

Internal Revenue Service

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LEGEND:

- Taxpayer =
- Parent =
- State A =
- State B =
- State C =
- State D =
- Commission =
- Date A =
- Director =

Dear :

This letter responds to Parent’s request, made on behalf of Taxpayer, dated October 23, 2014, for a ruling on the consequences under the normalization provisions of Taxpayer’s use of the Commission-approved formula rates as described below.

The representations set out in your letter follow.

Taxpayer, a single member limited liability company, is an independent transmission utility engaged in the transmission of electricity and operates a high-voltage system in States A, B, C, and D. It is subject to regulation by Commission with respect to terms and conditions of services, including the rates it may charge for its services. Taxpayer uses Commission-approved formula rates that are set annually.

The formula uses a cost-of-service model. On Date A of each year, Taxpayer estimates its revenue requirement for the following calendar year, the service year, based in part on the facilities in service at that time or expected to be placed in service during that year. This estimate of Taxpayer's revenue requirement and a Commission-approved rate of return are entered into the template for the formula to calculate the rates. The rates for that calendar year are determined under that formula approved by Commission and go into effect on January 1 of the following calendar year with no additional action by Commission.

In calculating its net annual revenue requirement for the formula, Taxpayer calculates average rate base. All elements of average rate base are calculated using the same test period, the service year. Taxpayer reduces its gross rate base by the average accumulated deferred income taxes. When Taxpayer estimates accumulated deferred income taxes for purposes of estimating its revenue requirement for the service year, Taxpayer does not use the proration formula required for future test periods by section 1.167(l)-1(h)(6) of the Income Tax Regulations. Average rate base is computed using monthly averages for plant balances, including accumulated depreciation. For this purpose, depreciation begins when the asset is placed in service. Certain other elements of average rate base, such as land held for future use, materials and supplies, prepayments, and accumulated deferred income taxes are calculated using an average of the beginning and end of year balances. In both cases, the averages are calculated in accordance with the provisions of the Commission-approved template.

The formula rate template contains a "true-up" mechanism under which the Taxpayer compares its actual revenue requirement to its actually-billed revenues for the service year. If billed revenue is greater than the actual revenue requirement for the service year the over-collection is refunded in customer bills within two years of the service year; if billed revenue is less than the actual revenue requirement for the service year the under-collection is collected two years after the service year. For both under and over collections, a carrying charge equivalent to Commission's standard refund interest rate is imposed.

Commission at all times has required that all public utilities under its jurisdiction use normalized methods of accounting.

Taxpayer requests that we rule as follows:

1. The computation of average rate base by Taxpayer with reference to 13-month average for plant and accumulated depreciation for a given service year and a simple average of the beginning- and end-of-year balances for accumulated deferred income taxes for the same service year complies with the consistency requirement of the normalization rules for accelerated depreciation under section 168(i)(9)(B) of the Internal Revenue Code.

2. In the event that the Service does not agree with the Taxpayer's conclusion regarding the first issue, Taxpayer's historical use of the averaging methodology described above is nevertheless not inconsistent with the requirements of § 168(i)(9)(B) and therefore the sanctions for violation of the deferred tax normalization requirements involving disallowance of accelerated depreciation do not apply to Taxpayer as a result of its use of the historical averaging methodology employed.
3. The computation by Taxpayer of accumulated deferred income taxes for purposes of calculating average rate base without application of the rules for future test periods under § 1.167(l)-1(h)(6) involving the proration formula complies with the normalization requirements of § 168(i)(9).
4. In the event that the Service does not agree with the Taxpayer's conclusion regarding Issue 2, sanctions for violation of the deferred tax normalization requirements involving disallowance of accelerated depreciation do not apply as a result of the methodology employed.

Law and Analysis

Issues 1 and 2

Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(1)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, section 168(i)(9)(A) requires that a taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a

depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

In order to satisfy the requirements of §168(i)(9)(B), there must be consistency in the treatment of costs for rate base, regulated depreciation expense, tax expense, and deferred tax revenue purposes. Here, rate base, depreciation expense, and accumulated deferred income taxes are all calculated in consistent fashion – all are averaged over the same period. While there are minor differences in the convention used to average all elements of rate base including depreciation expense on the one hand, and accumulated deferred income taxes on the other, for purposes of §168(i)(9)(B), it is sufficient that both are determined by averaging and both are determined over the same period of time. Thus, the calculation of average rate base and accumulated deferred income taxes as described above complies with the consistency requirement of §168(i)(9)(B).

Because of the conclusion reached above, Taxpayer's second issue is moot and will not be considered further.

Issue 3

Section 1.167(l)-1(h)(6) sets forth additional normalization requirements with respect to public utility property. Under § 1.167(l)-1(h)(6)(i), a taxpayer does not use a normalization method of accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes excluded from the rate base, or treated as cost-free capital, exceeds the amount of the reserve for the period used in determining the taxpayer's ratemaking tax expense. Section 1.167(l)-1(h)(6)(ii) also provides the procedure for determining the amount of the reserve for deferred taxes to be excluded from rate base or to be included as no-cost capital. If, in determining depreciation for ratemaking tax expense, a period (the "test period") is used which is part historical and part future, then the amount of the reserve account for this period is the amount of the reserve at the end

of the historical portion of the period and a pro rata amount of any projected increase to be credited to the account during the future portion of the period. The pro rata amount of any increase during the future portion of the period is determined by multiplying the increase by a fraction, the numerator of which is the number of days remaining in the period at the time the increase is to accrue, and the denominator of which is the total number of days in the future portion of the period.

