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LEGEND:

Taxpayer =

Parent =

State A =
State B =
Commission A =
Commission B =
Developer =
Date X =
Date Y =
Date Z =
Date ZZ =
Date ZZZ =
Date ZZZZ =
X =
Y =
Z =
Year =
Order =
Director =

Dear :

This letter responds to the request, dated August 31, 2009, 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 a regulated utility incorporated and headquartered in State A. It is an indirect wholly-owned subsidiary of Parent, a holding company incorporated in State B. Taxpayer is included in the consolidated federal income tax return of Parent. Taxpayer is principally engaged in the generation, transmission, distribution, and sale of electricity in State A. Taxpayer is regulated with respect to the terms and conditions of service and, most particularly, regarding the rates it may charge for its services by Commission A and Commission B. With respect to the jurisdiction of both Commission A and Commission B, Taxpayer's rates are determined using a cost of service basis that allow Taxpayer to earn a reasonable rate of return. Taxpayer has elected to account for its ITC pursuant to former § 46(f)(2).

Taxpayer owns various transmission assets. The tariff that Taxpayer may charge its wholesale customers and third parties for their use of these transmission assets, the Open Access Transmission Tariff (OATT), is regulated by Commission B. Taxpayer's OATT rates in effect prior to Date X were established using procedures consistent with former § 46(f)(2), meaning that Taxpayer reduced the tax expense element of cost of service by no more than a ratable portion of its ITC and that Taxpayer did not reduce rate base by any portion of the credit.

In Date Y, Commission B issued Order, in which it encouraged electrical transmission providers under its jurisdiction to use formula rates in computing their OATT rates. The formula rates allowed for periodic adjustments to rates to reflect increases or decreases in costs without the necessity of providers having to formally file for rate adjustments with Commission B. In general, under a formula rates approach, the transmission provider and its customers agree on a template, which translates increases and decreases in certain costs into rate adjustments. This template is then required to be approved by Commission B. Taxpayer decided to follow this approach and selected a template developed by Developer. This template had been used by numerous other transmission providers. The template had been developed in such a way that transmission providers could use it whether they had made an election to use former § 46(f)(1) or former § 46(f)(2). Transmission providers that had made the election to use former § 46(f)(1) reduced rate base by the accumulated deferred investment tax credit balance (ADITC) and providers, such as Taxpayer, that had made the election to use former § 46(f)(2) reduced the tax expense element of cost of service an appropriate amount. Taxpayer's regulatory personnel were not familiar with the normalization tax rules and did not understand that the two fields related to the recovery of Taxpayer's ITC were alternative and so populated not only the reduction of tax expense element of cost of service field, which was appropriate given Taxpayer's

election to use former § 46(f)(2), but also the rate base reduction field, which was inconsistent with Taxpayer's election.

After negotiations with its customers, Taxpayer reached a comprehensive settlement agreement and filed this agreement with Commission B. Commission B approved the comprehensive settlement and the formula-based OATT rates became effective on Date X. At no point in either the negotiations with customers or the consideration of the comprehensive settlement by Commission B did anyone notice the error in populating the template. On Date Z, Taxpayer filed an update to its OATT rate, including reductions to both rate base and cost of service. Customers again did not challenge the updated numbers. While preparing for the Year OATT update, Taxpayer's regulatory personnel were considering the regulatory complexities associated with the ownership of ITC-eligible solar generating assets and requested an explanation of normalization rules as they applied to these assets. After reviewing this explanation, the regulatory personnel realized their earlier computation of the OATT rates had been in error. Taxpayer had filed its Year OATT update on Date ZZ, using the same procedures as in previous years. After realizing the normalization error, Taxpayer immediately, on Date ZZZ, filed a correction in which the reduction to rate base was excluded from the template. This correction caused a slight increase in rates and, under the rules of Commission B, a period of X days was required before the increase could take effect. On Date ZZZZ, the corrected rates went into effect.

Law and Analysis

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.

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 erroneously populated the template and thus improperly reduced rate base, the practical effect of this error was to lower rates and thus, to flow the ITC to its customers slightly more rapidly than if the template had been correctly populated. Rate base was reduced by between Y and Z percent of the total rate base, depending on the period. These amounts were less than one percent of rate base for the periods before the error was corrected. This reduction was not the intent of either the Taxpayer or Commission B. Further, Taxpayer has acted upon discovery of these errors and adjusted its rates so that they now reflect the same amounts as if no errors had occurred. We conclude that Taxpayer's actions as described above are not inconsistent with the requirements of former § 46(f). Finally, Commission B never specifically addressed these matters in a rate case involving

Taxpayer and so did not issue and order on these matters during this period. In accord with the Senate Reports quoted above, disallowance or recapture of the ITC should be imposed only after a regulatory body has required or insisted upon such treatment by a utility. Because Commission B did not insist on the errors discussed above, 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.

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Sincerely,

Peter C. Friedman
Senior Technician Reviewer, Branch 6
(Passthroughs & Special Industries)

cc: