROE Adjuster); (2) a change in the federal or State A income tax rate that resulted in a change to Taxpayer's other Commission A approved tariff rates (Tax Rate Adjuster); and (3) the receipt of any liquidated damages from the engineering procurement, and construction contractor for the Facility as a result of the failure of the Facility to meet its designed output capacity (LD Adjuster). If any of these events were to occur, Taxpayer agreed to use the model discussed above to calculate a new levelized price per kWh to be used for pricing the electrical energy from the Facility on a going forward basis. However, in calculating the new fixed rate, only the agreed upon input related to the particular adjuster would change. The formulas built into the model would then automatically calculate the new fixed rate. No other cost-of-service inputs are changed, regardless of whether the actual costs of providing electric service from the Facility have increased or decreased. Furthermore, any adjustment to the rate would not impact the

exclusion of the Facility's investment and operating costs from the Taxpayer's Commission A-approved standard base rates.

Under the Settlement Agreement, the fixed rate was based upon an assumed annual level of production in kWh (Production Baseline) from the Facility under a d-year declining schedule. For each year, the fixed rate would be multiplied by the Production Baseline and that amount would be added as a recoverable cost within Taxpayer's mechanism. If the rolling three year average of actual production from the Facility is more or less than e% or f% of the Production Baseline, respectively, the excess or shortfall amount would be multiplied by the fixed rate and added or subtracted from the Production Baseline amount for true-up within the mechanism in future periods.

On Date 5, Commission A issued Order A, which approved the Settlement Agreement without change, granted the CPCN, and approved the Facility as a clean energy project under State A law.

On Date 6, Commission A issued Order B approving an amendment to the Settlement Agreement (the Amended Settlement Agreement) to remove the ROE Adjuster as one of the three ways that the fixed rate for sale of electricity from the Facility could be adjusted.

Despite good faith efforts, Taxpayer and Contractor were unable to reach an agreement for the construction of the Facility. On Date 8, Taxpayer and Contractor, a subsidiary of Company, entered into a Termination Agreement, whereby the Engineering Procurement and Construction (EPC) Agreement entered into on Date 7 and a Transformer and Invertor Purchase order were terminated. Also on Date 8, Taxpayer and Company entered into a new agreement, the Module Sale Agreement, whereby Taxpayer agreed to purchase photovoltaic solar modules for the Facility. Company also assigned all its rights, title, interests, obligations, duties in, to, and under an OEM Transformer Purchase Order to Taxpayer.

Because of the termination of the EPC Agreement, the LD Adjuster will not be used to modify the fixed rate charged by Taxpayer for electrical energy generated by the Facility that was agreed to in the Settlement Agreement and approved by Commission A. Furthermore, the termination of the EPC Agreement will not change Commission A's approval of the Settlement Agreement.

Taxpayer planned to begin receiving materials and installing the stormwater pollution prevention facilities at Facility on Date 9. Facility is expected to be placed in service by Date 10.

RULING REQUESTED

Taxpayer requested the following ruling:

The Tax Rate Adjuster will not cause the Facility to be “public utility property” within the meaning of § 168(i)(10) and former § 46(f)(5) because the use of the model to recalculate the fixed rate in the event of a Tax Rate Adjuster does not cause the fixed rate to be treated as having been derived from cost-of-service, 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 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), contain 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 the Facility in the trade or business of the furnishing or sale of electric energy. Therefore, the Facility 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, the Facility will also meet the second requirement.

However, as described above, the rate Taxpayer charges for electricity to be produced by the Facility will be the rate determined by reference to comparable, competitive market prices and agreed upon in the Settlement Agreement (as modified by the Amended Settlement Agreement). This rate will be the only source of compensation to Taxpayer for electricity produced by the Facility. The fixed rate established for the sale of electrical energy from the Facility under the terms of the Settlement Agreement (as modified by the Amended Settlement Agreement), including adjustments to the fixed rate under the Tax Rate Adjuster, does not include recovery of Taxpayer's costs on a cost-of-service, rate-of-return basis, and all costs of the Facility will be permanently excluded from Taxpayer's base rates. The ROE Adjuster and LD Adjuster will have no effect following the Amended Settlement Agreement and termination of the EPC Agreement. Therefore, the Facility will not meet the third requirement. Accordingly, we conclude that the Tax Rate Adjuster will not cause the Facility to be public utility property within the meaning of § 168(i)(10) and former § 46(f)(5).

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 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 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 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: