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1992

PLR/TAM 9224056 - 9224001

PLR 9224040 -- IRC Sec(s). 167, 3/16/1992

Private Letter Rulings

Private Letter Ruling 9224040, 3/16/1992, IRC Sec(s). 167

UIL No. 0167.22-01; 0168.24-01

Headnote:

Reference(s): **Code Sec. 167;**

IRS RULES ON EFFECT OF NORMALIZATION REQUIREMENTS ON DETERMINING UTILITY'S DEFERRED TAX RESERVE.

A public utility is regulated by a public utility commission. In a pending request for rate increases filed with the commission, the utility based its revenue requirements on a test year and used an average rate base for that test year, consisting of an average of the estimated rate bases at specified times. The estimated rate bases were developed using the utility's actual financial data through a certain period and estimated data for a future period.

The utility and the commission's staff disagreed over the application of regulation section 1.167(l)-1(h)(6) in determining the maximum amount of the deferred tax reserve that may be deducted from the average rate base for the test year. The disagreement concerned two areas. The first was the period to which the proration formula under regulation section 1.167(l)-1(h)(6)(ii) is applied. The second area of disagreement is the methodology to use to determine the maximum amount of the deferred tax reserve to be deducted from the rate base, when an average rate base is used for the test year and when some or all of the test year is a future period for purposes of regulation section 1.167(l)-1(h)(6)(ii).

The Service has ruled that when a test year is based entirely on estimated data and the effective date of the rate order occurs within the test year, the portion of the test year occurring after the effective date of the rate order represents the future portion of the period for purposes of regulation section 1.167(l)-1(h)(6)(ii). Thus, the proration formula provided in the regulation applies only to the estimated changes in the deferred tax reserve accruing after the effective date of the rate order.

The Service also ruled that when an average rate base is used and when the test period is part historical and part future for purposes of regulation section 1.167(l)-1(h)(6)(ii), failure to reduce the average rate base by the average of (1) the estimated deferred taxes at the beginning of the test period and (2) the estimated deferred taxes at the end of the test period as prorated under section 1.167(l)-1(h)(6)(ii) will violate the consistency rules of section 168(i)(9)(B).

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Full Text:

Date: March 16, 1992

CC:P&SI:06 -- TR-31-2515-91

In re: Private Letter Ruling Request Regarding Normalization

Dear

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This letter responds to your representative's letter of December 23, 1991, requesting rulings under the

normalization requirements of section 1.167(l)-1(h)(6) of the Income Tax Regulations and section 168(i)(9)(B) of the Internal Revenue Code.

Taxpayer represents that the facts are as follows:

Taxpayer is a public utility engaged in the production, purchase, distribution, and sale of electricity and natural gas in State X. Taxpayer is a wholly owned subsidiary of Parent, which files a consolidated federal income tax return on a calendar year basis.

Taxpayer is regulated by the Commission. In its pending request for rate increases in Docket Y, Taxpayer based its revenue requirements on a

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test year and used an average rate base for that test year, consisting of an average of the estimated rate bases at

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These estimated rate bases were developed using Taxpayer's actual financial data through

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and estimated data for the period

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through

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The Commission is expected to authorize a rate increase effective in

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In Docket Y, Taxpayer and the Commission's staff disagree over the application of section 1.167(l)-1(h)(6) of the regulations in determining the maximum amount of the deferred tax reserve that may be deducted from the average rate base for the test year. The disagreement concerns two areas.

The first area of disagreement is the period to which the the proration formula under section 1.167(l)-1(h)(6)(ii) of the regulations is applied. Because Taxpayer believes that its test year is solely a future period for purposes of this regulation, Taxpayer applied the proration formula to the estimated changes in the deferred tax reserve from

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through

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. The Commission's staff disagrees, contending that the portion of the test year that occurs after a rate order's effective date is the future period and thus, the proration formula should be applied only to the estimated changes in the deferred tax reserve accruing during that period.

The second area of disagreement is the methodology to use to determine the maximum amount of the deferred tax reserve to be deducted from the rate base, where an average rate base is used for the test year and where some or all of the test year is a future period for the purposes of section 1.167(l)-1(h)(6)(ii) of the regulations. Taxpayer, after applying the proration formula to the estimated changes in the deferred tax reserve from

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then deducted from the average rate base for the test year, the average of the prorated estimated deferred taxes at

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. The Commission's staff, however, believes that the average of the estimated (not prorated) deferred tax balances at

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may be deducted from the average rate base for the test year if that average is less than the prorated estimated deferred taxes at

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Taxpayer is concerned that an incorrect determination of the maximum amount of the deferred tax reserve that may be deducted from the rate base in Docket Y may violate the normalization

requirements of section 168(i)(9) of the Code. Accordingly, Taxpayer seeks the following rulings:

1. Where a test year is based entirely on estimated data and the effective date of the rate order occurs

within the test year, whether the normalization rules of section 1.167(l)-1(h)(6) of the regulations require the proration formula provided in this regulation to be applied only to the estimated changes in the deferred tax reserve accruing after the effective date of the rate order?

2. Where an average rate base is used and where the test period is part historical and part future

under section 1.167(l)- 1(h)(6)(ii) of the regulations, whether the consistency rules of section 168(i)(9)(B) of the Code require the average rate base to be reduced by the average of (i) the estimated deferred taxes at the beginning of the test period and (ii) the prorated estimated deferred taxes at the end of the test 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.

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code requires the 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 no 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.

According to section 168(i)(9)(B)(i) of the Code, one way in which the requirements of section 168(i)(9)(A) are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment

that is inconsistent with these requirements. Under section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense,

depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii) unless such estimate or projection is also used, for ratemaking purposes, with respect to all 3 items and with respect to the rate base.

Section 1.167(l)-1(h)(6) of the regulations provides another way in which the normalization requirements for public utility property are not satisfied.

Under section 1.167(l)-1(h)(6)(i) of the regulations, a taxpayer does not use a normalization method of accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes that is excluded from the rate base, or that is treated as cost-free capital, exceeds the amount of the reserve for deferred taxes for the period used in determining the taxpayer's tax expense for ratemaking purposes.

Section 1.167(l)-1(h)(6)(ii) of the regulations describes the procedure for determining the maximum amount of the reserve for deferred taxes to be excluded from the rate base or to be included as cost-free capital. If, a period ("test period") is used that 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 or decrease to be charged to the account during the future portion of the period. The pro rata amount of any increase or decrease during the future portion of the period shall be determined by multiplying the increase or decrease by a fraction, the numerator of which is the number of days remaining in the period at the time the increase or decrease is to be accrued, and the denominator of which is the total number of days in the future portion of the period.

Any public utility that uses accelerated depreciation in determining its federal income tax liability must use "normalization" accounting in calculating the rates to be charged its customers and in maintaining its regulated books of account. The purpose of the normalization requirement is to preserve for public utilities the benefit of accelerated depreciation as a source of cost-free capital. This benefit is preserved by prohibiting its "flowthrough" to current utility ratepayers (in its most common form, flowthrough is the process by which a reduction in current tax liability resulting from accelerated depreciation is reflected in utility rates as a current reduction in regulatory tax expense).

Although the normalization rules prohibit flowthrough, ratepayers are permitted to benefit from a utility's use of accelerated depreciation in calculating its federal income tax liability. The normalization rules do not limit whatever authority a regulatory agency might have to passthrough to ratepayers the benefit of accelerated depreciation, but only require that any such passthrough take place over the period for which the taxes are deferred (any acceleration of this process is a form of flowthrough). S. Rep. No. 552, 91st Cong., 1st Sess. 173 (1969). A utility commission may establish rates to be charged a utility's

customers that reflect the capital cost savings represented by accelerated depreciation either by excluding the deferred tax reserve from the base upon which a utility's rate-of-return is calculated or by treating the reserve as cost-free capital in determining a fair rate- of-return.

Section 1.167(l)-1(h)(6) of the regulations provides guidance as to the amount of the deferred tax reserve that may be excluded from the rate base or treated as cost-free capital, without resulting in flowthrough.

If a public utility computes its ratemaking tax expense and rate base exclusion amount using projected data, in whole or in part, then the utility must use the formula provided in section 1.167(l)- 1(h)(6)(ii) of the regulations to calculate the amount of the deferred tax reserve excludable 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. Consequently, the proration formula stops flowthrough by limiting the accruals to the deferred tax reserve that may be excluded from the rate base according to the length of time these accruals are actually in the reserve account. Thus, the earnings on rate base that may be disallowed are limited so as to prevent flowthrough.

Taxpayer's first ruling request relates to the meaning of the terms "historical" or "future" in section 1.167(l)-1(h)(6)(ii) of the regulations. The meaning of these terms does not depend upon the type or quality of the data used in the ratemaking process -- whether the data used is actual or estimated -- but on when the utility's rates become effective. Thus, the historical period is that portion of the test period before the effective date of the rate order, while the future period is that portion of the test period after the effective date of the rate order.

These date-based definitions of the terms "historical" and "future" are consistent with the purpose of normalization, which is to preserve for public utilities the benefit of accelerated depreciation as a source of cost-free capital. This cost-free capital is made available by prohibiting flowthrough. However, whether or not flowthrough can be accomplished by means of a rate base exclusion depends primarily upon whether, at the time rates become effective, the amounts originally projected to accrue to the deferred tax reserve have actually accrued.

If the rates become effective before the end of the test period, then in regard to the portion of the test period that is prior to the rate order's effective date, at least some of the projected increases or decreases in the deferred tax reserve have actually accrued even though based on estimated data. As a result, these increases or decreases are no longer projected but are historical. Thus, the opportunity to flowthrough the benefit of future accelerated depreciation to current ratepayers does not exist for the

portion of the test period that is prior to the effective date of a rate order and consequently, the

application of the proration formula under section 1.167(l)-1(h)(6)(ii) of the regulations to the estimated deferred tax accruals for this period is not required.

Taxpayer's second ruling request concerns the determination of the maximum amount of the deferred

tax reserve that may be deducted from the rate base under section 1.167(l)-1(h)(6) of the regulations.

In this regard, Taxpayer and the Commission's staff disagree over the application of the consistency requirements of section 168(i)(9)(B) of the Code in determining the maximum amount of the deferred tax reserve that may be excluded from an average rate base. The consistency rules of section 168(i)(9)(B) require that ratemaking estimates or projections of tax expense, depreciation expense, and the reserve for deferred taxes must be consistent with each other and with the estimate or projection of the rate base. As a result, if an average rate base for the test year is used in developing rates, all rate base components, including the deferred tax reserve, must be averaged. Thus, in determining the amount of the deferred tax reserve that may be deducted from an average rate base, the failure to exclude the average of Taxpayer's reserve at the beginning and end of the test year will violate the consistency requirements of section 168(i)(9)(B).

Besides the question of whether the consistency rules of section 168(i)(9)(B) of the Code require the averaging of the deferred tax reserve accounts, there is the question of whether section 1.167(l)-1(h)(6) of the regulations requires proration of the deferred tax reserve where a portion of the test year is a future period as determined under this ruling.

Under section 1.167(l)-1(h)(6)(i) of the regulations, the maximum amount of the deferred tax reserve that may be excluded from the rate base is the amount of the deferred tax reserve for the test year used in determining the tax expense for ratemaking purposes. If a portion of the test year is a

section 1.167(l)-1(h)(6)(ii) provides that the estimated changes in the deferred tax reserve for this period must be prorated.

The Commission's staff argues that in determining the amount of the deferred tax reserve that may be

excluded from rate base, proration is not necessary under section 1.167(l)-1(h)(6) of the regulations when an average rate base is used for a future test year because the deferred tax expense is matched with the change in the accumulated deferred income taxes associated with the accelerated depreciation of public utility property. This position, however, ignores the purpose of the proration

formula. As explained in section 1.167(l)-1(h)(1)(a)(1), "[t]he formula 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."

If averaging of the deferred reserve account at the end of the historical portion of the test year and at the end of the future portion of the test period substitutes for proration, the regulatory agency is only focusing on the average amount of the reserve during the test period instead of accounting for the actual time that the accruals to the deferred tax reserve are expected to be in the reserve during the test period. Consequently, too much of the changes in the deferred tax reserve may be excluded from rate base and thus, the utility is denied a current return for an accelerated depreciation benefit it is only projected to have. This procedure is a form of flowthrough because current rates are reduced to reflect the capital cost savings of accelerated depreciation deductions not yet claimed or accrued by the utility. Thus, the simple average of the deferred tax reserve account at the beginning and end of the test

period will violate the normalization requirements of section 1.167(l)-1(h)(6) of the regulations.

While the purpose of both the consistency requirements of section 168(i)(9)(B) of the Code and the

timing requirements of section 1.167(l)-1(h)(6) of the regulations is to prevent the flowthrough of the benefit of accelerated depreciation to ratepayers, these requirements are two separate normalization requirements that must be satisfied. If an average rate base is used, the failure to average the deferred

tax reserve at the beginning and end of the test year will violate the consistency requirements of

section 168(i)(9)(B). If a portion of the test year is a future period for purposes of section 1.167(l)-1(h)(6), the failure to use the prorated deferred tax reserve will violate the timing requirements

of section 1.167(l)-1(h)(6). Thus, here, the average of Taxpayer's (i) estimated deferred tax reserve at

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and (ii) prorated estimated deferred tax reserve at

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must be used in determining the maximum amount of the deferred tax reserve that may be excluded

from the rate base under section 1.167(l)-1(h)(6).

Based on Taxpayer's representations and the analysis as set forth above, we conclude as follows:

1. Where a test year is based entirely on estimated data and the effective date of the rate order occurs within the test year, the portion of the test year occurring after the effective date of the rate order

section 1.167(l)-1(h)(6)(ii) of the regulations. Thus, the proration formula provided in this regulation applies only to the estimated changes in the deferred tax reserve accruing after the effective date of the rate order.

2. Where an average rate base is used and where the test period is part historical and part future for purposes of section 1.167(l)-1(h)(6)(ii) of the regulations, failure to reduce the average rate base by the average of (i) the estimated deferred taxes at the beginning of the test period and (ii) the estimated deferred taxes at the end of the test period as prorated under section 1.167(l)-1(h)(6)(ii), will violate the consistency rules of section 168(i)(9)(B) of the Code.

Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the power of attorney, a copy of this letter is being sent to your authorized representatives.

Sincerely yours,

Charles B. Ramsey

Chief, Branch 6

Office of Assistant Chief

Counsel

(Passthroughs and Special

Industries)

Enclosures (2):

Copy of this letter

section 6110 purposes

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