**Internal Revenue Service**

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Department of the Treasury
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Date:
October 15, 2015

LEGEND:

Taxpayer =

Parent =

State =
Commission A =
Commission B =
New System =
Case =
Year A =
Year B =
Year C =
Date A =
X =
Director =

Dear :

This letter responds to Parent's request, made on behalf of Taxpayer, dated April 24, 2015, for a ruling on the application of the normalization rules to certain regulatory procedures applied in State as described below.

The representations set out in your letter follow.

Taxpayer, a wholly-owned subsidiary of Parent, is primarily engaged in the business of transmitting and distributing electric power to customers in State. It is

subject to regulation by Commission A and Commission B with respect to terms and conditions of services, including the rates it may charge for its services. Both Commissions establish Taxpayer's rates based on Taxpayer's costs, including a provision for a return on the capital employed by Taxpayer in its regulated business. We are concerned here only with the rates established by Commission A for Taxpayer.

The law of State provides a process under which a utility may establish its rates over multiple years, setting the rates for the first year in a traditional rate case but them adjusting the rates for subsequent years by application of a formula rather than through new rate cases. Taxpayer used this process in Case, a Year A rate case to establish its distribution rates for a five year period beginning in Year B. The values for the various components of rate base were derived from Taxpayer's legacy accounting system. As relevant to this ruling request, Taxpayer's legacy system contained unrecognized errors resulting in a lower amount of deferred tax expense than would have been calculated if the errors had not been present as well as a lower accumulated deferred federal income tax balance (ADFIT). The net effect of these errors was a lower revenue requirement, partially offset by the lower ADFIT balance, and thus some portion of the benefit of accelerated depreciation was flowed through to ratepayers during the five year period.

Taxpayer was unaware of the errors embedded in its legacy accounting system until it installed its New System and ran the actual values for Year C using both the legacy system and the New System and compared the outcome. Discovering the error, Taxpayer believed that it was unable to get the error recognized and corrected by Commission A during the five year period in which the original rates were adjusted by formula each year and so Taxpayer calculated the amount by which the benefits of accelerated depreciation were being flowed through to ratepayers beginning in Year C and created an entry on its regulatory books of this amount. On Date A, Taxpayer filed a notice of intent to file a general rate case with Commission A. In that rate case, Taxpayer sought to amortize the amount it calculated as "unfunded deferred tax" over a period of X years in order to "cure" the normalization violation that had occurred. Commission A felt that the errors in deferred tax calculation should be treated the same as all other items of revenues and costs under the formula that had been applied to the original rates and the amounts considered recovered in the rates. Due to the seriousness of possible sanctions for a normalization violation and the different approaches used by Taxpayer and Commission A, this ruling request was jointly prepared and submitted to the Internal Revenue Service.

Commission A 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. Taxpayer's ratemaking and accounting procedures described above which resulted in the partial flow through of the tax benefits of accelerated depreciation

were not inconsistent with the requirements of section 168(i)(9) of the Internal Revenue Code and § 1.167(l)-1 of the Treasury regulations and hence not violative of the normalization rules so long as Taxpayer implements corrective measures that are adequate under those rules.

2. The proposal by the staff of Commission A not to permit recovery of Taxpayer's proposed regulatory asset but to use the New System to calculate deferred tax expense prospectively would not be violative of the normalization rules because Taxpayer was operating under an alternative rate plan which adjusted rates based on an external formula rather than on a cost of service basis that would allow Taxpayer to request rate changes based on its actual cost of service.
3. If adopted by Commission A, Taxpayer's proposal to amortize the regulatory asset as described above and to use the New System to calculate deferred tax expense prospectively would constitute corrective measures that are adequate under the normalization rules.

Law and Analysis

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.

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 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 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 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 discovered the errors embedded in its legacy accounting system when it adopted a more robust New System and has sought to calculate the amounts that were flowed through to ratepayers. Taxpayer has also made Commission aware of the errors as soon as practicable. Likewise, Commission A has, at all times, required that utilities under its jurisdiction use normalization methods of accounting and has never required Taxpayer to violate the normalization provisions. Thus, if properly corrected, it is not currently appropriate to apply the sanction of denial of accelerated depreciation to Taxpayer.

Regarding the two proposed corrections of the errors, we do not mandate any particular corrective measure. Rather, we interpret the normalization provisions and identify violations and, when asked, evaluate whether certain corrective measures are sufficient. In this case, Commission A proposes that the errors in deferred tax calculation should be treated the same as all other items of revenues and costs under the formula that had been applied to the original rates and the amounts considered recovered in the rates. While the ratemaking process used here was designed to replace frequent rate cases with a formula providing adjustments for costs and

expenses, the reflection of depreciation and the associated tax effects of depreciation are not like other elements of cost and expense that are used to calculate rate base. Rather, the timing of the reflection of depreciation and its associated tax effects are governed by the normalization provisions. The normalization provisions are designed by Congress to ensure that the benefits of accelerated depreciation and the investment tax credit inure to the benefit of the utility as an incentive for investment and are not converted through flow-through to consumer or individual tax benefits. Rather than an element of variable cost and expense that can be generally reflected in a formula that will provide appropriate adjustments over time, the benefits of accelerated depreciation must be more specifically accounted for as directed by Congress. Thus, the formula cannot be assumed to correct the errors embedded in the initial ratemaking due to Taxpayer's legacy accounting system. Taxpayer's proposal, however, to amortize the amounts calculated to have been erroneously flowed-through over a period of years, is adequate to cure the normalization violations inadvertently caused in this case.

Conclusions

1. Taxpayer's ratemaking and accounting procedures described above which resulted in the partial flow through of the tax benefits of accelerated depreciation were not inconsistent with the requirements of section 168(i)(9) of the Internal Revenue Code and § 1.167(l)-1 of the Treasury regulations and hence not violative of the normalization rules so long as Taxpayer implements corrective measures that are adequate under those rules.
2. The proposal by the staff of Commission A to use the New System solely to calculate deferred tax expense prospectively would not adequately correct the inadvertent violation of the normalization rules described above because the alternative rate plan Taxpayer was operating under, which adjusted rates based on an external formula rather than on a cost of service basis that would allow Taxpayer to request rate changes based on its actual cost of service, cannot be assumed to have corrected the errors embedded in Taxpayer's legacy accounting system.
3. If adopted by Commission A, Taxpayer's proposal to amortize the regulatory asset as described above and to use the New System to calculate deferred tax expense prospectively would constitute an adequate corrective measure under the normalization rules.

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)