

Internal Revenue Service

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Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B06
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Re:

Date:
December 30, 2021

LEGEND:

Taxpayer	=
Parent	=
State	=
Region	=
Commission A	=
Commission B	=
Operator	=
Commission B Form	=

Dear :

This letter responds to your letter, dated June 28, 2021, requesting a ruling on the application of the depreciation normalization requirements with respect to the computation of accumulated deferred income taxes in its calculation of rate base.

FACTS

Taxpayer files a consolidated federal income tax return on a calendar year basis with its affiliates, including its parent company, Parent. Taxpayer uses the accrual method of accounting. Parent is a State business trust and voluntary association. Taxpayer is a regulated electric utility that provides both distribution and transmission services. Taxpayer’s utility services are, in general, subject to regulation by Commission A and Commission B, as detailed below.

Taxpayer’s distribution business consists primarily of the purchase, delivery, and sale of electricity to residential, commercial, and industrial customers within its franchise service territory in both the eastern and western regions of State. Taxpayer’s distribution business is subject to regulation by Commission A.

Taxpayer's wholesale electric transmission business is the focus of this ruling. Taxpayer owns and maintains transmission facilities that are part of an interstate power transmission grid over which electricity is transmitted throughout Region. Taxpayer, its affiliates, and most other utilities in Region are parties to a series of agreements that provide for coordinated planning and operation of Region's transmission facilities and the rules by which they acquire transmission services. Under this agreement, Operator serves as the independent systems operator and regional transmission organization of Region.

Taxpayer's wholesale transmission revenues are recovered through Commission B-approved formula rates. Transmission revenues are collected from Region customers, including distribution customers of Taxpayer and its affiliated utilities.

Annual transmission revenue requirements rates are based on a cost-of-service model allowing for recovery of transmission costs, including a return on equity applied to transmission rate base. Accumulated Deferred Federal Income Taxes (ADFIT) reduce rate base in the formula rate templates for regional and local transmission rates. The transmission formula rates provide for an annual reconciliation and recovery or refund (true-up adjustment) of the rates set based on a projected revenue requirement computed prior to the beginning of the service year. The true-up adjustment reflects differences primarily between projected and actual operating costs, rate base and interest expense as well as differences between projected and actual customer loads. The true-up adjustment is recovered from, or refunded to, transmission customers in the next annual rate cycle. Interest is charged with respect to under-recovered amounts and interest is payable with respect to over-recovered amounts. Both are computed in accordance with Commission B-prescribed rules.

The revenue requirements for transmission services pursuant to Operator tariff are effective for a one-year service period that begins on January 1 and ends on December 31. Each year on or before July 31, Taxpayer and the other Region transmission owners collectively submit to Commission B an informational filing that details the updated annual transmission revenue requirement and the resulting derivation of the rate for transmission service that will be in effect from January 1 through December 31 of the subsequent year.

The two components of the revenue requirement for transmission services for a given calendar-year service period are:

1. A projection of the revenue requirement based on the following:
 - a. Actual (recorded) balances for transmission assets and costs reported in the most recently-filed Commission B Form (the calendar-year period ending prior to the year preceding the beginning of the service period), plus

- b. A projection of the additions to be placed in service in the two calendar years after the period described above (the year immediately after the filing of Commission B Form and the year corresponding to the service period).
2. A true-up component, representing the difference between rates charged based on the projected revenue requirement for the prior service period (including the forecasted costs for facilities expected to be placed in service through the end of the service period) and the actual revenue requirement (calculated based on actual transmission costs and actual plant additions for such service period), including interest.

The computation of the component of a projected revenue requirement described in 1.b, above also reflects projected depreciation-related ADFIT amounts corresponding to plant additions in the two calendar years after the filing of Commission B Form. The following amounts are used to compute the depreciation-related ADFIT for projected plant additions:

- Forecasted depreciation-related ADFIT activity in service in the year immediately after the year for which the most recent Commission B Form was filed with respect to projected plant additions during such year, plus
- Forecasted depreciation-related ADFIT activity for the service year with respect to plant additions during such year and the immediately preceding year as computed in accordance with application of the proration formula of Treas. Reg. § 1.167(l)-1(h)(6) to the entire 365 or 366 day service period.

In the computation of the true-up component, the actual allowed return is based on the actual (recorded) net plant balances and depreciation-related ADFIT balances during such period. Gross plant balances and accumulated book depreciation reflected in actual rate base are computed based on five-quarter averaging. Depreciation-related ADFIT balances reflected in actual rate base will be based on averaging using the methodology of the proration formula of Treas. Reg. § 1.167(l)-1(h)(6). Operating expenses, including depreciation expense, will be amounts reported in Commission B Form for such period. The allowed return will be computed with reference to the actual capital structure and weighted average cost of capital for the period as determined based on amount reported in the Commission B Form for such period. Income tax expense is calculated based on a tax gross-up of the computed allowed equity return.

RULINGS REQUESTED

1. The normalization requirements apply separately to the two computations comprising the projected revenue requirement:
 - a. The portion of the calculation based on a filed Commission B Form; and

- b. The portion of the calculation based on projected additions of public utility property
2. The portion of the computation of the projected revenue requirement based on a filed Commission B Form is subject to the rules under § 1.167(l)-1(h)(6)(ii) applicable where solely a historical period is used to determine depreciation for federal income tax expense for ratemaking purposes and the proration formula does not apply.
 3. The consistency requirement of IRC Section 168(i)(9)(B) applies separately to each component of the projected revenue requirement. As such, the portion of the projected revenue requirement calculation based on a Commission B Form using point-in-time balances of net depreciable plant and ADFIT (as of the same date for all rate base items in this portion of the calculation) complies with IRC Section 168(i)(9)(B) deferred-tax consistency requirement without regard to the methodology employed for the portion of the projected revenue requirement calculation based on projected additions of public utility property after such date.
 4. For the portion of the projected revenue requirement based on application of a carrying charge to forecasted gross additions of public utility property averaged using a five-quarter methodology over a test period that begins on the first day that rates are effective and reduced by associated prorated ADFIT, Taxpayer would comply with the consistency requirement under IRC Section 168(i)(9)(B) and the rules of Treas. Reg. Sec. 1.167(l)-1(h)(6) in computing such portion of its projected revenue requirement employing a future test period with an average rate base by (a) applying the proration formula rules under Treas. Reg. Sec. 1.167(l)-1(h)(6) to the projected monthly increases or decreases in ADFIT without (b) further applying an averaging convention, notwithstanding averaging of other elements of rate base including net depreciable plant, to either the prorated end-of-period ADFIT balance or the prorated increases or decreases in ADFIT used to compute the prorated end-of-period ADFIT balance.
 5. The portion of the computation of the projected revenue requirement based on a calculation with respect to projected additions of public utility property is subject to the rules under Treas. Reg. Sec. 1.167(l)-1(h)(6)(ii) applicable if solely a future test period is used to determine depreciation for federal income tax expense for ratemaking purposes and the proration formula must be applied.
 6. For purposes of computing ADFIT in the actual revenue requirement and resulting true-up adjustment, the proration formula of Treas. Reg. Sec. 1.167(l)-1(h)(6) must be applied to ADFIT increases or decreases to which the proration formula was applied in the projected revenue requirement. Taxpayer would be inconsistent with the normalization rules in computing its actual revenue requirement used to determine its true-up adjustment if the portions of its actual ADFIT increases or decreases that were subject to the proration formula of Treas. Reg. Sec. 1.167(l)-1(h)(6) in the computation of the projected revenue requirement were not again prorated in determining the actual revenue requirement.
 7. Application of the proration formula of Treas. Reg. Sec. 1.167(l)-1(h)(6) to all actual ADFIT increases or decreases (including to amounts related to vintages of

public utility property for which the proration formula was not applied in the first component of the projected revenue requirement as well as to differences between actual and projected ADFIT activity for vintages of public utility property for which the proration formula was applied in the second component of the projected revenue requirement) to determine the actual revenue requirement and the resulting true-up adjustment would not violate the normalization rules of Treas. Reg. Sec. 1.167(l)-(h)(6) and would comply with the IRC Section 168(i)(9)(B) consistency requirement notwithstanding the computation of average rate base using a five-quarter average for plant and accumulate depreciation balances.

LAW AND ANALYSIS

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.

Section 168(i)(10) 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 that definition is essentially unchanged in § 168(i)(10) and the regulations promulgated under former section 167(l) remain valid for application of the normalization rules.

Section 1.167(l)-1(a)(1) 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 depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account.

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) 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").

Section 1.167(l)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements of former § 167(l) with respect to public utility property defined in former § 167(l)(3)(A) 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 depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

Section 1.167(l)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under § 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under § 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(l)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under § 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount

for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under § 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under § 167(a).

Section 1.167(l)-1(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under § 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(l)-1(h)(6)(ii) 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 test 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.

Section 1.167(l)-1(h)(6)(ii) of the Regulations provides if, in determining depreciation for ratemaking tax expense, the test period used 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.

Ruling 1 and Ruling 3

Taxpayer has asked whether each of the two computations comprising the projected revenue requirement must be evaluated independently for compliance with the normalization rules or whether they are evaluated in the aggregate. The computations are: (a) the portion of the revenue requirement calculation based on a filed Commission B Form and (b) the portion of the revenue requirement calculation based on projected additions of public utility property. In this case the separate calculations of revenue requirement use a different time period and a different set of assets. Thus, the normalization rules must be applied separately to (a) the portion of the

revenue requirement calculation based on a filed Commission B Form and (b) the portion of the revenue requirement calculation based on projected additions of public utility property.

Furthermore, because the normalization rules apply separately to the two components of the revenue requirement, the consistency requirement of IRC Section 168(i)9(B) is also applied independently to the two components of the revenue requirement listed above.

Ruling 2, Ruling 5, and Ruling 6

The purpose of the proration formula is to prevent the immediate flow-through of the benefits of accelerated depreciation to ratepayers. It applies when a test period is partially or fully a "future" test period, as explained below. 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 questioned 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"). 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 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).

As discussed earlier, the normalization rules apply separately to (a) the portion of the revenue requirement calculation based on a filed Commission B Form and (b) the portion of the revenue requirement calculation based on projected additions of public utility property.

For the portion of the projected revenue requirement based on the filed Commission B Form, the period used is purely a historical period as the assets filed on the Commission B Form were placed into service the two years preceding the date the rates go into effect. Therefore, the proration formula rules under Treas. Reg. Sec. 1.167(l)-1(h)(6) are not applicable to this portion of the projected revenue requirement.

For the portion of the projected revenue requirement based on projected additions of public utility property, the period is purely a future test period. These assets are a projection of public utility property additions that will occur after the rates would go

into effect, thus necessitating the application of the proration formula in order to prevent the flow through of benefits of future accelerated depreciation to current ratepayers. Therefore, the proration formula rules under Treas. Reg. Sec. 1.167(l)-1(h)(6) are applicable to this portion of the projected revenue requirement.

Also, we agree with Taxpayer's assessment that it would be inconsistent with the normalization rules to compute the ADFIT in its actual revenue requirement and resulting true-up adjustment if the proration formula of § 1.167(l)-1(h)(6) is not applied to those increases or decreases that had been subject to the proration formula when those increases or decreases were used in the computation of the projected revenue requirement in the prior computation. The effect of not applying the proration formula in the actual revenue requirement to these amounts would be to remove the effect of the proration formula rather than the required maintaining of these effects.

Ruling 4

For this ruling, Taxpayer requests confirmation that in determining the limitation on the amount by which ADFIT balance may reduce rate base the § 168(i)(9)(B) consistency requirement does not require that the averaging conventions applied by Taxpayer to all other elements of rate base (plant, accumulated depreciation, cash, working capital, etc.) be applied to its prorated ADFIT balances. That is, the applicable normalization rules and Treasury regulations do not require Taxpayer to apply both conventions (averaging and proration) serially to changes in ADFIT balances.

We agree with Taxpayer that the applicable normalization rules and Treasury regulations do not require Taxpayer to apply both conventions serially to changes in ADFIT balances. 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 will occur over a period of time. When applied to entirely future test periods, the averaging convention 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.

Ruling 7

For this ruling, Taxpayer requests confirmation that the proration formula may be applied to all actual ADFIT increases or decreases (including to amounts related to vintages of public utility property for which the proration formula was not applied in the first component of the projected revenue requirement as well as to differences between actual and projected ADFIT activity for vintages of public utility property for which the proration formula was applied in the second component of the projected revenue requirement) to determine the actual revenue requirement and the true-up adjustment consistent with the normalization rules. We agree with Taxpayer that the proration formula may be used as an averaging methodology in situations such as those described here. Further, such application does not violate the "consistency rule"

described in § 168(i)(9)(B), notwithstanding the use of a different averaging convention (here a five-quarter average) to determine gross plant balances and accumulated book depreciation reflected in actual rate base.

Except as expressly provided herein, we express or imply no opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. A copy of this letter must be attached to any income tax return to which it is relevant.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This letter is being issued electronically in accordance with Rev. Proc. 2020-29, 2020-21 I.R.B. 859. A paper copy will not be mailed to Taxpayer.

Sincerely,

Patrick S. Kirwan
Branch Chief, Branch 6
(Passthroughs & Special Industries)

cc: