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PLR-125024-16
Date:
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Legend:

Taxpayer =

Commission A =
Commission B =
State =
Parent =

Season =
Date X =
Date Y =
Date Z =
Director =

Dear :

This letter responds to the request, dated August 11, 2016, submitted on behalf of Taxpayer for a ruling on the application of the depreciation normalization rules of § 168(i)(9) of the Internal Revenue Code (“Code”) and § 1.167(l)-1 of the Federal Income Tax Regulations (“Regulations”) (together, the “Normalization Rules”) to certain Commission and State regulatory procedures which are described below.

The representations set out in your letter follow.

Taxpayer is an investor-owned regulated utility incorporated under the laws of State engaged principally in the transmission and distribution of electric energy and gas

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service in State. Taxpayer is subject to regulation as to rates and conditions of service by Commission A and Commission B (the Commissions). Both Commissions establish Taxpayer's rates based on its costs, including a provision for a return on the capital employed by Taxpayer in its regulated businesses.

Taxpayer is wholly owned by Parent. Taxpayer is included in a consolidated federal income tax return of which Parent is the common parent. The return is under the audit jurisdiction of the Large Business and International Division of the Internal Revenue Service. Taxpayer is an accrual basis taxpayer and reports on a calendar year basis.

For purposes of Taxpayer's transmission ratemaking, the rate-setting mechanism employed by Taxpayer is a formula rate ("Transmission Formula Rate") which has been approved by Commission A. Rates are set on a calendar year basis. The Transmission Formula Rate is established in two parts: a rate calculated for the next succeeding calendar year ("Transmission Projected Rate") and a true-up calculation for the prior calendar year ("Transmission True-Up"). The Transmission Projected Rate is calculated based on the costs Taxpayer projects it will incur during the coming calendar year (the period for which rates are being set). All elements of ratemaking (including cost of service, rate base, and cost of capital) are projected for this purpose. In the calculation of rate base, a 13-month average is applied to all elements of rate base except for accumulated deferred federal income tax ("ADFIT").

After the actual results for the Transmission Projected Rate year have been recorded, the Transmission True-Up computation then calculates over- or under-recoveries (when compared to the Projected Rate) that occurred during the prior calendar year. Calculated over- or under-recoveries (plus interest) are reflected in rates charged for the year succeeding the year in which the Transmission True-Up is calculated.

Taxpayer has claimed (and continues to claim) accelerated depreciation on all of its public utility property to the full extent those deductions are available under the Code. For Commission A purposes, Taxpayer normalizes the federal income taxes deferred as a result of its claiming these deductions in accordance with the normalization rules. As a consequence, Taxpayer has a substantial balance of ADFIT that is attributable to accelerated depreciation reflected on its Commission A regulated books of account. In its Transmission Formula Rate template, Taxpayer included its ADFIT balance (as appropriately allocated to the jurisdiction) as a reduction in its computation of rate base. In calculating both its Transmission Projected Rate and its Transmission True-Up, Taxpayer derived the ADFIT balance by which it reduced rate base using a simple average of the beginning and ending balances for the relevant rate year, as required by Commission A. Taxpayer did not use the proration methodology that is required for future test periods by § 1.167(l)-1(h)(6) of the Regulations ("Proration Requirement").

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In addition to the transmission ratemaking described above, Taxpayer is permitted by Commission B to use riders to recover its costs for specific types of investments whereby those investments (and associated costs) are taken into account outside of a base rate case, the revenue requirement they demand is added as a surcharge to the base rates charged to customers and the elements of ratemaking are “tracked” and revenues “trued-up.” Taxpayer currently has several of these riders. With regard to ratemaking, the mechanics of the Riders are similar to those employed in Taxpayer’s transmission ratemaking. The rate for each Rider (“Rider Rate”) consists of two components: a projected rate calculation (“Rider Projected Rate”) and a true-up calculation (“Rider True-Up”). On or before Date X of each year, Taxpayer files with Commission B to reset its Rider Rate for each of the Riders. These rates are requested to become effective on Date Y of the same year and remain in effect for the subsequent twelve months and therefore through Date Z of the subsequent year. All Riders employ a future test period. To compute the Rider Projected Rate, Taxpayer calculates a revenue requirement for each month of the future test period. All elements of rate base (gross plant, accumulated depreciation and ADFIT) are forecast for each month of the period for which the rates will be in effect. Taxpayer computes a return for each month based on the average rate base during that month (taking into account changes in ADFIT balances). To this it adds the forecasted depreciation, operation and maintenance expenses and other costs for the month to derive the Rider Projected Rate.

To compute the Rider True-Up, Taxpayer calculates a revenue requirement based on the results from the previous period (a portion of which are actual and a portion of which are re-forecasted) that has not been trued-up. This revenue requirement is then compared to the revenues actually collected during the period. Any imbalance (along with interest) is charged or credited to customers as the Rider True-Up for the forthcoming effective rate period.

For purposes of its Rider ratemaking, Taxpayer normalizes the federal income taxes deferred as a result of its claiming accelerated depreciation in accordance with the Normalization Rules, as required by Commission B. As a consequence, Taxpayer has a substantial balance of ADFIT that is attributable to accelerated depreciation reflected on its State regulated books of account. In its Rider Rate filings, Taxpayer includes its ADFIT balance as a reduction in its computation of rate base. Similar to Taxpayer’s Transmission Projected Rate and its Transmission True-Up, in calculating both its Rider Projected Rate and its Rider True-Up, Taxpayer derives the ADFIT balance by which it reduces rate base using a simple average of the beginning and ending balances for the relevant rate month. Taxpayer has not applied the proration methodology required for future test periods as described by § 1.167(l)-1(h)(6) of the Regulations.

After the Service published rulings that addressed circumstances in which utility taxpayers employed ratemaking very similar to Taxpayer’s Transmission Formula Rate

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and somewhat similar to Taxpayer's State Riders, Taxpayer's tax department personnel reviewed § 167(l)-1(h)(6) of the Code and Taxpayer's treatment of its ADFIT in its Transmission Formula Rate filings and its State Riders and concluded that its Transmission Projected Rate and its Rider Projected Rate were subject to the Proration Requirement. That is, they concluded that Taxpayer must employ the computation methodology described in § 1.167(l)-1(h)(6) of the Regulations when calculating the ADFIT balance it used as an offset to rate base in those rate filings. They became concerned that Taxpayer had not properly observed the Proration Requirement in earlier Commission A and Rider filings.

Taxpayer represents that Taxpayer will be initiating the measures necessary to conform to the Normalization Rules for its Transmission Projected Rate. Once the Service clarifies the measures that are necessary to conform its Transmission True-Up, Rider Projected Rates, and Rider True-Ups to the Normalization Rules, Taxpayer will initiate those measures at the earliest available opportunity.

Taxpayer requests that we rule as follows:

1. Taxpayer's Transmission Projected Rate and Rider Projected Rates employ a future test period and, therefore, are subject to the Proration Requirement.
2. If Taxpayer employs a future test period in its Transmission Projected Rate and its Rider Projected Rates and the Proration Requirement applies, in computing Taxpayer's Transmission Projected Rate and its Rider Projected Rates, the Consistency Rule does not require that any averaging convention applied to other elements of rate base also apply to Taxpayer's prorated ADFIT balance.
3. Taxpayer's Transmission True-Up and Rider True-Ups employ an historical test period and, therefore, are not subject to the Proration Requirement.
4. If Requested Ruling #3 is affirmative, in computing its Transmission True-Up and Rider True-Ups, the Proration Requirement does not apply only to the differences between Taxpayer's originally projected changes in its ADFIT balances and its experienced changes in those balances. The Proration Requirement continues to apply to the originally projected changes.
5. If Requested Ruling #4 is affirmative, where, in a Transmission True-Up or Rider True-Up calculation, a difference between Taxpayer's originally projected changes in its ADFIT balances and its experienced changes in those balances is attributable to Taxpayer's over-projection in its Transmission Projected Rate or Rider Projected Rate of an increase or decrease in its ADFIT balance, it would be consistent with the Normalization Rules for Taxpayer to reverse the prorated ADFIT used in its Transmission Projected Rate or Rider Projected Rate calculation to the extent of the over-projection.
6. If Requested Ruling #4 is affirmative, where, in a Transmission True-Up or Rider True-Up calculation, a difference between Taxpayer's originally projected changes in its ADFIT balances and its experienced changes in those balances is attributable to Taxpayer's over-projection in its Transmission Projected Rate or

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its Rider Projected Rate of an increase or decrease in its ADFIT balance, it would be consistent with the Normalization Rules for Taxpayer to reflect the non-prorated change in the ADFIT balances.

