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PLR/TAM 9313029 - 9313001

[PLR 9313008 -- IRC Sec\(s\). 167, 12/17/1992](#)

Private Letter Rulings

Private Letter Ruling 9313008, 12/17/1992, IRC Sec(s). 167

UIL No. 0167.22-01; 0168.24-01

Headnote:

Reference(s): [Code Sec. 167](#);

IRS CLARIFIES NORMALIZATION REQUIREMENTS FOR PUBLIC UTILITY.

A regulated public utility requested a rate increase based on a 12-month test period ending September 30, 1993. In connection with the request, the company must calculate its average rate base, its average deferred income tax reserve balance to be excluded from the average rate base, and its cost of service.

The Service has ruled that when an average rate base is used to compute rates and when a test period is part historical and part future, the average rate base may be reduced by an amount no greater than the average of the projected deferred income tax balance at the beginning of the test period and the prorated projected deferred income tax reserve balance at the end of the test period. Reducing the average rate base by the average of the beginning and ending projected nonprorated deferred income tax reserve balances would be a normalization violation, the Service said.

The Service also ruled that if the cost of service is reduced by prorating the deferred income tax expense, a normalization violation would result. Determining the cost of service based on a nonprorated deferred income tax expense is not a consistency violation even if the estimated accruals to the deferred income tax reserve balance must be prorated to determine the rate base.

If a test period is partly historical and part future, the Service ruled, then accruals to the projected

deferred income tax reserve balance may be based only on the proration formula set forth in regulation



section 1.167(l)-1(h)(6).

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Full Text:

Date: December 17, 1992

CC:P&SI:6 # TR-31-1255-92

Dear

This is in response to your request of July 6, 1992, for rulings under the normalization requirements of




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

The Company is a regulated public utility engaged in the production, transportation, purchase, storage, distribution, and sale of natural gas within the boundaries of City 1 in the northern portion of State. It is a wholly owned subsidiary of Parent. Parent files a consolidated federal income tax return with the internal Revenue Service Center in City 2. The consolidated federal income tax return is based on a September 30 fiscal year-end. Parent and its subsidiaries are subject to the examination jurisdiction of the District Director of Internal Revenue in City 1.

The Company is subject to the ratemaking jurisdiction of the Commission. The Company's request for a rate increase is pending before the Commission. The Company's rate request is based on a 12- month test period ending September 30, 1993. In connection with this request, the Company calculated, inter alia, the amounts of three items; its average rate base, its average deferred income tax reserve balance to be excluded from the average rate base, and its cost of service.


The Company's average rate base was determined using its fully projected rate bases at September 30, 1992 and September 30, 1993, and its average deferred income tax reserve balance was determined based on its fully projected deferred income tax reserve balances at September 30, 1992, and September 30, 1993. These projected amounts were developed by using historical financial data for the fiscal year ending September 30, 1991 and estimated data for its 1992 and 1993 fiscal years.

In determining its projected deferred income tax reserve balance at September 30, 1993, the Company


applied the proration formula of  section 1.167(l)-1(h)(6)(ii) of the regulations. In keeping with that section, the formula was applied only to those estimated accruals to the reserve balance that occur after October 14, 1992, the projected effective date of the rate increase request, through the end of the fiscal year, September 30, 1993 (the "future period"), and not to the estimated accruals to the reserve balance that occur during the period before the rates go into effect (the "historical period").

The cost of service was based on the projected activity for the 12-month test period. The cost of service was estimated using historical data through September 30, 1991, and estimated data thereafter. The calculation of the estimated cost of service included, inter alia, depreciation expense and current and deferred income tax expense for the 12-month period.


It is the Commission's Staff (hereinafter "Staff") opinion that the application of the proration formula to the estimated accruals to the deferred income tax reserve balance is not required if the reduction to rate base (i.e., the deferred income tax reserve balance) is computed based on the average of the beginning and ending deferred income tax reserve balances. The Company objects, maintaining that proration of the estimated accruals to the deferred income tax reserve attributable to the future portion


of the test period is required by  section 1.167(l)-1(h)(6) of the regulations despite the use of an averaging convention. To ensure that the Company is properly applying the proration formula, the Staff requested the Company to ask for a ruling from the Internal Revenue Service stating that when rates are based on a test period that is part historical and part future and an average rate base is used to compute rates, the average rate base must be reduced by the average of (1) the projected deferred income tax reserve balance at the beginning of the test period and (2) the prorated projected deferred income tax reserve balance at the end of the test period.

The Staff subsequently proposed an adjustment reducing the Company's deferred income tax expense by requiring the Company to prorate its deferred income tax expense for the test period. The Staff

argues that the consistency requirements of  section 168(i)(9)(B) of the Code mandate the proration of the deferred income tax expense if the accruals to the deferred-income tax reserve balance are prorated.

The Company argues that a reduction to deferred income tax expense results in a direct flow-through to the ratepayers of the tax benefits of accelerated depreciation, a direct violation of the normalization


rules of  section 168(i)(9)(A) of the Code. Further, the Company posits that the proration

requirements of section 1.167(l)-1(h)(6) of the regulations and the consistency requirements of  section 168(i)(9)(B) are two separate and distinct requirements, and that the consistency requirements were intended to apply to the factors used in calculating cost of service and not to the proration requirements used to determine the appropriate rate base deductions.

Finally, for purposes of prorating the accruals to the deferred income tax reserve balance, the Staff is proposing the use of a formula other than that set forth in section 1.167(l)-(1)(h)(6) of the regulations. The Staff argues that its formula is more precise than the formula set forth in the regulations and therefore its formula should be used for purposes of calculating the prorated accruals to the reserve balance.

In determining the prorated accruals to its deferred income tax reserve balance, the Company followed the formula mandated by the regulations. It is the Company's position that the only accepted formula for prorating these accruals is the formula set forth in the regulations, and that the use of any other formula is outside the scope of the regulations and is a normalization violation if it results in a greater reduction to rate base than the formula in the regulations.


The Company is concerned that an incorrect determination of the maximum amount of the deferred income tax reserve balance or an incorrect determination of the deferred income tax expense may

violate the normalization requirements of  section 168(i)(9)(A) and (B) of the Code. Accordingly, the Company seeks the following rulings:


1. Where an average rate base is used to compute rates and where a test period is part historical and part future, should the average rate base be reduced by the average of the projected deferred income tax reserve balance at the beginning of the test period and the prorated projected deferred income tax reserve balance at the end of the test period (such prorated amount being computed from the


projected effective date of new rates to the end of the test period)? Where an average rate base is used and where a test period is part historical and part future, may the average rate base be reduced by the average of the beginning and projected NONPRORATED ending deferred income tax reserve balances?


2. Where the accruals to the deferred income tax reserve balance to be excluded from rate base are


computed based on the proration formula in  section 1.167(l)-1(h)(6) of the regulations, should the deferred income tax expense used to determine cost of service also be prorated?


3. Where the accruals to the deferred income tax reserve balance are computed based on a proration


formula, may a formula other than the one set forth in  section 1.167(l)-1(h)(6) of the regulations be used to compute the prorated amount of accruals to the reserve balance if the proposed formula results in a greater reduction to rate base than the formula in the regulations?

Pursuant to  section 168(f)(2) of the Code, an allowance for depreciation shall not be available for


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 provides that the taxpayer must, in computing its tax expense for ratemaking purposes and for reflecting operating results in its regulated books of account, use a method of depreciation with respect to the 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 the requirements of  section 168(i)(9)(A) will not be met is if, for ratemaking purposes, the taxpayer uses a procedure or adjustment


that is inconsistent with these requirements. Under  section 168(i)(9)(B)(ii), such inconsistent procedures or 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 three of these items and with respect to the rate base.

In general, according to  section 1.167(l)-1(h)(1)(iii) of the regulations, the amount of federal income tax liability deferred as a result of the use of a different method of depreciation is the excess (computed without regard to credits) of the amount the tax liability would have been had a subsection (1) method been used over the amount of the actual tax liability. This deferred income tax expense must be included in a public utility's cost of service; otherwise, a normalization violation will occur.

 Section 1.167(l)-1(h)(6) of the regulations sets forth additional normalization requirements with

respect to public utility property. Under  section 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


 Section 1.167(l)-1(h)(6)(ii) also provides the procedure for determining the amount of the reserve for deferred taxes to be excluded from rate base or to be included as no-cost capital. If, in determining depreciation for ratemaking tax expense, a period (the "test period") is used which is part historical and part future, then the amount of the reserve account for this period is the amount of the reserve at the end of the historical portion of the period and a pro rata amount of any projected increase to be credited to the account during the future portion of the period. The pro rata amount of any increase during the future portion of the period is determined by multiplying the increase by a fraction, the numerator of which is the number of days remaining in the period at the time the increase is to accrue, and the denominator of which is the total number of days in the future portion of the period.



Any public utility taking advantage of 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 (the measure of this benefit is the difference between a company's federal income tax liability calculated using accelerated depreciation and the tax liability it would have were it to use a nonaccelerated method of depreciation). This benefit is preserved by prohibiting its "flow through" 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 pass through to ratepayers the benefit of accelerated depreciation, but only require that such pass-through 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 reserve for deferred taxes from the base upon which a utility's rate-of-return is calculated or by treating the deferred taxes as cost-free capital in determining a fair rate-of-return.


Section 1.167(l)-1(h)(6) was added to the regulations in response to a ratemaking practice by which tax expense for purposes of computing cost of service was determined using historical or actual data, whereas the amount of the reserve for deferred taxes to be excluded from rate base was calculated on the basis of a projection of the amount in the reserve at the end of some future period. This practice presented two problems. First, assuming a financially healthy utility, the amount excluded from rate base was greater than the reserve for deferred taxes at the end of the historical period. Failure to allow an investment return on the excess of this excluded amount over the amount of the reserve for the historical period resulted in flowthrough of the benefits of the projected reserve accrual. Second, even though any projected increase in the reserve for deferred taxes would accrue over time, the entire


amount expected to be in the reserve at the end of the future period was excluded from rate base. Excluding the full projected amount, even if ratemaking tax expense was computed using the same projections, resulted in denying a return on a greater amount than the utility was projected to have on hand at any particular time over this future period. section 1.167(l)-1(h)(6)(i) deals with the first problem, that of consistency, while section 1.167(l)-1(h)(6)(ii) addresses the second problem, that of timing.


 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  section 1.167(l)-1(a)(1), the rules provided in  section 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, in whole or in part, then it MUST USE the formula provided in  section 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  section


1.167(l)-1(a)(1), the formula in  section 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. 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.

If rates go into effect before the end of the test period and none of the rate base reduction is prorated, then with regard to the portion of the period after the effective date, the utility is denied a current return by taking into account an accelerated depreciation benefit that it is only projected to have. This procedure is a form of flowthrough, for current rates are reduced to reflect the capital cost savings of accelerated depreciation deductions not yet claimed or accrued by the utility. Yet, the use of projected data is an accepted methodology 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 estimated accruals to the deferred tax reserve attributable to the future portion of the test period are


prorated according to the formula in  section 1.167(l)-1(h)(6)(ii) of the regulations, this reserve may be deducted from rate base in determining a utility's allowable return on capital. In other words, if estimated data is used in computing ratemaking tax expense and rate base exclusion, then the passage of time must be accounted for if flowthrough is to be avoided.


The first ruling the Company has requested deals with how the proration formula of  section 1.167(l)-1(h)(6) of the regulations should be applied when a public utility uses an average rate base and where the test period is part historical and part future. The issue is whether, if the beginning and ending reserve balance are averaged to derive the figure to be excluded from rate base in order to set rates,

the ending reserve balance must be prorated under  section 1.167(l)-1(h)(6). It is the Staff's opinion that averaging the beginning and ending reserve balance has the same effect as prorating the accruals to the reserve balance, and that averaging the beginning and the nonprorated ending reserve balance is an acceptable substitute for the proration requirements of section 1.167(l)-1(h)(6). We do not agree with this argument.


If an average test year rate base is used in developing rates,  section 168(i)(9)(A) of the Code

requires that all rate base components, including the deferred income tax reserve, must be averaged. If

a portion of the test year is a future period,  section 1.167(l)-1(h)(6) of the regulations requires that projected accruals to the deferred tax reserve must be prorated. If averaging of the entire reserve

substitutes for this proration, the timing requirement of  section 1.167(l)-1(h)(6) will be violated (too much will be excluded from rate base, thus denying the utility a return for "capital" it is only projected to have). Accordingly, if an average rate base is used to set rates, the average rate base may be reduced by an amount not in excess of the average of the beginning deferred income tax reserve balance and the prorated projected ending reserve balance.

The second ruling request deals with the Staff's proposed reduction to the Company's deferred income

tax expense. The Staff argues that this adjustment is required to meet the consistency requirements of  section 168(i)(9)(B) of the Code. It is the Staff's position that if the accruals to the deferred income tax reserve balance must be prorated, then the deferred income tax expense must also be prorated. We do not agree with this position.

Proration of the projected accruals to the deferred tax reserve is an adjustment; its purpose is not to properly account for the deferred income tax expense but to account for the passage of time in determining the amount of the reserve that may be excluded from rate base. Though the proration formula is applied to reserve accruals, this proration is not an adjustment to the reserve. Application of the proration formula does not affect the actual amount of accumulated deferred income taxes nor does it affect the actual deferred income tax expense.

The Staff's proposed adjustment reduces the deferred income tax expense to an amount equal to the prorated increase in the deferred income tax reserve balance, resulting in the deferred income tax expense being understated for purposes of computing cost of service. This understatement is a normalization violation because the Company will never recover from its ratepayers the full amount of deferred federal income tax expense related to accelerated depreciation.

When a test period is used, the determination of the amount of the deferred income tax reserve balance to be excluded from rate base must be based on the proration formula as described above. This determination is separate from the determination of the deferred income tax expense to be included in cost of service. Therefore, the use of a nonprorated deferred income tax expense to determine cost of service is not a consistency violation. The use of a prorated deferred income tax

expense is, however, a normalization violation.


Finally, for purposes of computing the accruals to the deferred income tax reserve balance, the Staff has suggested using a formula other than the one set forth in the regulations. The language of the regulations indicates that the use of the enumerated formula is mandatory. In addition, any formula that causes a reduction to rate base that is greater than the reduction to rate base resulting from the application of the formula in the regulation results in a normalization violation. The Staff's proposed formula reduces rate base by an amount greater than the amount computed using the formula in the regulations. Accordingly, use of the Staff's formula would cause a normalization violation.

Accordingly, based solely on the information provided by the Company above, and viewed in light of the applicable law and regulations, we rule as follows:


1. Where an average rate base is used to compute rates and where a test period is part historical and part future, the average rate base may be reduced by an amount no greater than the average of the projected deferred income tax balance at the beginning of the test period and the prorated projected deferred income tax reserve balance at the end of the test period. Where an average rate base is used, and where a test period is part historical and part future, reducing the average rate base by the average of the beginning and ending projected nonprorated deferred income tax reserve balances would be a normalization violation.

2. If the cost of service is reduced by prorating the deferred income tax expense, a normalization violation would result. Determining the cost of service based on a nonprorated deferred income tax expense is not a consistency violation even if the estimated accruals to the deferred income tax reserve balance must be prorated in order to determine rate base.

3. If a test period is part historical and part future, then accruals to the projected deferred income tax

reserve balance may be based only on the proration formula set forth in  section 1.167(l)-1(h)(6) of the regulations.

In accordance with the power of attorney on file at this office, we are sending a copy of this letter to your authorized representative.

This ruling is directed only to the taxpayer who requested it.  Section 6110(j)(3) of the Code provides that a private letter ruling may not be used or cited as precedent.

Sincerely yours,

Charles B. Ramsey

Chief, Branch 6

Office of the Assistant Chief


Counsel

(Passthroughs and Special

Industries)

Enclosures: 2

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