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October 10, 2007

LEGEND:

Taxpayer =

State =
Commission A =
Commission B =
Order =
X =
Y =
Director =

Dear :

This letter responds to the request, dated September 29, 2006, of Taxpayer for a ruling on the consequences of Taxpayer's accounting and regulatory treatment of the Investment Tax Credit (ITC).

The representations set out in your letter follow.

Taxpayer is an investor-owned public utility incorporated under the laws of State. Taxpayer's primary business is the generation, transmission, and distribution of electric power. It is subject to the regulatory jurisdiction of Commission A and Commission B with regard to its retail rates and certain conditions of service. Both Commission A and Commission B require Taxpayer to comply with tax normalization rules and Taxpayer timely filed an affirmative election to account for its ITC under former section 46(f)(2) of the Internal Revenue Code of 1954.

Historically, Taxpayer has determined depreciation expense for regulatory purposes by applying a composite annual percentage rate to the original cost of assets on a functional group basis. The composite annual percentage rate is based on an estimate of average useful life of the assets in the functional group and net salvage. Net salvage is the estimated amount to be received for the asset upon retirement less the estimated cost to retire or remove the asset. While net salvage can be positive or negative depending on the functional group, in the aggregate the Taxpayer's net salvage is negative, meaning that the experience and expectation of Taxpayer is that it will cost more for Taxpayer to remove and retire an asset than will be received for such asset as salvage. Taxpayer has used composite annual percentage rates including the negative net salvage in determining depreciation expense for ratemaking purposes, with the approval of Commission A, in . In addition, Taxpayer used these same composite annual percentage rates, including the negative net salvage value, for Commission B ratemaking purposes. Both Commission A and Commission B relied on calculations by Taxpayer and were not specifically aware that Taxpayer was using composite annual percentage rates that included negative net salvage as part of the calculation. Taxpayer also used these same rates to calculate the asset life over which to amortize the deferred ITC for ratemaking purposes.

The effect of including negative net salvage as part of the composite annual percentage rate for calculating depreciation for regulatory purposes is that Taxpayer recovers the original cost of the asset somewhat earlier than under a calculation that does not include negative net salvage value. Similarly, using these rates to calculate asset life for ITC purposes results in a more rapid amortization of the deferred ITC than using the expected asset life unmodified by salvage considerations. During the period from through , Taxpayer amortized approximately $Y more in ITC than would have been amortized if actual asset life had been used rather than asset life as modified by the depreciation rates that take negative net salvage value into account.

In Order, Commission A approved, *inter alia*, an increase in annual depreciation expense by allowing Taxpayer to recover interim net salvage (recognizing that parts of major structures are retired before the retirement of the entire structure) and by allowing Taxpayer to include in its depreciation calculation terminal net salvage for Taxpayer's steam electric generation facilities. Order was effective for rates as of X, subject to appeal. Several parties appealed various items to the State Court of Appeals (the Court),

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During preparation for the appeals of Order Taxpayer became uncertain whether it had correctly amortized the ITC because of the use of net salvage value in its calculation of the asset life for ITC purposes. This ruling request followed.

Law and Analysis

In general, the ITC was introduced in 1962 and repealed for years after 1985 by the Tax Reform Act of 1986. Former section 46(f) and section 1.46-6 of the Income Tax regulations provide limitations on the use of tax credits by public utilities. Former section 46(f)(1) provides a general rule that disallows tax credits for “public utility property” if, for ratemaking purposes, such investment tax credit is used to reduce the taxpayer’s cost of service or to reduce the taxpayer’s rate base unless such base rate reduction is restored ratably, or faster, over the property’s useful life for ratemaking purposes.

Former section 46(f)(2) of the Code provides an election for ratable flow through under which an elector may flow through the investment tax credit to cost of service. However, former 46(f)(2)(A) provides that no investment tax credit is available if the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the credit determined under former 46(a) and allowable by section 38. Also, under former section 46(f)(2)(B) no investment tax credit is available if the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit determined under former 46(a) and allowable by section 38.

Former section 46(f)(6) of the Code provides that for purposes of determining ratable portions under former section 46(f)(2)(A), the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account shall be used.

Under section 1.46-6(g)(2) of the regulations, "ratable" for purposes of former section 46(f)(2) of the Code is determined by considering the period of time actually used in computing the taxpayer's regulated depreciation expense for the property for which a credit is allowed. Regulated depreciation expense is the depreciation expense for the property used by a regulatory body for purposes of establishing the taxpayer's cost of service for ratemaking purposes. Such period of time shall be expressed in units of years (or shorter periods), units of production, or machine hours and shall be determined in accordance with the individual useful life or composite (or other group asset) account system actually used in computing the taxpayer's regulated expense. A method of reducing is ratable if the amount to reduce cost of service is allocated ratably in proportion to the number of such units. Thus, for example, assume that the regulated depreciation expense is computed under the straight line method by applying a composite annual percentage rate to original cost (as defined for purposes of computing depreciation expense). If cost of service is reduced annually by an amount computed by applying a composite annual percentage rate to the amount of the credit, cost of service is reduced by a ratable portion. If such composite annual percentage rate were revised for purposes of computing depreciation expense beginning with a particular

accounting period, the computation of ratable portion must also be revised beginning with such period. A composite annual percentage rate is determined solely by reference to the period of time actually used by the taxpayer in computing its regulated depreciation expense without reduction for salvage or other items such as over and under accruals. A composite annual percentage rate determined by taking into account salvage value or other items shall be considered to be ratable in the case of a determination (whether or not final) issued before March 22, 1979, and any rate order (whether or not final) that is entered into before June 20, 1979, in response to a rate case filed before April 23, 1979. For this purpose, the term "rate order" does not include an order by a regulatory body that perfunctorily adopts rates as filed if such rates are suspended or subject to rebate.

Section 1.46-6(f)(4) provides that the ITC is disallowed for any section 46(f) property placed in service by a taxpayer before the date a final decision of a regulatory body that is inconsistent with section 1.46-6(f)(2) is put into effect on or after such date and before the date a subsequent decision consistent with section 1.46-6(f)(2) is put into effect.

Section 1.46-6(f)(2) provides that there is no disallowance of a credit before the first final inconsistent determination is put into effect for the taxpayer's § 46(f) property.

Section 1.46-6(f)(8)(1) provides that "inconsistent" refers to a determination that is inconsistent with § 46(f)(1) or (2). For example, a determination to reduce the taxpayer's cost of service by more than a ratable portion of the credit would be a determination that is inconsistent with § 46(f)(2).

Senate Report No. 94-36, 94th Cong., 1st Sess. 44-45 (1975), 1975-1 C.B. 590, 610, provides, in its explanation of the ratemaking treatment to be accorded the additional ITC allowed public utilities under the 1975 Act, explains that the additional ITC is to be disallowed if the regulatory agency requires the flowing-through of a company's additional ITC at a rate faster than permitted, or insists upon a greater rate base adjustment than is permitted, but only after a final determination is put into effect. That report further provides that the rules provided under existing law with respect to determinations made by a regulatory body and the finality of its orders would apply to this provision.

Senate Report No. 92-437, 92nd Cong., 1st Sess. 40-41 (1971), 1972-2 C.B. 559, 581, provides, in its explanation of amendments to the Revenue Act of 1971 dealing with the limitations on the ratemaking treatment of the ITC under section 46(e)(1) and (e)(2), that the Committee hopes that the sanctions of disallowance of the ITC will not have to be imposed.

For the periods during which Taxpayer included negative net salvage in its calculation of asset life for ITC purposes, it appears that the practical effect of that

action was to flow the ITC to ratepayers more rapidly than if calculated without the negative net salvage. However, this was not the intent of either the Taxpayer or either Commission A or Commission B. In accord with the Senate Reports quoted above, disallowance or recapture of the ITC should be imposed, if at all, only after a regulatory body has required or insisted upon such treatment by a utility. Because Commission A and Commission B at all times required that Taxpayer comply with the normalization tax rules and because the matter of the ITC flow-through calculation was not specifically addressed in the earlier orders by either of the Commissions, no disallowance or recapture is required in this case.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above. In particular, orders concerning this matter finalized by either of the Commissions after the date of this ruling are not necessarily subject to the same analysis as those considered above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. 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 ruling to the Director.

Sincerely,

Charles B. Ramsey
Chief, Branch 6
(Passthroughs & Special Industries)