7. In order to comply with the Consistency Rule, it is not necessary that Taxpayer use the same averaging convention it uses in computing the other elements of rate base (a 13-Month Average) in computing its ADFIT balance for purposes of its Transmission Formula Rate.
8. If Requested Ruling #1 is affirmative, and/or Requested Ruling #2 and/or Requested Ruling #7 is negative, if Taxpayer reduced rate base by an amount in excess of the limitation provided for in §1.167(l)-1(h)(6) of the Regulations due to its failure to conform to the Proration Requirement and/or it failed to comply with the Consistency Rule as described above, any such failure by Taxpayer in any year prior to taking the necessary corrective action was not a violation of the Normalization Rules.

Law and Analysis

For purposes of the Law and Analysis portion of this ruling letter, references to “Projected Rates” shall include both Taxpayer’s Transmission Projected Rate and its Rider Projected Rates. Similarly, references to “True-Ups” shall include both Taxpayer’s Transmission True-Up and its Rider True-Ups.

Issues 1 and 3

Section 1.167(l)-1(h)(6) of the Regulations sets forth 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.

Section 1.167(l)-1(h)(6)(ii) of the Regulations provides that for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under § 1.167(l)-1(h)(6)(i), if solely an historical period is used to determine depreciation for federal income tax expense for ratemaking purposes, then the amount of the reserve account for the period is the amount of the reserve (determined under § 1.167(l)-1(h)(2)) at the end of the historical period. Section 1.167(l)-1(h)(6)(ii) provides that if solely a future period is used for such determination, the amount of the reserve account for the period is the amount of the reserve at the beginning of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during such period.

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Section 1.167(l)-1(h)(6)(ii) of the Regulations provides 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) of the Regulations 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 § 1.167(l)-1(a)(1), the rules provided in § 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 § 1.167(l)-1(h)(6)(ii) of the Regulations 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 § 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) of the Regulations 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 test period for determining depreciation for ratemaking tax expense. How are these time periods to be measured? One interpretation focuses on the type or quality of the

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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 § 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 § 1.167(l)-1(h)(6)(ii) of the Regulations, 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,

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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 calculates its Transmission Projected Rate to be effective for the succeeding calendar year. The rate is based on costs Taxpayer projects it will incur during that year. Rates go into effect as of the beginning of the service year. Therefore, rates go into effect before the end of the test period. Similarly, Taxpayer calculates its Rider Rates during Season to be effective during the twelve month period Date Y of the current year through Date Z of the succeeding year. This is calculated based on the costs Taxpayer projects it will incur during that period. The addition of the true-up increases the ultimate accuracy of the rates but does not convert a future test period into an historical test period as those terms are used in the normalization regulations. Accordingly, the test periods for Taxpayer's Transmission Projected Rate and Rider Projected Rate are future test periods, subject to the Proration Requirement, and Taxpayer is required to apply the proration formula in calculating ADFIT for purposes of calculating rate base in these ratemakings.

In contrast, the Taxpayer's True-Ups represent amounts that are incorporated into rates charged to customers after the end of the test period on which those amounts are based. In the case of the Transmission True-Up, the true-up component is determined by reference to a purely historical period. In the case of the Rider True-Ups, the charge is calculated based on results (part historical and part re-forecasted) for a span of time before the effective date of rates including the true-up. Thus, in each case, the test period is one that occurs prior to the effective date of the rates which result from the computation. Accordingly, the Transmission True-Up and Rider True-Up employ an historical test period, and there is no need to use the proration formula to calculate the differences between Taxpayer's projected ADFIT balance and the actual ADFIT balance during the period. The True-Ups are not subject to the Proration Requirement.

Issues 2 and 7

Former § 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 § 167(l)(3)(G) in a manner consistent with that found in section § 168(i)(9)(A). Section 1.167(l)-1(a)(1) of the 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 § 167 and the use of straight-line depreciation for computing tax expense and

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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 § 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.

In order to use a normalization method of accounting, § 168(i)(9)(A) of the Code 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 § 168(i)(9)(A)(ii), if the amount allowable as a deduction under § 168 differs from the amount that would be allowable as a deduction under § 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under § 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 § 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 § 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 § 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 (hereinafter referred to as the "Consistency Rule").

Taxpayer has two requests relating to its compliance with the Consistency Rule. First, Taxpayer requests in requested ruling two that in determining the limitation on the amount by which the ADFIT balance may reduce rate base, the Normalization Rules do not require that the averaging convention applied by Taxpayer to all other elements of rate base (plant, accumulated depreciation, cash working capital, etc.) be applied to its prorated ADFIT balance. That is, Taxpayer requests confirmation that the Normalization Rules do not require Taxpayer to apply both conventions serially to changes in ADFIT balances. Second, Taxpayer requests in requested ruling seven that in order to comply with the Consistency Rule, it is not necessary that Taxpayer use the identical averaging convention it uses in computing the other elements of rate base (a 13-Month Average) in computing its ADFIT balance for purposes of its Transmission Formula Rate.

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Taxpayer's requested ruling two is based on the premise that, where the purpose of the regulatory averaging and proration can be shown to be the same, the Consistency Rule should not apply. Taxpayer represents that the purpose of the Proration Requirement is to take into account for ratemaking purposes the economic fact that changes in ADFIT balances in a future test period (and, of course, the attendant cash flows) will occur over a period of time. According to Taxpayer, the critical question is whether the averaging convention has a different purpose. How is it determined if the averaging conventions have a different purpose? According to Taxpayer, the answer appears to lie in the nature of the test period. If the test period is part historical, part future, the timing of the rate base expenditures cannot be what regulatory averaging was meant to address. However, Taxpayer maintains that the purposes of regulatory averaging and proration can be the same when the entire test year is a future test period. Taxpayer proposes that averaging conventions, when applied to entirely future test periods, should presumptively be treated as having the same purpose as the Proration Requirement, thereby negating the necessity to apply both conventions serially to changes in ADFIT balances.

Taxpayer's requested ruling seven acknowledges that § 168(i)(9)(B) of the Code requires consistency between the regulatory conventions used to determine the amount included in the rate base for public utility property, the associated ADFIT attributable to accelerated depreciation, depreciation expense and tax expense included in cost of service. Taxpayer acknowledges that Taxpayer used an averaging convention for ADFIT that in some regard differed from the averaging convention it used for the other elements of rate base, however, Taxpayer used an averaging convention for both purposes and the time period covered by both averaging conventions was identical.

In regard to Taxpayer's requested ruling two, we agree with Taxpayer that averaging conventions, when applied to entirely future test periods, should presumptively be treated as having the same purpose as the Proration Requirement, thereby negating the necessity to apply both conventions serially to changes in ADFIT balances. In regard to Taxpayer's requested ruling seven, while there are minor differences in the convention used to average all elements of rate base including depreciation expense on the one hand, and ADFIT 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 ADFIT as described above complies with the consistency requirement of § 168(i)(9)(B).

Because of the two conclusions reached above, the portion of Taxpayer's requested ruling eight which is based on a negative conclusion in Taxpayer's rulings two and seven is moot and will not be considered further,

Issues 4, 5, and 6

Because the Service ruled affirmatively with respect to Requested Ruling #3, Taxpayer requests guidance regarding the way it must calculate its True-Ups in order to remain compliant with the Normalization Rules. Taxpayer's True-Ups are derived from a comparison of two amounts. Each is computed by replicating the Projected Rate revenue requirement computation using, in the case of Taxpayer's Transmission True-Up, actual, rather than forecasted, amounts and, in the case of its Rider True-Up, part actual and part re-forecasted amounts. This produces the total revenues with respect to the prior Projected Rate test period which Taxpayer is ultimately allowed to recover (ignoring interest). This permissible revenue requirement is then compared to the revenue actually collected while the Projected Rate was in effect. The difference is the True-Up revenue requirement that is incorporated into rates for the next following rate-effective period. The manner in which the True-Up revenue requirement is derived creates ambiguity.

The mechanics of the True-Up calculations leave open two possible interpretations as to the application of the Normalization Rules. The first interpretation is that it is only the differences between the changes in the ADFIT balances projected for purposes of the Projected Rate calculation and the actual changes in those balances (determined after the fact) that are free of the Proration Requirement. The second interpretation is that the freedom from the Proration Requirement applies not just to the variations between projected ADFIT changes and actual ADFIT changes but to the calculation of the total revenues that Taxpayer is ultimately allowed to recover for the period. The consequence of this second interpretation is that, because the replicated revenue requirement does not incorporate any proration whatsoever, and because it is that revenue requirement to which the Projected Rate revenue requirement is trued-up, the resulting True-Up calculation will entirely reverse the impact of proration that was embedded in the Projected Rate. Thus, this second interpretation effectively neutralizes any Proration Requirement impact that is embedded in the Projected Rate calculation.

The fact that the Projected Rate and the True-Up are treated as two distinct rate-setting processes having distinct test periods, one future and one historical, strongly suggests that proration should matter. And to make proration matter, the freedom from proration can only apply to the variations in the changes in the ADFIT balance used in the True-Up computation, not to the entire change in the ADFIT balances used in that computation. The True-Up component is determined by reference to a purely historical period and, accordingly, there is no need to use the proration formula to calculate the differences between Taxpayer's projected ADFIT balance and the actual ADFIT balance during the period. In calculating the True-Up, proration applies to the original projection amount but the actual amount added to the ADFIT over the test year is not modified by application of the proration formula.

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Because Requested Ruling #4 is affirmative, Taxpayer requests guidance on the computation. Specifically, Taxpayer requests guidance in a situation when the actual ADFIT activity is less than the projected amount (that is, there was an over-projection of the ADFIT balance changes used in the Projected Rate calculation). A strict application of the “non-proration” approach may produce curious results because the projected change in the ADFIT balance is prorated while the over-projection is not. According to Taxpayer, non-proration of the variation between the projected ADFIT and the actual ADFIT may produce an ADFIT balance used in the true-up that would be less than either the beginning or ending ADFIT balance. Taxpayer requests (Ruling Request #5) that we rule that, even though the proration methodology is not required to be applied to the variations between projected and actual ADFIT balances, application of that methodology is permissible in certain cases, such as where an over-projection of ADFIT occurred and the prorating of the variation produces a more economically precise result. Taxpayer also requests (Ruling Request #6) that we rule that not applying the proration methodology to the variation between the projected and actual ADFIT balances is also permissible.

We have concluded that the Normalization Rules do not require the application of the proration methodology in the context of an historical test period such as a true-up and thus, we affirm that not applying the proration methodology to the variation between the projected and actual ADFIT balances is permissible under the Normalization Rules. However, as explained in § 1.167(l)-1(a)(1), the formula in § 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; it does not exclude the use of the proration formula from being used in all other instances other than where required. Thus, where the regulatory body concludes that proration of variations between projected and actual ADFIT is necessary to accurately reflect the changes captured by the true-up ratemaking and that such use does not result in impermissible flow-through of accelerated depreciation-related benefits, such use of proration is permissible under the Normalization Rules.

Issue 8

Because the Service has ruled in Issue 1 that Taxpayer was required to follow the Proration Requirement applicable to future test periods for the projected revenue requirement for Taxpayer’s Transmission Projected Rate and Rider Projected Rates, prospectively adhering to the Service’s interpretation of § 1.167(l)-1(h)(6)(ii) requires adjustments to conform to this ruling.

Taxpayer requests that any such failure by Taxpayer in any year prior to taking the necessary corrective action was not a violation of the Normalization Rules.