Section 1.167(l)-1(h)(6)(i) makes it clear that the reserve excluded from rate base must be determined by reference to the same period as is used in determining ratemaking tax expense. A taxpayer may use either historical data or projected data in calculating these two amounts, but it must be consistent. As explained in section 1.167(l)-1(a)(1), the rules provided in section 1.167(l)-1(h)(6)(i) are to insure that the same time period is used to determine the deferred tax reserve amount resulting from the use of an accelerated method of depreciation for cost of service purposes and the reserve amount that may be excluded from the rate base or included in no-cost capital in determining such cost of services.

If a taxpayer chooses to compute its ratemaking tax expense and rate base exclusion amount using projected data then it must use the formula provided in section 1.167(l)-1(h)(6)(ii) to calculate the amount of deferred taxes subject to exclusion from the rate base. This formula prorates the projected accruals to the reserve so as to account for the actual time these amounts are expected to be in the reserve. As explained in § 1.167(l)-1(a)(1), the formula in section 1.167(l)-1(h)(6)(ii) provides a method to determine the period of time during which the taxpayer will be treated as having received amounts credited or charged to the reserve account so that the disallowance of earnings with respect to such amounts through rate base exclusion or treatment as no-cost capital will take into account the factor of time for which such amounts are held by the taxpayer.

The purpose of the proration formula is the same as that of the requirement for consistent periods discussed above: to prevent the immediate flow-through of the benefits of accelerated depreciation to ratepayers. The proration formula stops flow-through by limiting the deferred tax reserve accruals that may be excluded from rate base, and thus the earnings on rate base that may be disallowed, according to the length of time these accruals are actually in the reserve account.

The effectiveness of § 1.167(l)-1(h)(6)(ii) in resolving the timing issue has been limited by its failure to define some key terms. Nowhere does this provision state what is meant by the terms "historical" and "future" in relation to the period for determining depreciation for ratemaking tax expense (the "test period"). How are these time periods to be measured? One interpretation focuses on the type or quality of the data used in the ratemaking process. According to this interpretation, the historical period is that portion of the test period for which actual data is used, while the portion of the period for which data is estimated is the future period. The second interpretation focuses on when

the utility rates become effective. Under this interpretation, the historical period is that portion of the test period before rates go into effect, while the portion of the test period after the effective date of the rate order is the future period.

The first interpretation, which focuses on the quality of the ratemaking data, is an attractive one. It proposes a simple rule, easy to follow and to enforce: any portion of the reserve for deferred taxes based on estimated data must be prorated in determining the amount to be deducted from rate base. The actual passage of time between the date ratemaking data is submitted and the date rates become effective is of no importance. But this interpretation of the regulations achieves simplicity at the expense of precision; in other words, it is overbroad. The proration of all estimated deferred tax data does serve to magnify the benefits of accelerated depreciation to the utility, but this is not the purpose of normalization. Congress was explicit: normalization "in no way diminishes whatever power the [utility regulatory] agency may have to require that the deferred taxes reserve be excluded from the base upon which the utility's permitted rate of return is calculated." H.R. Rep. No. 413, 91st Cong., 1st Sess. 133 (1969).

In contrast, the second interpretation of section 1.167(l)-1(h)(6)(ii) of the regulations is consistent with the purpose of normalization, which is to preserve for regulated utilities the benefits of accelerated depreciation as a source of cost-free capital. The availability of this capital is ensured by prohibiting flow-through. But whether or not flow-through can even be accomplished by means of rate base exclusions depends primarily on whether, at the time rates become effective, the amounts originally projected to accrue to the deferred tax reserve have actually accrued.

If rates go into effect before the end of the test period, and the rate base reduction is not prorated, the utility commission is denying a current return for accelerated depreciation benefits the utility is only projected to have. This procedure is a form of flow-through, for current rates are reduced to reflect the capital cost savings of accelerated depreciation deductions not yet claimed or accrued by the utility. Yet projected data is often necessary in determining rates, since historical data by itself is rarely an accurate indication of future utility operating results. Thus, the regulations provide that as long as the portion of the deferred tax reserve based on truly projected (future estimated) data is prorated according to the formula in section 1.167(l)-1(h)(6)(ii), a regulator may deduct this reserve from rate base in determining a utility's allowable return. In other words, a utility regulator using projected data in computing ratemaking tax expense and rate base exclusion must account for the passage of time if it is to avoid flow-through.

But if rates go into effect after the end of the test period, the opportunity to flow through the benefits of future accelerated depreciation to current ratepayers is gone, and so too is the need to apply the proration formula. In this situation, the only question that is important for the purpose of rate base exclusion is the amount in the deferred tax

reserve, whether actual or estimated. Once the future period, the period over which accruals to the reserve were projected, is no longer future, the question of when the amounts in the reserve accrued is no longer relevant (at the time the new rate order takes effect, the projected increases have accrued, and the amounts to be excluded from rate base are no longer projected but historical, even though based on estimates).

Taxpayer uses formula rates with the elements determined by estimates of the various elements being averaged as discussed above. Rates go into effect as of the beginning of the service year.¹ As such, the rates are in effect during the test year and the proration formula must be used. The addition of the true up increases the ultimate accuracy of the rates but does not convert a future test period into a historical test period as those terms are used in the normalization regulations. Therefore, Taxpayer is required to apply the proration formula in calculating accumulated deferred income taxes for purposes of calculating rate base.

Issue 4

Because the Service has ruled in Issue 3 that Taxpayer's use of formula rates with true-up adjustments with carrying charges mandates use of the proration formula applicable to future test periods for the projected revenue requirement, prospectively adhering to the Service's interpretation of § 1.167(l)-1(h)(6)(ii) may require Taxpayer to seek and obtain an order from Commission to make the necessary changes to the rate templates, not simply unilaterally adjusting the calculations (or the manner in which the templates are completed) in the next annual projections or true-up adjustments. If Taxpayer must request these changes through a filing with Commission, Taxpayer has represented that, in the event of an adverse conclusion with respect to Issue 3 by the Service, it will make a filing with Commission to amend its formula rate template within six months of receipt of this ruling letter, requesting that Commission apply a methodology in accordance with this letter using an effective date of the first month following the date of the filing made with Commission. Following Commission's order in that filing, Taxpayer will prospectively apply the methodology consistent with this letter approved by Commission. Until Commission acts on the filing, Taxpayer will continue to use the methodology described above.

If Taxpayer determines that it is not required to make a formal filing with Commission to implement the computational changes required by the letter ruling, Taxpayer would reflect the holding of the private letter ruling in its next annual projected revenue requirement filing. For example, assuming that the letter ruling is received in April 2015 indicating that the projected revenue requirement is based solely on a future period and the actual revenue requirement used for the true-up mechanism is based solely on a historical period, Taxpayer would compute its year-end accumulated deferred income tax amount for its beginning-of-year/end-of-year average of

¹ We note that, because Taxpayer is using estimated data for the test period, the test period at issue here constitutes a "future test period" under the first interpretation discussed above as well.

accumulated deferred income taxes based on application of the proration formula to the monthly net increases or decreases to its accumulated deferred income taxes for annual projected revenue requirement filings after receipt of the private letter ruling (i.e., beginning with the filing due September 1, 2015, for the calendar-year 2016 test year and service period).

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting. However, in the legislative history to the enactment of the normalization requirements of the Investment Tax Credit, Congress has stated that it hopes that sanctions will not have to be imposed and that disallowance of the tax benefit (there, the ITC) should be imposed only after a regulatory body has required or insisted upon such treatment by a utility. See Senate Report No. 92-437, 92nd Cong., 1st Sess. 40-41 (1971), 1972-2 C.B. 559, 581.

Here, Taxpayer has used a template approved by Commission to calculate formula-based rates. Commission has, at all times, required that utilities under its jurisdiction use normalization methods of accounting. Taxpayer also intended at all times to comply with the normalization rules. However, Taxpayer concluded that the use of the true-up would allow the entirety of the rate calculation to be considered a purely historical period and thus not require the application of the proration formula described in § 1.167(l)-1(h)(6)(ii). As concluded above, this conclusion is not in accord with the normalization rules. However because both Commission and Taxpayer at all times sought to comply, because Taxpayer merely populated a Commission-approved formula template rather than Commission carefully considering the calculation and ordering its use by Taxpayer, and because Taxpayer will take the corrective actions described above, it is not currently appropriate to apply the sanction of denial of accelerated depreciation to Taxpayer.

Conclusions

1. The computation of average rate base by Taxpayer with reference to 13-month average for plant and accumulated depreciation for a given service year and a simple average of the beginning- and end-of-year balances for accumulated deferred income taxes for the same service year complies with the consistency requirement of the normalization rules for accelerated depreciation under section 168(i)(9)(B) of the Internal Revenue Code.
2. Because of the conclusion reached in Issue 1, Issue 2 is moot.
3. The computation by Taxpayer of accumulated deferred income taxes for purposes of calculating average rate base without application of the rules for future test periods under § 1.167(l)-1(h)(6) involving the proration formula for its projected revenue requirement does not comply with the normalization requirements of § 168(i)(9). The computation by Taxpayer of accumulated

deferred income taxes for purposes of calculating average rate base without application of the rules for future test periods under § 1.167(l)-1(h)(6) involving the proration formula for its actual revenue requirement used for the true-up mechanism complies with the normalization requirements of § 168(i)(9).

4. If the Taxpayer takes the corrective actions described above, and assuming compliance by the Commission with this methodology on a prospective basis, sanctions for violation of the deferred tax normalization requirements involving disallowance of accelerated depreciation do not apply as a result of the methodology employed.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described 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,

Peter C. Friedman
Senior Technician Reviewer, Branch 6
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)