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LEGEND:

Taxpayer =

Parent =

State A =

Commission A =

Commission B =

Program =

$a =

$b =

c =

$d =

e =

f =

g =

$h =

i =

Dear :

This is in response to your request for rulings, submitted by your authorized representative, concerning the federal income tax consequences of the transaction described below.

Background and Facts

Parent is a publicly traded holding company. Taxpayer is a State A corporation and a wholly-owned subsidiary and a member of Parent's affiliated group. Taxpayer is primarily engaged in the business of generating, transmitting, and distributing electrical energy at retail to its customers in State A as a public utility and, as such, is subject to the regulatory jurisdiction of the Commission A. Taxpayer's retail customer base is located in a service area consisting of eight counties in Northwest State A. Taxpayer is also subject to the regulation of Commission B with regard to its electric utility businesses, including the transmission of electricity, the sale of electricity to municipalities and electric cooperatives, and interchange and other purchases and sales of electricity involving other utilities. Taxpayer has elected to amortize investment tax credits using a normalization method of accounting for public utility property complying with former Code § 46(f)(2).

Taxpayer's retail electric rates are cost-based rates approved by Commission A and are a combination of base rates and several separate cost recovery clauses for specific categories of costs. These separate cost recovery clauses address such items as fuel and purchased energy costs, purchased power capacity costs, energy conservation and demand side management programs, and the costs of compliance with environmental laws and regulations. Costs not addressed through one of the specific cost recovery clauses are recovered through Taxpayer's base rates. Taxpayer also engages in wholesale electric power sales under the jurisdiction of the Commission B.

Taxpayer's voluntary community solar pilot program (Program) is designed to allow Taxpayer customers the choice of participating in and receiving the benefits of a solar photovoltaic electrical generating facility. The Program is strictly voluntary and is designed to appeal to those Taxpayer customers who are either unable or do not desire to install solar generation systems on their residences or businesses. The power plant for the Program will be an f megawatt solar powered electrical generating facility that will be built, owned, and operated by Taxpayer (Facility). Taxpayer's investment in the Facility will not be included in the determination of revenue requirements for base rates in any regulatory rate filings before Commission A.

Any Taxpayer customer - residential, commercial, or industrial - will be eligible to participate in the Program (a Participant) by paying an annual $b subscription fee, or in exchange for a c year commitment, a reduced $d subscription fee (Subscription Fee). In exchange for the Subscription Fee, Participants receive a monthly incentive fee (Incentive Fee) paid by Taxpayer to the Participants, which is intended to compensate Participants for the energy output of the Facility based on Taxpayer's Avoided Fuel Charge (as defined below), as well as the retirement of any Renewable Energy Certificates or Credits (green tags) associated with the Facility. The Incentive Fee will be paid to Participants in the form of a line item credit on the Participant's regular monthly electric bill.

Participation in the Program does not entitle a Participant to any energy generated by the Facility. Rather, Program Participants will continue to be billed for their energy consumption at Taxpayer's Commission A approved retail electric rates. Because the Facility will not be in Taxpayer's regulated rate base, the Subscription Fees will be the only way that Taxpayer will earn any revenue from owning and operating the Facility during the term of the Program.

Taxpayer's general body of customers will pay for the electrical energy generated by the Facility at Taxpayer's solar-weighted average annual avoided fuel cost (the Avoided Fuel Charge). Basically, this is the market price of other fuel, such as natural gas, that the Company will not have to buy when the Facility is producing power during the daylight hours. The Avoided Fuel Charge will be accounted for and recovered in a manner similar to purchased power through the Company's Fuel and Purchased Power Cost Recovery Clause (the Fuel Clause). For the first year of the Program, the Avoided Fuel Charge is expected to be g cents per kilowatt hour based upon the sum of the products of the hourly avoided energy costs and the hourly solar generation, divided by the annual solar generation from the Facility. This formula is designed to determine on an average annual basis, the cost per kilowatt hour of fuel that Taxpayer will not need to purchase to operate its other generating units, but for the operation of the Facility.

Commission A has previously approved cost recovery clauses for fuel and other specific categories of costs (for example, for purchased power). The costs addressed through the Fuel Clause are a mechanism that simply allows Taxpayer to recover its

actual incurred costs. Unlike a utility's base rates (rates used to recover capital costs, depreciation and a rate of return), amounts included in the Fuel Clause simply recover actual fuel expense and purchase power costs that are incurred to provide service to the Taxpayer's customers. Unlike Taxpayer's base rates, the electrical energy sold to Taxpayer's general body of customers from the Facility will be recovered through Taxpayer's Fuel Clause, with no Facility rate-of-return associated with those electrical energy sales.

The monthly Incentive Fee is determined prior to the beginning of each calendar year and stated on an average monthly basis. The initial monthly Incentive Fee will be $h per subscription based upon each subscription's respective hypothetical portion of the energy output of the Facility priced at the Avoided Fuel Charge, which initially will be g cents per kilowatt hour.

As discussed previously, the aggregate annual Subscription Fees are intended to cover the full projected annual revenue requirement of the Facility. The projected annual revenue requirement includes all costs associated with engineering, procurement, construction, ownership, operation, and maintenance of the Facility, including Program marketing costs.

Because depreciation expense causes the net investment in the Facility, and hence the dollar amount of the equity return, to be naturally higher at the beginning of the life of a stand-alone generating facility and to gradually decrease over time, for purposes of determining the number of available subscriptions Taxpayer will "levelize" the projected annual revenue requirement for the Facility on a net present value basis over the i year estimated economic useful life of the Facility so that the required annual number of subscriptions stays the same during the life of the Program.

The levelized annual revenue requirement for the Facility is expected to be approximately $a, which includes a return on and of Taxpayer's investment in the Facility and all anticipated period costs. The levelized number of annual subscriptions needed to fully subscribe the Program will be determined by dividing the projected levelized annual revenue requirement by the established annual Subscription Fee. Based on marketing surveys, Taxpayer chose an annual Subscription Fee in the amount of $b and a c year Subscription Fee in the amount of $d, which balanced the dual objectives of creating a low-cost participation option for those customers interested in supporting the development of solar energy and minimizing the number of subscriptions needed to fully subscribe the Program. At an equal mix of $b level subscriptions and $d level subscriptions, approximately e subscriptions will be needed annually to fully subscribe the Program on a levelized basis, which is less than one half of one percent of Taxpayer's retail customers. Because of this aspect of the Program's design, the economic risk of not selling e subscriptions annually throughout the life of the Program, and therefore not meeting the Facility's revenue requirement, is borne by Taxpayer's shareholders, not its customers. The number of subscriptions needed to fully

subscribe the Program is dependent on Taxpayer's total actual investment in the Facility, which will be determined after a contract to build the Facility is executed. Further, Participants can choose to purchase more than one subscription, so that the number of subscriptions and the number of Participants can differ.

Taxpayer sought and received approval for the Community Solar Program from Commission A. It did so for two reasons. One, Taxpayer planned to limit participation in the Program to its customers and to use its customers' regular monthly electric bills as a cost effective way of collecting the Subscription Fees from and paying Incentive Fees to those customers who choose to participate in the Program. Two, Taxpayer sought approval of the Program from Commission A because it wanted to be certain that the Program did not run afoul of any possible Commission A rules or regulations for the ownership and operation of the Facility. Commission A approved the Program based in part upon the assurance that the costs of owning and operating the Facility would not be passed through to Taxpayer's customers, i.e., the costs would be borne by Participants or the Company's shareholders.

Rulings Requested:

Taxpayer seeks a ruling that the Facility will not be "public utility property" within the meaning of Code section 168(i)(10) and Former Code section 46(f)(5) because:

(1) none of the payments for the electrical energy produced by the Facility at the Avoided Fuel Charge (market rate) constitutes a payment for the furnishing or sale of electrical energy at a price that reflects cost-based, rate-of-return ratemaking, and

(2) the Subscription Fee is not for the furnishing or sale of electrical energy from the Facility.

Law and Analysis:

Section 168(f)(2) of the Internal Revenue Code (Code) 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) of the Code 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.

Prior to the Revenue Reconciliation Act of 1990, the definition of public utility

property was contained in § 167(l)(3)(A) and § 168(i)(10), which defined public utility property by means of a cross reference to § 167(l)(3)(A). The definition of public utility property is unchanged. 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. Section 1.167(l)-1(b) restates the statutory definition providing that property will be considered public utility property if it is used predominantly in a public utility activity and the rates are regulated. Section 1.167(l)-1(b)(1) provides that rates are regulated for such purposes if they are established or approved by a regulatory body. The terms established or approved are further defined to include the filing of a schedule of rates with the regulatory body which has the power to approve such rates even though the body has taken no action on the filed schedule or generally leaves undisturbed rates filed.

The regulations under former § 46, specifically § 1.46-3(g)(2), contain an expanded definition of regulated rates. This expanded definition embodies the notion of rates established or approved on a rate of return basis. In addition, 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. Thus, it is clear that, 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.

Accordingly, the key factors in determining whether property is public utility property are that (1) the property 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.

With respect to the first issue, as previously discussed, all energy generated by the Facility will be included in Taxpayer's electric rates at an initial Avoided Fuel Charge of g cents per kilowatt hour and collected through the Fuel Clause. This price will be paid by all of Taxpayer's customers, including Participants, as part of their regular monthly electric bills based upon their individual consumption. This Avoided Fuel Charge cannot cause the Facility to be treated as public utility property under Code § 168(i)(10) or Former Code § 46(f)(5) because it is market driven by the average price of fuel that Taxpayer will not have to purchase because of the operation of the Facility. Accordingly, the price paid for the electrical energy generated by the Facility is not determined based upon cost-based, rate-of-return rate regulation. The market derived Avoided Fuel Charge of g cents per kilowatt hour, which is also the basis for the amount of the Incentive Fee, cannot cause the Facility to be public utility property within the meaning of Code section 168(i)(10) or Former Code section 46(f)(5).

With respect to the second issue, The Subscription Fee is paid for the right to participate in the Program, which does not include the right to a single megawatt hour of electrical energy from the Facility or any other generating unit owned by Taxpayer. The price paid by a Participant to Taxpayer for electricity as a customer of Taxpayer is not changed in any way by their participation in the Program. Because the Subscription Fee does not involve the sale or furnishing of electrical energy from the Facility, it cannot cause the Facility to be treated as public utility property under Code § 168(i)(10) or Former Code § 46(f)(5) regardless of how the required number of subscriptions under the Program is calculated.

Accordingly, we conclude that:

1. the Facility will not be "public utility property" within the meaning of Code § 168(i)(10) and Former Code § 46(f)(5) because none of the payments for the electrical energy produced by the Facility at the Avoided Fuel Charge (market rate) constitutes a payment for the furnishing or sale of electrical energy at a price that reflects cost-based, rate-of-return ratemaking, and

2. the Facility will not be "public utility property" within the meaning of Code § 168(i)(10) and Former Code § 46(f)(5) because the Subscription Fee is not for the furnishing or sale of electrical energy from the Facility.

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). Specifically, no opinion is expressed concerning whether the contract to sell electricity constitutes a service contract under § 7701(e). In addition, no opinion is expressed concerning

whether the Taxpayer is the owner of the Facility generating electricity for federal income tax purposes. Further, no opinion is expressed or implied on the classification of the property under § 168(e). Except as provided in § 168(e)(3), section 5.03 of Rev. Proc. 87-56, 1987-2 C.B. 674, provides, however, that asset classes in Rev. Proc. 87-56 include property described in such asset classes without regard to whether a taxpayer is a regulated public utility or an unregulated company.

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 Industry Director.

Sincerely,

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