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Taxpayer has represented that Taxpayer will be initiating the measures necessary to conform to the Normalization Rules for its Transmission Projected Rate. Taxpayer stated that once the Service clarifies the measures that are necessary to conform its Transmission True-Up, Rider Projected Rates, and Rider True-Ups to the Normalization Rules, Taxpayer will initiate those measures at the earliest available opportunity.

Section 168(f)(2) of the 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. 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.

Both Commission A and Commission B have, at all times, required that utilities under their respective jurisdictions use normalization methods of accounting. Taxpayer also intended at all times to comply with the normalization rules. As concluded above, Taxpayer was required to use the proration methodology in these ratemaking proceedings for its Projected Rates. However, because the Commissions as well as Taxpayer at all times sought to comply, and because Taxpayer will take corrective actions, it is not currently appropriate to apply the sanction of denial of accelerated depreciation to Taxpayer.

Here, Taxpayer's failure to comply with the Normalization Rules in its prior Transmission Formula Rate and Rider Rate proceedings was that it may have offset its rate base by an amount of ADFIT in excess of that permitted. It was not a reduction which Taxpayer, any participant in any of the proceedings, or the regulator in any of the proceedings recognized. No potential proration-related normalization issue was ever identified. Thus, there was clearly no required or insistent treatment that was inconsistent with the Normalization Rules. There was no determination made with respect to Taxpayer's calculation of its ADFIT balance by either Commission.

Any rates that have been calculated using procedures inconsistent with this ruling ("nonconforming rates") which are or which have been in effect and which, under applicable state or federal regulatory law, can be adjusted or corrected to conform to the requirements of this ruling, must be so adjusted or corrected. Where nonconforming rates cannot be adjusted or corrected to conform to the requirements of this ruling due to the operation of state or federal regulatory law, then such correction must be made in the next regulatory filing or proceeding in which Taxpayer's rates are considered.

We rule as follows:

1. Taxpayer's Transmission Projected Rate and Rider Projected Rates employ a future test period and, therefore, are subject to the Proration Requirement.
2. If Taxpayer employs a future test period in its Transmission Projected Rate and its Rider Projected Rates and the Proration Requirement applies, in computing Taxpayer's Transmission Projected Rate and its Rider Projected Rates, the Consistency Rule does not require that any averaging convention applied to other elements of rate base also apply to Taxpayer's prorated ADFIT balance.
3. Taxpayer's Transmission True-Up and Rider True-Ups employ an historical test period and, therefore, are not subject to the Proration Requirement.
4. In computing its Transmission True-Up and Rider True-Ups, the Proration Requirement does not apply only to the differences between Taxpayer's originally projected changes in its ADFIT balances and its experienced changes in those balances. The Proration Requirement continues to apply to the originally projected changes.
5. Where, in a Transmission True-Up or Rider True-Up calculation, a difference between Taxpayer's originally projected changes in its ADFIT balances and its experienced changes in those balances is attributable to Taxpayer's over-projection in its Transmission Projected Rate or Rider Projected Rate of an increase or decrease in its ADFIT balance, it would be consistent with the Normalization Rules for Taxpayer to reverse the prorated ADFIT used in its Transmission Projected Rate or Rider Projected Rate calculation to the extent of the over-projection.
6. Where, in a Transmission True-Up or Rider True-Up calculation, a difference between Taxpayer's originally projected changes in its ADFIT balances and its experienced changes in those balances is attributable to Taxpayer's over-projection in its Transmission Projected Rate or its Rider Projected Rate of an increase or decrease in its ADFIT balance, it would be consistent with the Normalization Rules for Taxpayer to reflect the non-prorated change in the ADFIT balances.
7. In order to comply with the Consistency Rule, it is not necessary that Taxpayer use the same averaging convention it uses in computing the other elements of rate base (a 13-Month Average) in computing its ADFIT balance for purposes of its Transmission Formula Rate.
8. Because Requested Ruling #1 is affirmative, if Taxpayer reduced rate base by an amount in excess of the limitation provided for in §1.167(l)-1(h)(6) of the Regulations due to its failure to conform to the Proration Requirement, any such failure by Taxpayer in any year prior to taking the necessary corrective action was not a violation of the Normalization Rules.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

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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,

Patrick S. Kirwan
Chief, Branch 6
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

cc: