Section 1.46-6(b)(3)(ii)(A) of the regulations provides that in determining whether, or to what extent, the investment credit has been used to reduce rate base, reference shall be made to any accounting treatment that affects rate base. In addition, reference shall be made to any accounting treatment that reduces the permitted return on investment by treating the credit less favorably than the capital that would have been provided if the credit were unavailable.

Section 1.46-6(b)(4)(i) of the regulations provides that cost of service or rate base is also considered to have been reduced by reason of all or a portion of a credit if such reduction is made in an indirect manner. Under section 1.46-6(b)(4)(ii), one type of such indirect reduction is any ratemaking decision in which the credit is treated as operating income subject to ratemaking regulation or is treated less favorably than the capital that would have been provided if the credit were unavailable. For example, if the credit is accounted for as nonoperating income on a company's regulated books of account but a ratemaking decision has the effect of treating the credit as operating income in determining rate of return to common shareholders, then cost of service has been indirectly reduced by reason of the credit.

According to section 1.46-6(b)(4)(iii) of the regulations, a second type of indirect reduction is any ratemaking decision intended to achieve an effect similar to a direct reduction to cost of service or rate base. In determining whether a ratemaking decision is intended to achieve this effect, consideration is given to all the relevant facts and circumstances of each case, including, but not limited to, the record of the proceeding, the regulatory body's orders or opinions (including any dissenting views), and the anticipated effect of the ratemaking decision on the company's revenues in comparison to a direct reduction to cost of service or rate base by reason of the investment tax credits available to the regulated company.

For purposes of determining whether or not the taxpayer's cost of service for ratemaking purposes is reduced by more than a ratable portion of the investment credit, section 46(f)(6) of the Code provides that the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account shall be used. Section 1.46-6(g) of the regulations provides that the investment tax credit amortization period must be no shorter than the one used to calculate ratemaking depreciation expense.

Furthermore, under section 1.46-6(g)(2) of the regulations, what is "ratable" is determined by considering the period of time actually used in computing the taxpayer's regulated depreciation expense for the property for which a credit is allowed. The term "regulated depreciation expense" means the depreciation expense for the property used by a regulatory body for purposes of establishing the taxpayer's cost of service for ratemaking purposes. In addition, if there is a revision for purposes of computing regulated depreciation expense beginning with a particular accounting period, the computation of ratable portion of investment tax credit must also be revised beginning with such period.

Section 46(f)(2) of the Code states that a taxpayer satisfies the normalization requirements if the cost of service is reduced by no more than the ratable portion of the investment tax credit. Ratable is determined under section 1.46-6(g)(2) of the regulations by reference to the period of time actually used in computing a taxpayer's regulated depreciation expense for the property for which the credit is allowed. Accordingly, as long as the investment tax credit is amortized no more rapidly than over the period actually used for regulated depreciation purposes, the ratemaking treatment of the credit will comply with the normalization requirements. In the facts set forth above, the Taxpayer's investment tax credit amount will always be ratable by reference to the related asset's regulated depreciation period. This will be true whether the depreciable basis is recovered over the anticipated 8-year or 5-year periods (Plant A and Plant B, respectively), or whether the depreciable basis recovery is deferred or accelerated due to the rate cap. So long as the amortization of the investment tax credit is deferred or accelerated ratably on the same basis as the recovery of the depreciable basis, there will be no violation of the normalization rules.

Taxpayer has requested a one-time catch-up adjustment that includes the incremental difference in amortization from the effective dates of the Decisions to the date of this ruling. Under the method described above, the period of time over which the investment tax credit is amortized is linked to the rate recovery period actually used in computing the Taxpayer's regulated depreciation expense. As in the previous analysis, there will be no violation of the normalization rules so long as at no time does the cumulative amount of the investment tax credit reduce cost of service more rapidly than ratably.

If there is unamortized investment tax credit at the end of the rate freeze period, the Taxpayer proposes to retain the remaining investment tax credit for the benefit of its shareholders. This action will not constitute a reduction in the Taxpayer's cost of service for ratemaking purposes or on its regulated books of account within the meaning of section 46(f)(2)(A) of the Code, nor a reduction of the base to which the rate of return for ratemaking purposes is applied under section 46(f)(2)(B). Thus, there is no normalization violation for the Taxpayer's retention of the remaining investment tax credit under the facts presented.

CONCLUSIONS

1. The ratable amortization of the Taxpayer's remaining investment tax credits for Plants A and B over a new 5-year regulatory period instead of over the previous periods of 16 and 28 years, respectively, complies with the normalization provisions of section 46(f) of the Code.

2. A one-time catch-up adjustment that includes the incremental difference in amortization from the effective dates of the Decisions to the date of this ruling complies with section 46(f).

3. If at the end of the revised regulatory lives of the Plants, all of the sunk cost and the associated investment tax credit has not been reflected in rates due to the rate cap, the remaining credit may accrue to the benefit of its shareholders without violating the normalization rules.

4. If the rate cap allows a depreciation recovery more rapid than anticipated, the investment tax credit may be flowed through to rates based on the new anticipated depreciable period without violating the normalization rules. If depreciation is deferred due to the rate cap, then the investment tax credit must also be deferred.

Except as specifically set forth above, no opinion is expressed concerning the federal income tax consequences of the above-described facts under any other provision of the Code or regulations. This letter ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that this ruling may not be used or cited as precedent.

In accordance with the power of attorney on file in this office, a copy of this letter is being sent to your authorized legal representatives. In addition, a copy of this letter is being sent to the District Director of the District.

Sincerely yours,

CHARLES B. RAMSEY

Chief, Branch 6

Office of the Assistant Chief Counsel

(Passthroughs and Special Industries)

This document may not be used or cited as precedent. Section 6110(j)(3) of the Internal Revenue Code.

PLR 9852028, 1998 WL 894989 (IRS PLR)

END OF DOCUMENT

FIGURE RWH-R17
PLR 200004038

C

Internal Revenue Service (I.R.S.)

Private Letter Ruling

Issue: January 28, 2000
October 26, 1999

Section 168 -- (Repealed-1976 Act) Amortization of Emergency Facilities

168.00-00 (Repealed-1976 Act) Amortization of Emergency Facilities

168.24-00 Public Utility Property

168.24-01 Normalization Rules

Section 46 -- Amount of Credit

46.00-00 Amount of Credit

46.01-00 Amount of Investment Credit

CC:DOM:P&SI:6 PLR-105884-99

Re: Private Letter Ruling Request on Normalization of Investment Tax Credit and Average Rate Assumption Method Benefits

Taxpayer =

Parent =

District =

Bill =

State =

Date 1 =

Date 2 =

a =

b =

c =

Dear *** :

This letter responds to the request of Taxpayer, dated March 12, 1999, and supplemental information submitted on behalf of Taxpayer, for a determination as to the normalization requirements under § 46(f)(2) of the Internal Revenue Code and § 203(e) of the Tax Reform Act of 1986 for the accumulated deferred investment tax credit ("ADITC") and average rate assumption method ("ARAM") benefits associated with certain generation plants that were sold by Taxpayer. Specifically, Taxpayer has asked the Internal Revenue Service to rule on three issues:

1. For plants that are sold at a net after-tax book gain, whether there would be a normalization violation if the remaining unamortized ADITC and ARAM benefits balances existing at the date of sale are incorporated in the gain on sale computation and returned to ratepayers through a Transition Cost Balancing Account ("TCBA").

2. For plants that are sold at a net after-tax book loss, whether there would be a normalization violation if the remaining unamortized ADITC and ARAM benefits balances existing at the date of sale are incorporated in the loss on sale computation and returned to ratepayers by amortizing those amounts to a TCBA.

3. Alternatively, if ruling number two above is deemed to be a normalization violation, whether a proportionate part of the ADITC and ARAM benefits may be returned to ratepayers without causing a normalization violation. For purposes of this ruling, the proportionate part of the ADITC and ARAM benefits to be returned to ratepayers is based on the percentage of the plant cost remaining at the date of sale which is paid for by ratepayers through the loss recovery mechanism.

Taxpayer represents that the facts and information relating to its request are as follows:

Taxpayer is 100 percent owned by Parent and files a consolidated Federal income tax return with Parent. Taxpayer is under the audit jurisdiction of the District Director of District.

On Date 1, Bill became effective in State. Bill initiated changes to the regulated electric utility market structure and it permitted customer choice of electric generation providers. Any stranded costs caused as a result of the deregulation are to be collected from ratepayers on a nonbypassable basis. The recovery of costs from ratepayers, however, shall not extend beyond Date 2 ("transition recovery period"). Whatever stranded costs are not recovered during the transition recovery period will not be eligible for recovery from ratepayers and will be absorbed by Taxpayer's shareholders.

As a result of Bill, Taxpayer sold all a of its oil and gas fired generation stations to unrelated third parties. Of the plants that were sold, b were sold for a net book gain and c were sold for a net book loss. The cumulative result was a net book gain. Prior to the sale of the plants, stranded costs were being amortized over the transition recovery period.

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

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 § 168(i)(9)(A). Section 1.167(l)-1 of the Income Tax 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 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 1.167(l)-1(h)(1)(i) of the regulations provides that the reserve established for public utility property should reflect 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) of the regulations 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 tax year in which the different methods of depreciation are used.

Section 1.167(l)-1(h)(2)(i) of the regulations 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 the aggregate amount allocable to deferred taxes shall not be reduced except to reflect the amount for any tax 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 depreciation used in determining the allowance for depreciation under § 167(a).

The first determination involves the proper normalization treatment by Taxpayer, a § 46(f)(2) elector, of its ADITC relating to its oil and gas fired generation stations that were sold to unrelated third parties.

Section 46(f) of the Code provides an election for ratable flow through under which an elector may flow through the investment tax credit to cost of service. However, § 46(f)(2)(A) provides that no investment tax credit is available if the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the credit determined under § 46(a) and allowable by § 38. Also, under § 46(f)(2)(B) no investment tax credit is available if the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit determined under § 46(a) and allowable by § 38.

Section 46(f)(6) of the Code provides that for purposes of determining ratable portions under § 46(f)(2)(A), the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account shall be used.

Under § 1.46-6(g)(2) of the Income Tax Regulations, "ratable" for purposes of § 46(f)(2) of the Code is determined by considering the period of time actually used in computing the taxpayer's regulated depreciation expense for the property for which a credit is allowed. Regulated depreciation expense is the depreciation expense for the property used by a regulatory body for purposes of establishing the taxpayer's cost of service for ratemaking purposes. Such period of time shall be expressed in units of years (or shorter periods), units of production, or machine hours and shall be determined in accordance with the individual useful life or composite (or other group asset) account system actually used in computing the taxpayer's regulated expense. A method of reducing is ratable if the amount to reduce cost of service is allocated ratable in proportion to the number of such units. Thus, for example, assume that the regulated depreciation expense is computed under the straight line method by applying a composite annual percentage rate to original cost (as defined for purposes of computing depreciation expense). If cost of service is reduced annually by an amount computed by applying a composite annual percentage rate to the amount of the credit, cost of service is reduced by a ratable portion. If such composite annual percentage rate were revised for purposes of computing depreciation expense beginning with a particular account period, the computation of ratable portion must also be revised beginning with such period. A composite annual percentage rate is determined solely by reference to the period of time actually used by the taxpayer in computing its regulated depreciation expenses without reduction for salvage or other items such as over and under accruals.

The method prescribed by § 1.46-6(g)(2) of the regulations for determining whether the taxpayer's cost of service for ratemaking is reduced by more than a ratable portion of the investment tax credit depends upon correlating the credit with the regulatory depreciable useful life actually used for the property that generated the credit That the correlation must remain constant and current is illustrated by the requirement that the ratable portion must be adjusted to reflect correspondingly any revision to the composite annual percentage rate applied for purposes of computing regulated depreciation expense.

Should the property for which the ADITC is allowed become no longer available for computing the regulated depreciation expense, there could no longer be any correlation between the property and the credit. In that event, the requirements of § 46(f)(2) of the Code are violated if any portion of the credit is used to reduce the taxpayer's cost of service.

In this case Taxpayer has sold the assets that generated the ADITC and, as a result, the asset for which regulated depreciation expense is computed is no longer available. Consequently, no portion of the related unamortized ADITC remaining at the date of sale may be returned to ratepayers by amortizing those amounts to a TCBA.

The second determination involves the proper normalization treatment by Taxpayer of average rate assumption method ("ARAM") benefits relating to its oil and gas fired generation stations that were sold to unrelated third parties.

Section 203(e)(1) of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 63 ("Act"), provides that a normalization method of accounting shall not be treated as being used with respect to any public utility property for purposes of § 167 or § 168 of the Code if the taxpayer, in computing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, reduces the excess tax reserve more rapidly or to a greater extent that this reserve would be reduced under the average rate assumption method.

The term "excess tax reserve" is defined in § 203(e)(2)(A) of the Act as the excess of:

(i) the reserve for deferred taxes as described in former § 167(l)(3)(G)(ii) or § 168(e)(3)(B)(ii) of the Code as in effect on the day before the date of the enactment of the Act, over;

(ii) the amount that would be the balance in this reserve if the amount of the reserve were determined by assuming that the corporate rate reductions provided in the Act were in effect for all prior periods.

Section 203(e)(2)(B) of the Act defines the ARAM and explains the calculations under this method. ARAM is the method under which the excess in the reserve for deferred taxes is reduced over the remaining lives of the property as used in its regulated books of account that gave rise to the reserve for deferred taxes. Under the ARAM, if timing differences for the property reverse, the amount of the

adjustment to the reserve for the deferred taxes is calculated by multiplying:
(i) the ratio of the aggregate deferred taxes for the property to the aggregate timing differences for the property as of the beginning of the period in question, by;
(ii) the amount of the timing differences that reverse during this period.

Rev. Proc. 88-12, 1988-1 C.B. 637, provides further guidance as to the application of the ARAM to the excess tax reserve. Section 2.04 of Rev. Proc. 88-12 provides that under the ARAM, excess tax reserves pertaining to a particular vintage or vintage account are not flowed through to ratepayers until such time as the timing differences in the particular vintage account reverse. Moreover, it is a violation of § 203(e) of the Act for taxpayers to adopt any accounting treatment that, directly or indirectly, circumvents the rule set forth in the previous sentence. Section 2.04 also provides that § 203(e) of the Act does not modify the normalization requirements of former § 167(l) or § 168(i) of the Code.

Sections 3 and 4.01 of Rev. Proc. 88-12 provide that a taxpayer who lacks sufficient vintage account data necessary to apply the ARAM, can use the "Reverse South Georgia Method." In general, a taxpayer uses that method if it (a) computes the excess tax reserve on all public utility property included in the plant account on the basis of the weighted average life or composite rate used to compute depreciation for regulatory purposes, and (b) reduces the excess tax reserve ratably over the remaining regulatory life of the property.

For a public utility to use accelerated depreciation in determining its Federal income tax liability, § 203(e) of the Act requires that normalization accounting be used to reduce the excess tax reserve in calculating the rates to be charged the utiliry's customers and in maintaining the regulated books of account. Under § 203(e) of the Act, the immediate flow through of the excess tax reserve to the utility's customers is prohibited. Instead, the excess tax reserve is to be reduced and flowed through to cost of service no more rapidly that this reserve would be reduced under the ARAM, or, where appropriate, the Reverse South Georgia Method.

Section 203(e) of the Act limits the rate at which the excess tax reserve may be reduced and flowed through to the utility's customers in setting rates. It does not require the utility to flow through the excess tax reserve to its customers, but permits the utility to do so provided the reduction to cost of service is not more rapidly than would be under the ARAM. Thus, § 203(e) of the Act imposes a limitation on when the excess tax reserve may be returned to the utility's customers in the form of reduced rates.

In the present case, Taxpayer has sold the aforementioned public utility assets. Retirements of public utility property subject to the normalization requirements of § 168 are reflected in adjustments to Taxpayer's deferred tax reserve as well as its excess tax reserve (see § 1.167(l)-1(h)(2)(i), and Rev. Proc. 88-12, 1988-1 C.B. 637, at 639). As a result of the sale, these reserves cease to exist. A violation of the normalization rules will occur if there is any return to ratepayers, after the sale date, of the unamortized excess deferred reserve attributable to accelerated depreciation on public utility property. Further, both ARAM and the Reverse South Georgia Method rely on mechanisms requiring a regulatory life. Once the asset is sold, the regulatory life ceases to exist.

Hence, in each of the three rulings requested by Taxpayer, there would be a normalization violation if the remaining unamortized ADITC and ARAM benefits balances (or a proportionate part thereof) existing at the date of sale are returned to ratepayers by amortizing those amounts to a TCBA. Since Taxpayer has sold the assets that generated the ADITC, the asset for which regulated depreciation expense is computed is no longer available. Consequently, no portion of the related unamortized ADITC remaining at the date of sale may be returned to ratepayers by amortizing those amounts to a TCBA. Additionally, a violation of the normalization rules will occur if there is any return to ratepayers, after the sale date, of the unamortized excess deferred reserve attributable to accelerated depreciation on public utility property.

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

Pursuant to the power of attorney on file with this office, a copy of this letter is being sent to your authorized legal representatives.

Sincerely yours,

Peter C. Friedman

Assistant to the Branch Chief, Branch 6

Office of the Assistant Chief Counsel (Passthroughs and Special Industries)

This document may not be used or cited as precedent. Section 6110(j)(3) of the Internal Revenue Code.

PLR 200004038, 2000 WL 92406 (IRS PLR)

END OF DOCUMENT

FIGURE RWH-R18
PLR 200016020

Westlaw.

PLR 200016020
2000 WL 1690225 (IRS PLR)

Page 1

C

Internal Revenue Service (I.R.S.)

Private Letter Ruling

Issue: April 21, 2000
January 6, 2000

Section 46 -- Amount of Credit

46.00-00 Amount of Credit

46.14-00 Public Utility Property - Section 1.46-3(g) of the Income Tax Regulations

CC:DOM:P&SI:6-PLR-108377-99

Re: Request for Private Letter Ruling

Regarding Normalization

Legend:

Taxpayer =

Subsidiary =

State =

Commission =

Dear *** :

This letter responds to the request, dated April 29, 1999, of Taxpayer on behalf of its Subsidiary for a private letter ruling on the proper treatment of two of the Subsidiary's deferred tax accounts. Those tax accounts are the accumulated deferred investment tax credits (ADITC) under former §46(f)(2) of the Internal Revenue Code, and excess deferred income tax (EDIT) under former § 167(l) and §

168(f) and §203(e) of the 1986 Tax Reform Act, 1986-3(Vol.1) C.B. 1, 63 (Act).

Your representations set out in your letter follow.

Subsidiary is an investor-owned regulated public utility engaged in the generating, transmission, distribution, and sale of electrical power in State. Subsidiary has elected to use the ratable flow through method of normalizing its investment tax credits under former §46(f)(2) of the Code and has consistently applied this method to its unamortized investment tax credit balances associated with its public utility property placed in service prior to 1986, when the investment tax credit was repealed, as well as to its public utility property placed in service during the transition period after the repeal. Subsidiary also adopted a normalization method of accounting for purposes of claiming accelerated depreciation for public utility property in accordance with former §167(l) and § 168(f) and §168(i)(9). Subsidiary has normalized its EDIT in accordance with § 203(e) of the Act and Rev. Proc. 88- 12, 1988-1 C.B. 637.

Pursuant to a State statute to restructure State's electric utility industry, Subsidiary is required to divest itself of its generation assets. Consequently, Subsidiary agreed to sell its fossil, hydro, and biomass generating assets to an unrelated party. The purchaser will not be subject to rate regulation in the operation of these plants.

The sales price proceeds exceeded Subsidiary's book value of the plants. The proceeds up to net book value will be retained by Subsidiary; the proceeds in excess of net book value will be used to mitigate Subsidiary's stranded costs in connection with the above-market power purchase agreements and uneconomic nuclear investments. In general, Subsidiary will be given an opportunity to recover all prudently incurred generation-related stranded costs from ratepayers. Among the stranded costs which Subsidiary will be eligible to recover are generation-related federal income taxes which were not subject to the normalization rules and were not provided for by ratepayers.

Commission staff has proposed retention of the entire EDIT, but only the net present value of the unamortized investment tax credit benefits which the ratepayer would have received over the remaining regulatory life of the generation assets sold. Taxpayer had argued that any rate making treatment that directly or indirectly retained the economic benefits of the unamortized ADITC and EDIT for ratepayers upon the sale of the generation facilities would violate the governing normalization provisions of the Code. Taxpayer has been directed by the Commission to request a ruling concerning whether a final determination put into effect by Commission requiring Taxpayer to flow the unamortized ADITC and EDIT balances to ratepayers, directly or indirectly, following the sale of Taxpayer's generation assets pursuant to the State restructuring laws, would violate the normalization rules set forth in former § 46(f)(2) and §168(i)(9).

The first issue involves the proper normalization treatment by Subsidiary of unamortized EDIT relating to the sale of its public utility property.

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)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for rate making 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 rate making 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 rate making purposes, with respect to all three of these items and with respect to the rate base.

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 § 168(i)(9)(A). Section 1.167(l)-1(a)(1) of the Income Tax 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 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 1.167(l)-1(h)(1)(i) of the regulations provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and rate making purposes.

Section 1.167(l)-1(h)(1)(iii) of the regulations provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and rate making purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for rate making 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.

Section 1.167(l)-1(h)(2)(i) of the regulations 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 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 203(e) of the Act provides another way in which a normalization method of accounting is not being used for public utility property.

According to §203(e)(1) of the Act, a normalization method of accounting shall not be treated as being used with respect to any public utility property for purposes of §167 or 168 of the Code if the taxpayer, in computing its cost of service for rate making purposes and reflecting operating results in its regulated books of account, reduces the excess tax reserve more rapidly or to a greater extent that this reserve would be reduced under the average rate assumption method (ARAM).

The term "excess tax reserve" is defined in §203(e)(2)(A) of the Act as the excess of:

(i) the reserve for deferred taxes as described in former §167(l)(3)(G)(ii) or 168(e)(3)(B)(ii) of the Code as in effect on the day before the date of the enactment of the Act, over;

(ii) the amount that would be the balance in this reserve if the amount of the reserve were determined by assuming that the corporate rate reductions provided in the Act were in effect for all prior periods.

Section 203(e)(2)(B) of the Act defines the ARAM and explains the calculations under this method. ARAM is the method under which the excess in the reserve for deferred taxes is reduced over the remaining lives of the property as used in its books of account that gave rise to the reserve for deferred taxes. Under the ARAM, if timing differences for the property reverse, the amount of the adjustment to the reserve for the deferred taxes is calculated by multiplying:

(i) the ratio of the aggregate deferred taxes for the property to the aggregate timing differences for the property as of the beginning of the period in question, by;

(ii) the amount of the timing differences that reverse during this period.

Rev. Proc. 88-12, 1988-1 C.B. 637, provides further guidance as to the application of the ARAM to the excess tax reserve. Section 2.04 of Rev. Proc. 88-12 provides that under the ARAM, excess tax reserves pertaining to a particular vintage or vintage account are not flowed through to ratepayers until such time as the timing differences in the particular vintage account reverse. Moreover, it is a violation of §203(e) of the Act for taxpayers to adopt any accounting treatment that, directly or indirectly, circumvents the rule set forth in the previous sentence. Section 2.04 also provides that § 203(e) of the Act does not modify the normalization requirements of former § 167(l) or §168(i) of the Code.

Sections 3 and 4.01 of Rev. Proc. 88-12 provide that a taxpayer who lacks sufficient vintage account data necessary to apply the ARAM, can use the

""Reverse South Georgia Method." In general, a taxpayer uses that method if it (a) computes the excess tax reserve on all public utility property included in the plant account on the basis of the weighted average life or composite rate used to compute depreciation for regulatory purposes, and (b) reduces the excess tax reserve ratably over the remaining regulatory life of the property.

For a public utility to use accelerated depreciation in determining its federal income tax liability, §203(e) of the Act requires that normalization accounting be used to reduce the excess tax reserve in calculating the rates to be charged the utility's customers and in maintaining the regulated books of account. Under § 203(e) of the Act, the immediate flow through of the excess tax reserve to the utility's customers is prohibited. Instead, the excess tax reserve is to be reduced and flowed through to cost of service no more rapidly that this reserve would be reduced under the ARAM, or, where appropriate, the Reverse South Georgia Method.

Section 203(e) of the Act limits the rate at which the excess tax reserve may be reduced and flowed through to the utility's customers in setting rates. It does not require the utility to flow through the excess tax reserve to its customers, but permits the utility to do so provided the reduction to cost of service is not more rapidly than would be under the ARAM. Thus, §203(e) of the Act imposes a limitation on when the excess tax reserve may be returned to the utility's customers in the form of reduced rates.

In the present case, Subsidiary has sold the aforementioned public utility assets. Retirements of public utility property subject to the normalization requirements of §168 are reflected in adjustments to Subsidiary's deferred tax reserve as well as its excess tax reserve (see §1.167(l)-1(h)(2)(i), and Rev. Proc. 88-12, 1988-1 C.B. at 638). As a result of the sale, the reserves cease to exist. A violation of the normalization rules will occur if there is any reduction to Subsidiary's' rate base, after the acquisition date, for the unamortized EDIT reserve attributable to accelerated depreciation on public utility property. Further, both ARAM and the Reverse South Georgia Method rely on mechanisms requiring a regulatory life. Once the asset is sold, the regulatory life ceases to exist.

The second issue involves the proper normalization treatment by Subsidiary, a former §46(f)(2) elector, of ADITC relating to the sale of its public utility property.

Former §46(f) of the Code provides an election for ratable flow through under which an elector may flow through the investment tax credit to cost of service. However, former §46(f)(2)(A) provides that no investment tax credit is available if the taxpayer's cost of service for rate making purposes or in its regulated books of account is reduced by more than a ratable portion of the credit determined under former §46(a) and allowable by §38. Also, under former § 46(f)(2)(B) no investment tax credit is available if the base to which the taxpayer's rate of return for rate making purposes is applied is reduced by reason of any portion of the credit determined under former §46(a) and allowable by §38.

Former §46(f)(6) of the Code provides that for purposes of determining ratable portions under former §46(f)(2)(A), the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account shall be used.

Under §1.46-6(g)(2) of the regulations, "ratable" for purposes of former § 46(f)(2) of the Code is determined by considering the period of time actually used in computing the taxpayer's regulated depreciation expense for the property for which a credit is allowed. Regulated depreciation expense is the depreciation expense for the property used by a regulatory body for purposes of establishing the taxpayer's cost of service for rate making purposes. Such period of time shall be expressed in units of years (or shorter periods), units of production, or machine hours and shall be determined in accordance with the individual useful life or composite (or other group asset) account system actually used in computing the taxpayer's regulated expense. A method of reducing is ratable if the amount to reduce cost of service is allocated ratable in proportion to the number of such units. Thus, for example, assume that the regulated depreciation expense is computed under the straight line method by applying a composite annual percentage rate to original cost (as defined for purposes of computing depreciation expense). If cost of service is reduced annually by an amount computed by applying a composite annual percentage rate to the amount of the credit, cost of service is reduced by a ratable portion. If such composite annual percentage rate were revised for purposes of computing depreciation expense beginning with a particular accounting period, the computation of ratable portion must also be revised beginning with such period. A composite annual percentage rate is determined solely by reference to the period of time actually used by the taxpayer in computing its regulated depreciation expense without reduction for salvage or other items such as over and under accruals.

The method prescribed by §1.46-6(g)(2) of the regulations for determining whether the taxpayer's cost of service for rate making is reduced by more than a ratable portion of the investment tax credit depends upon correlating the credit with the regulatory depreciable useful life actually used for the property that generated the credit. That the correlation must remain constant and current is illustrated by the requirement that the ratable portion must be adjusted to reflect correspondingly any revision to the composite annual percentage rate applied for purposes of computing regulated depreciation expense.

Should the property for which the investment tax credit is allowed become no longer available for computing the regulated depreciation expense, there could no longer be any correlation between the property and the credit. In that event, the requirements of former §46(f)(2) of the Code are violated if any portion of the credit is used to reduce the taxpayer's cost of service.

In this case, Subsidiary has sold the assets that generated the investment tax credit and, as a result, the asset for which regulated depreciation expense is computed is no longer available. Consequently, no portion of the related unamortized ADITC remaining at the date of sale may be used to reduce Subsidiary's cost of service.

This letter ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. Pursuant to a power of attorney on file with this office, the original of this letter ruling has been sent to Taxpayer's authorized representative and a copy has been sent to Taxpayer.

Sincerely yours,

Kathleen Reed

Senior Technician Reviewer, Branch 6

Office of Assistant Chief Counsel (Passthroughs and Special Industries)

This document may not be used or cited as precedent. Section 6110(j)(3) of the Internal Revenue Code.

PLR 200016020, 2000 WL 1690225 (IRS PLR)

END OF DOCUMENT

FIGURE RWH-R19

Proposed Rules, 68 FR 10190-01

Westlaw.

68 FR 10190-01
2003 WL 715842 (F.R.)
(Cite as: 68 FR 10190)

PROPOSED RULES

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-104385-01]

RIN 1545-AY75

Application of Normalization Accounting Rules to Balances of Excess Deferred Income Taxes and Accumulated Deferred Investment Tax Credits of Public Utilities Whose Generation Assets Cease to be Public Utility Property

Tuesday, March 4, 2003

***10190** AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that provide guidance on the normalization requirements applicable to electric utilities that benefit (or have benefitted) from accelerated depreciation methods or from the investment tax credit permitted under pre-1991 law. The proposed regulations permit a utility whose electricity generation assets cease to be public utility property to return to their ratepayers the normalization reserves for excess deferred income taxes (EDFIT) and accumulated deferred investment tax credits (ADITC)) with respect to those assets. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by June 2, 2003. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for June 25, 2003, at 10 a.m. must be received by June 2, 2003.

ADDRESSES: Send submissions to: CC:PA:RU (REG-104385-01), room ***10191** 5226, Internal Revenue Service, Post Office Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:PA:RU (REG-104385-01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically by submitting comments directly to the IRS Internet site at www.irs.gov/regs. The public hearing will be held in the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, David Selig, at (202) 622-3040; concerning submissions of comments, the hearing, or to be placed on the building access list to attend the hearing, Treena Garrett, at (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) relating to the normalization requirements of sections 168(f)(2) and 168(i)(9) of the Internal Revenue Code (Code), section 203(e) of the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2146), and former section 46(f) of the Code. The proposed regulations respond to changes in the electric power industry resulting from deregulation of electricity generation facilities.

Section 168 of the Code permits the use of accelerated depreciation methods. Section 168(f)(2) provides, however, that accelerated depreciation is permitted with respect to public utility property only if the taxpayer uses a normalization method of accounting for ratemaking purposes.

Under a normalization method of accounting, a utility calculates its ratemaking tax expense using depreciation that is no more accelerated than its ratemaking depreciation (typically straight-line). In the early years of an asset's life, this results in ratemaking tax expense that is greater than actual tax expense. The difference between the ratemaking tax expense and the actual tax expense is added to a reserve (the accumulated deferred federal income tax reserve, or ADFIT). The difference between ratemaking tax expense and actual tax expense is not permanent and reverses in the later years of the asset's life when the ratemaking depreciation method provides larger depreciation deductions and lower tax expense than the accelerated method used in computing actual tax expense.

This accounting treatment prevents the immediate flowthrough to utility ratepayers of the reduction in current taxes resulting from the use of accelerated depreciation. Instead, the reduction is treated as a deferred tax expense that is collected from current ratepayers through utility rates, and thus is available to utilities as cost-free investment capital. When the accelerated method provides lower depreciation deductions in later years, only the ratemaking tax expense is collected from ratepayers and the difference between actual tax expense and ratemaking tax expense is charged to ADFIT, depleting the utility's stock of cost-free capital.

Excess Deferred Income Tax

The Tax Reform Act of 1986 reduced the highest corporate tax rate from 46 percent to 34 percent. The excess deferred federal income tax (EDFIT) reserve is the balance of the deferred tax reserve immediately before the rate reduction over the balance that would have been held in the reserve if the 34 percent rate had been in effect for prior periods. The EDFIT reserves were amounts that utilities had collected from ratepayers to pay future taxes that, as a result of the reduction in corporate tax rates, would not have to be paid.

Section 203(e) of the Tax Reform Act of 1986 specifies the manner in which the EDFIT reserve can be flowed through to ratepayers under a normalization method of accounting. It provides that the EDFIT reserve may be reduced, with a corresponding reduction in the cost of service the utility collects from ratepayers, no more rapidly than the EDFIT reserve would be reduced under the average rate assumption method (ARAM). For taxpayers that did not have adequate data to apply the average rate assumption method, subsequent guidance permitted use of the reverse South Georgia method as an alternative. In general, both the average rate assumption method and the reverse South Georgia method spread the flowthrough of the EDFIT reserve over the remaining lives of the property that gave rise to the excess.

Accumulated Deferred Investment Tax Credits (ADITC)

Former section 46 of the Code similarly limited the ability of ratepayers to benefit from the investment tax credit determined under that section. Under former section 46(f)(2), an electing utility could flow through the investment credit ratably (that is, could reduce the cost of service collected from ratepayers by a ratable portion of the credit) over the investment's regulatory life. The balance of the credit remaining to be flowed through to ratepayers would be held in a reserve for accumulated deferred investment tax credits (ADITC). If the utility elected ratable flowthrough of the credit, the rate base (the amount on which the utility is permitted to collect a return from ratepayers) could not be reduced by reason of any portion of the credit.

Deregulation of Generation Assets

When the normalization provisions were added to the Internal Revenue Code, electric utilities were vertically integrated to include generation, transmission, and distribution functions. Accelerated depreciation, investment credits, and normalization enhanced the cash flow needed to acquire and construct new generation assets. Driven by changes in technology and economics, however, the electric industry has been undergoing substantial changes. Many utilities have been selling generation assets to new entities that are not subject to rate of return regulation and are becoming transmission and distribution (or distribution-only) companies. In many cases, the deregulation of generation assets is occurring before the EDFIT and ADITC reserves associated with those assets have been flowed through to ratepayers.

The Service has issued a number of private letter rulings holding that flowthrough of the EDFIT and ADITC reserves associated with an asset is not permitted after the asset's deregulation, whether by disposition or otherwise. These rulings were based on the principle that flowthrough is permitted only over the asset's regulatory life and when that life is terminated by deregulation no further flowthrough is permitted. After further consideration, the Service and Treasury have concluded that neither former section 46(f)(2) nor section 203(e) of the Tax Reform Act suggests that the EDFIT and ADITC reserves should not ultimately be flowed through to ratepayers. Instead, Congress provided a schedule for flowing through the reserves so that utilities would have the benefit of cost-free capital for a predictable period.

The proposed regulations provide that utilities whose generation assets cease to be public utility property, whether by disposition, deregulation, or otherwise, may continue to flow through EDFIT and ADITC reserves associated with those assets without violating the normalization rules. The rate of *10192 flowthrough is limited, however, to the rate that would have been permitted if the assets had remained public utility property and the taxpayer had continued to use a normalization method of accounting (or ratable flowthrough of the credit) with respect to the assets. This result does not impose on utilities any burden unanticipated prior to deregulation and provides the flow-through originally anticipated by ratepayers, utility commissions, and utilities.

Comments Requested

In addition to comments relating to this notice of proposed rulemaking, comments are requested on the proper disposition of tax reserves (ADFIT, EDFIT, and ADITC) under the following set of facts. Regulated transmission assets from several public utilities (related or otherwise) are transferred to a utility partnership. This partnership is created solely as a transmission company. The transaction is subject to section 721 of the Code. The transmission assets are public utility property before the transfer and will be public utility property after the transfer. Is there a normalization violation if the deferred tax reserves are transferred to the new transmission company's regulated books and are considered in setting rates for the new transmission company? Alternatively, is there a normalization violation if the deferred tax reserves remain on the transferors' regulated books and are considered in setting their rates?

In addition, the proposed regulations do not address the treatment of deregulated assets under former section 46(f)(1) (relating to the use of the investment credit to reduce the rate base of electing taxpayers). Comments are also requested on this issue.

Proposed Effective Date

The regulations are proposed to apply to property that becomes deregulated generation property after March 4, 2003. In addition, a utility may elect to apply the proposed rules to property that becomes deregulated generation property on or before March 4, 2003. The election is made by attaching a written statement to the utility's return for the tax year in which the proposed rules are published as final regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted (in the manner described in the ADDRESSES caption) timely to the IRS. All comments will be available for public inspection and copying. Treasury and IRS specifically request comments on the clarity of the proposed regulations and how they may be made clearer and easier to understand.

A public hearing has been scheduled for June 25, 2003, at 10 a.m. in the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 30 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit comments and submit an outline of the topics to be discussed and the time to be devoted to each topic by June 2, 2003.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is David Selig, Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.46-6 is amended by adding paragraph (k) to read as follows:

§ 1.46-6 Limitation in case of certain regulated companies.

* * * * *

(k) Treatment of accumulated deferred investment tax credits upon the deregulation of regulated generation assets--(1) Scope. This paragraph (k) provides rules for the application of former section 46(f)(2) of the Internal Revenue Code with respect to public utility property that is used in electric generation and ceases, whether by disposition, deregulation, or otherwise, to be public utility property (deregulated generation property).

(2) Amount of reduction. If public utility property of a taxpayer becomes deregulated generation property to which this section applies, the reduction in the taxpayer's cost of service permitted under former section 46(f)(2) is equal to the amount by which the cost of service could be reduced under that provision if all such property had remained public utility property of the taxpayer and the taxpayer had continued to reduce its cost of service by a ratable portion of the credit with respect to such property.

(3) Cross reference. See § 1.168(i)-(3) for rules relating to the treatment of balances of excess deferred income taxes when utilities dispose of regulated generation assets.

(4) Effective date--(i) General rule. This paragraph (k) applies to property that

becomes deregulated generation property after March 4, 2003.

(ii) Election for retroactive application. A utility may elect to apply this paragraph (k) to property that becomes deregulated generation property on or before March 4, 2003. The election is made by attaching the statement "ELECTION UNDER § 1.46-6(k)" to the taxpayer's return for the tax year in which this paragraph (k) is published as a final regulation.

Par. 3. Section 1.168(i)-3 is added to read as follows: ***10193**

§ 1.168(i)-(3) Treatment of excess deferred income tax reserve upon disposition of regulated generation assets.

(a) Scope. This section provides rules for the application of section 203(e) of the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2146) with respect to public utility property that is used in electric generation and ceases, whether by disposition, deregulation, or otherwise, to be public utility property (deregulated generation property).

(b) Amount of reduction. If public utility property of a taxpayer becomes deregulated generation property to which this section applies, the reduction in the taxpayer's excess tax reserve permitted under section 203(e) of the Tax Reform Act of 1986 is equal to the amount by which the reserve could be reduced under that provision if all such property had remained public utility property of the taxpayer and the taxpayer had continued use of its normalization method of accounting with respect to such property.

(c) Cross reference. See § 1.46-6(k) for rules relating to the treatment of accumulated deferred investment tax credits when utilities dispose of regulated generation assets.

(d) Effective date--(1) General rule. This section applies to property that becomes deregulated generation property after March 4, 2003.

(2) Election for retroactive application. A taxpayer may elect to apply this section to property that becomes deregulated generation property on or before March 4, 2003. The election is made by attaching the statement "ELECTION UNDER § 1.168(i)-3" to the taxpayer's return for the tax year in which this section is published as a final regulation.

David A. Mader,

Assistant Deputy Commissioner of Internal Revenue.

[FR Doc. 03-4885 Filed 3-3-03; 8:45 am]

BILLING CODE 4830-01-P

68 FR 10190-01, 2003 WL 715842 (F.R.)

END OF DOCUMENT

FIGURE RWH-R20

APB Opinion No. 20

APB Opinion No. 20
Accounting Changes

STATUS

Issued: July 1971

Effective Date: For fiscal years beginning after July 31, 1971

Affects: Amends ARB 43, Chapter 2A, paragraph 3
Amends ARB 44 (Rev.), paragraph 3
Amends APB 9, paragraphs 18 and 20
Supersedes APB 9, paragraph 25
Amends APB 15, paragraph 13

Affected by: Paragraph 3 amended by FAS 71 and FAS 95
Paragraph 4 amended by FAS 111
Paragraph 7 amended by FAS 111
Paragraph 9 amended by FAS 111
Paragraph 16 amended by FAS 111
Paragraphs 20 and 21 amended by FAS 128
Paragraph 27 amended by FAS 73
Paragraph 34 amended by FAS 58
Paragraphs 42 through 44 and 46 through 48 amended by FAS 128
Footnote 2 superseded by FAS 111
Footnote 4 amended by FAS 111
Footnote 5 superseded by FAS 32 and FAS 111
Footnote 9 superseded by FAS 16

Other Interpretive Pronouncements: AIN-APB 20, Interpretations No. 1 and 2 (Superseded by FAS 128)
FIN 1
FIN 20
FTB 87-1 (Superseded by FAS 106)

Issues Discussed by FASB Emerging Issues Task Force (EITF)

Affects: No EITF Issues

Interpreted by: Paragraphs 7 and 16 interpreted by EITF Issue No. 84-9

Related Issues: EITF Issue No. 84-10 and Topics No. D-1 and D-74

APB Opinion No. 20
Accounting Changes

CONTENTS

INTRODUCTION

1. A change in accounting by a reporting entity may significantly affect the presentation of both financial position and results of operations for an accounting period and the trends shown in comparative financial statements and historical summaries. The change should therefore be reported in a manner which will facilitate analysis and understanding of the financial statements.

Scope of Opinion

2. This Opinion defines various types of accounting changes and establishes guides for determining the manner of reporting each type. It also covers reporting a correction of an error in previously issued financial statements.

3. The Opinion applies to financial statements which purport to present financial position, changes in financial position, and results of operations in conformity with generally accepted accounting principles. The guides in this Opinion also may be appropriate in presenting financial information in other forms or for special purposes. Companies in regulated industries may apply generally accepted accounting principles differently from nonregulated companies because of the effect of the rate-making process. This Opinion should therefore be applied to regulated companies in accordance with the provisions of the Addendum to APB Opinion No. 2.

4. This Opinion does not change the policy of the Board that its Opinions, unless otherwise stated, are not intended to be retroactive. Each published Opinion specifies its effective date and the manner

16. The presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle on the basis that it is preferable. However, a method of accounting that was previously adopted for a type of transaction or event which is being terminated or which was a single, nonrecurring event in the past should not be changed. For example, the method of accounting should not be changed for a tax or tax credit which is being discontinued or for preoperating costs relating to a specific plant. The Board does not intend to imply, however, that a change in the estimated period to be benefited for a deferred cost (if justified by the facts) should not be recognized as a change in accounting estimate. The issuance of an Opinion of the Accounting Principles Board that creates a new accounting principle, that expresses a preference for an accounting principle, or that rejects a specific accounting principle is sufficient support for a change in accounting principle. The burden of justifying other changes rests with the entity proposing the change.[5]

General Disclosure—A Change in Accounting Principle

17. The nature of and justification for a change in accounting principle and its effect on income should be disclosed in the financial statements of the period in which the change is made. The justification for the change should explain clearly why the newly adopted accounting principle is preferable.

Reporting a Change in Accounting Principle

18. The Board believes that, although they conflict, both (a) the potential dilution of public confidence in financial statements resulting from restating financial statements of prior periods and (b) consistent application of accounting principles in comparative statements are important factors in reporting a change in accounting principles. The Board concludes that most changes in accounting should be recognized by including the cumulative effect, based on a retroactive computation, of changing to a new accounting principle in net income of the period of the change (paragraphs 19 to 26) but that a few specific changes in accounting principles should be reported by restating the financial statements of prior periods (paragraphs 27 to 30 and 34 to 35).

19. For all changes in accounting principle except those described in paragraphs 27 to 30 and 34 to 35, the Board therefore concludes that:

a. Financial statements for prior periods included for comparative purposes should be presented as previously reported.
b. The cumulative effect of changing to a new accounting principle on the amount of retained earnings at the beginning of the period in which the change is made should be included in net income of the period of the change (paragraph 20).
c. The effect of adopting the new accounting principle on income before extraordinary items and on net income (and on the related per share amounts) of the period of the change should be disclosed.
d. Income before extraordinary items and net income computed on a pro forma basis[6] should be shown on the face of the income statements for all periods presented as if the newly adopted accounting principle had been applied during all periods affected (paragraph 21).

Thus, income before extraordinary items and net income (exclusive of the cumulative adjustment) for the period of the change should be reported on the basis of the newly adopted accounting principle. The conclusions in this paragraph are modified for various special situations which are described in paragraphs 23 to 30.

20. *Cumulative effect of a change in accounting principle.* The amount shown in the income statement for the cumulative effect of changing to a new accounting principle is the difference between (a) the amount of retained earnings at the beginning of the period of a change and (b) the amount of retained earnings that would have been reported at that date if the new accounting principle had been applied retroactively for all prior periods which would have been affected and by recognizing only the direct effects of the change and related income tax effect.[7] The amount of the cumulative effect should be shown in the income statement between the captions "extraordinary items" and "net income." The

[5]The issuance of an industry audit guide by a committee of the American Institute of Certified Public Accountants also constitutes sufficient support for a change in accounting principle (paragraph 4).

[6]The pro forma amounts include both (a) the direct effects of a change and (b) nondiscretionary adjustments in items based on income before taxes or net income, such as profit sharing expense and certain royalties, that would have been recognized if the newly adopted accounting principle had been followed in prior periods; related income tax effects should be recognized for both (a) and (b). Direct effects are limited to those adjustments that would have been recorded to restate the financial statements of prior periods to apply retroactively the change. The nondiscretionary adjustments described in (b) should not therefore be recognized in computing the adjustment for the cumulative effect of the change described in paragraph 20 unless nondiscretionary adjustments of the prior periods are actually recorded.

[7]See footnote 6.

FIGURE RWH-R21

Joint Order in Docket Nos. 6765 and 6766

Petition of Houston Lighting and Power Company for Authority to Change Rates
Petition of Houston Lighting and Power Company for Approval of Proposed Interim Accounting Treatment for Limestone Unit I
Docket Nos. 6765 and 6766
Texas Public Utility Commission
November 14, 1986

Before Bailey, Administrative Law Judge; Fisher, and Pugsley, Hearings Examiners; Thomas, Rosson, and Campbell, Commissioners.

BY THE COMMISSION:

Bailey, Administrative Law Judge; Fisher, and Pugsley, Hearings Examiners.

*1 XII. Rate Design

A. Residential Electric Service Tariff

HL&P proposes no changes to the design of its residential service (RS) tariff which was adopted by stipulation in Docket No. 5779; rather, only proposes to change the RS charges. Explaining the current rates, HL&P witness Standish testified that generally low usage customers benefit from the inclusion of 250 KWH in the minimum bill which produces a lower cost per KWH than the residential user rate; which lower rate reflects these customers' smaller than average contribution to the system peak due to their typical higher than average load factor. According to Mr. Standish December 1985 test year data reflects that 22 percent of all residential energy consumption occurs at or below 250 KWH per month and that 12 percent of HL&P's residential bills, annually, are below 250 KWH. Mr. Standish further testified that customers with both summer and winter peak usage patterns benefit from the lower winter KWH charge for usage over 1,000 KWH; which lower charge results from the existence of more annual KWH (summer and winter) over which to spread the demand related cost as compared to summer peaking only customers. Mr. Standish noted that the summer rate remains flat after 250 KWH and at a rate higher than the average rate for the first 250 KWH; resulting in an increasing average unit price which sends the proper pricing signal: higher summer usage residential customers contribute proportionally more to the system peak. (HL&P Ex. 19 at 10.)

Regarding the proposed pricing change for the RS rate, Mr. Standish testified that HL&P proposes to decrease its fuel charge, and base rate charges have been increased to produce approximately the same increase in rates for the various size and usage pattern of all RS customers. (Id.)

City witness Ileo recommends that the residential minimum bill remain at $9.00 per month. (City Ex. 58 at 18.)

Staff witness George Mentrup pointed out that HL&P's minimum RS bill is $10.60 including 250 KWH; with a charge of $.066780 per KWH for consumption in excess of

29. It is reasonable and appropriate to adjust the Company's return on equity to reflect the Company's reduced conservation efforts for reasons set forth in Section V of the Examiners' Report.

30. The staff's adjustment to the Company's cost of equity is reasonable and appropriate for the reasons set forth in Section V.F. of the Examiners' Report.

31. The reasonable and appropriate return on equity for the Company after application of the conservation adjustment is 14.44 percent as shown in modified Finding of Fact No. 74.

*63 32. HL&P has a total invested capital of $4,687,399,000 as illustrated below:

PLANT IN SERVICE	$5,797,391,000
ACCUMULATED DEPRECIATION	$1,201,575,000
NET PLANT	$4,595,816,000
CWIP IN RATE BASE	$ 678,072,000
NFIP IN RATE BASE	$ 58,946,000
PROPERTY HELD FOR FUTURE USE	$ 3,095,000
OTHER LONG TERM ASSETS	$ 0
WORKING CASH ALLOWANCE	$ 0
OTHER WORKING CAPITAL	$ (54,828,000)
MATERIALS AND SUPPLIES	$ 56,663,000
PREPAYMENTS	$ 14,748,000
FUEL INVENTORY	$ 9,397,000
DEFERRED LIMESTONE CHARGES	$ 0
UNRECOVERED STORM COST	$ 0
DEFERRED TAXES	$ (631,503,000)
PRE1971 INVESTMENT TAX CREDITS	$ (6,302,000)
CUSTOMERS DEPOSITS	$ (32,538,000)
CUSTOMER ADVANCES	$ (15,889,000)
PROPERTY INSURANCE RESERVE	$ 1,428,000
DAMAGES AND INJURIES RESERVE	$ (5,597,000)
RETIREMENT PLAN	$ (38,937,000)
TOTAL INVESTED CAPITAL	$4,687,399,000

58. Rate base should be offset by the amount of deferred federal income tax (DFIT) of $631,503,000, an increase of $29,878,000 over the Company's proposed amount. Because ratepayers are currently providing FIT on a normalized basis in the Company's cost of service, this adjustment is reasonable and necessary to recognize government supplied capital. This adjustment does not require the Company to flow-through to ratepayers all benefits from tax deductions excluded from cost of service, but instead disallows a return to be earned on cost free capital.

74. HL&P has a cost of equity of 14.60 percent based on Findings of Fact Nos. 68-73. Application of the conservation adjustment referenced in modified Findings of Fact Nos. 29 and 30 results in a cost of equity of 14.44 percent for HL&P in this case.

75. It is appropriate to set HL&P's capital structure utilizing the most updated data available, and adjusted for subsequent changes, for the reasons discussed in Section VII.B.5. of the Examiners' Report.

75(a). There is insufficient evidence in the record to definitely determine that under Accounting Release No. 13 (AR-13), a company is permitted to accrue AFUDC on the bond proceeds held in trust, only if the AFUDC rate reflects the lower cost of

FIGURE RWH-R22

Motion to Supplement the Record

RECEIVED

2004 MAY 18 PM 3:25

COMMISSION FILING CLERK

SOAH DOCKET NO. 473-04-2459
PUC DOCKET NO. 29206

APPLICATION OF TEXAS-NEW MEXICO POWER COMPANY, FIRST CHOICE POWER, INC., AND TEXAS GENERATING COMPANY, L.P. TO FINALIZE STRANDED COSTS UNDER PURA § 39.262	§ § § § § §	BEFORE THE STATE OFFICE OF ADMINISTRATIVE HEARINGS

MOTION TO SUPPLEMENT THE RECORD

TO THE HONORABLE ADMINISTRATIVE LAW JUDGES:

COME NOW, Texas-New Mexico Power Company, First Choice Power, Inc., and Texas Generating Company, L.P. ("Applicants") and file this their Motion To Supplement The Record in accordance with P.U.C. Proc. R. § 22.203. Applicants make this request to assure only that the record is complete and are not filing this motion for the purpose of delay or any other inappropriate purpose. Applicants request that the Affidavit of Mr. Warren, attached hereto as Exhibit 1, be admitted into the record of this case as supplemental evidence. In support of this motion, Applicants would show the following:

I.
SUPPLEMENTAL INFORMATION OFFERED

During the hearing on the merits, Office of Public Utility Counsel ("OPC") witness Ellen Blumenthal provided oral testimony concerning several IRS private letter rulings relied upon in both the testimony of Cities' witness Lane Kollen and Applicants' witness James Warren. These rulings dealt with whether the flowthrough of investment tax credit reserves associated with an asset after the asset's deregulation or disposition would constitute a normalization violation. She stated affirmatively that those private letter rulings had been revoked. She stated that such information was obtained from an IRS official identified as Mr. David Selig. Tr. 497, lines 6-11 (April 15, 2004).

Ms. Blumenthal's factual statement as to the status of the private letter rulings was a surprise to TNMP witness Warren who works regularly in this area. Given Mr. Warren's area of practice and expertise, Mr. Warren felt compelled to verify Ms. Blumenthal's claim. He contacted Mr. Charles B. Ramsey, Branch Chief, Branch 6, Office of Associate Chief Counsel of Passthroughs and Special Industries at the IRS, to determine the accuracy of Ms. Blumenthal's claim. As Branch Chief for Branch 6, he heads the IRS branch responsible for private letter rulings on passthroughs.[1]

When he reached Mr. Ramsey about the alleged "revocation," Mr. Ramsey asked that the request be made in writing. The letter he sent to Mr. Ramsey is attached as Attachment A to the Affidavit of James Warren. In this letter Mr. Warren requests information concerning all private letter rulings that might be affected by the Proposed Rulemaking on the Application of Normalization Accounting Rules. This Proposed Rulemaking was discussed during the hearing and can be found as an attachment to the testimony of OPC witness Blumenthal. Direct Testimony of Ellen Blumenthal, OPC Ex. 1 at Appendix C. (For your convenience a copy of the Notice of Proposed Rulemaking is attached as Exhibit 2). At page 2 of 3 of the Notice of the Proposed Rulemaking, the IRS states "the Service has issued a number of private letter rulings holding that the flowthrough of EDFIT and ADITC reserves associated with an asset is not permitted after the asset's deregulation . . . ." This statement is consistent with Mr. Warren's testimony at the hearing.[2] Quoting from the preamble in the Notice of Proposed Rulemaking, he stated to Mr. Ramsey the following:

> The Service has issued a number of private letter rulings holding that flowthrough of the EDFIT and ADITC reserves associated with an asset is not permitted after the asset's deregulation, whether by disposition or otherwise. These rulings were based on the principle that flowthrough is permitted only over the asset's regulatory life and when that life is terminated by deregulation no further flowthrough is permitted.

He then asked whether the IRS has revoked those rulings. This request was sufficiently broad to cover any private letter rulings relevant to the question of whether a flowthrough would constitute a normalization violation. Mr. Ramsey stated that none had been "revoked." This conclusion specifically demonstrates that Ms. Blumenthal was incorrect when she proposed to reduce TNMP's stranded costs by the amount of unamortized ITC.[3]

---

[1] Affidavit of James Warren at para. 4. Cities' witness Kollen (Cities Ex. 1) attaches several private rulings to his testimony as exhibits (pages 103-124). All of these rulings were issued from Branch 6 (pages 108, 112, 119, and 120), including one under Mr. Ramsey's signature (page 112). This confirms that Mr. Ramsey was in a position to know the status of such private letter rulings.

[2] Rebuttal Testimony of James Warren, TNMP Ex. 16 at 23-25.

[3] As TNMP set forth in its briefs, TNMP has also argued that Ms. Blumenthal was similarly incorrect when she stated that her proposed adjustments are consistent with generally accepted accounting principles (GAAP). *See* TNMP's Initial Brief at 13-18, 20; TNMP's Reply Brief at 12-17, 20.

II.
PERMISSION SOUGHT UNDER THE COMMISSION PROCEDURAL RULES TO SUPPLEMENT THE RECORD

Under P.U.C. Subst. R. § 22.203(b)(4), a party is permitted to provide supplemental rebuttal testimony "in response to matters first brought up on cross-examination of a non-applicant witness and only to the extent that the applicant could not have reasonably anticipated the need for such evidence in time to file it in written form." The supplemental information must be filed within five (5) working days. However, this requirement is waived if production of the evidence on that schedule was not "feasible." In this circumstance, Applicants clearly could not have anticipated that Ms. Blumenthal would testify to IRS actions now known not to have occurred. Applicants could not have met the five (5) day requirement as this issue arose during the course of the hearing and time was required for Mr. Warren to reach Mr. Ramsey and to obtain a written response. For these reasons the attached affidavit should be considered.

As an alternative ground for consideration of the affidavit, P.U.C. Proc. R. § 22.203(b)(7) permits the ALJs to seek additional evidence in advance of issuing a proposal for decision. TNMP would ask that the ALJs exercise their authority under that provision and consider this Affidavit in the interest of justice. Justice cannot be served if a decision is made in whole or in part based on incorrect factual information. To assure that all requirements of P.U.C. Proc. R. § 22.203(b)(7) are met, TNMP would present, if requested, Mr. Warren for further cross-examination by telephone on the limited scope of his affidavit.

WHEREFORE, PREMISES CONSIDERED, Applicants respectfully request that the Commission grant its Motion to Supplement the Record.

Respectfully submitted,

Bouis S. Zimmerman

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ATTORNEYS FOR THE APPLICANTS, TEXAS-NEW MEXICO POWER COMPANY, FIRST CHOICE POWER, INC. AND TEXAS GENERATING COMPANY, L.P.

CERTIFICATE OF SERVICE

Counsel for Applicants hereby certify that a true and correct copy of this pleading was served on all parties of record on May 18, 2004, by hand delivery, facsimile transmission, electronic transmission, and/or first class mail.

Bouis S. Zimmerman

Louis S. Zimmerman

AFFIDAVIT

STATE OF NEW YORK

COUNTY OF NEW YORK

BEFORE ME, the undersigned authority, on this day personally appeared James L Warren, known to me to be the person whose name is subscribed to the foregoing instrument, and acknowledged to me that he executed the same for the purposes and consideration therein expressed, whereby he did depose and state the following:

1. My name is James I. Warren. I am of legal age, a resident of the state of New Jersey and competent to make this affidavit. I certify that the following statements, offered by me on behalf of Texas-New Mexico Power Company, First Choice Power, Inc., and Texas Generating Company, L.P. ("Applicants"), are true and correct and based upon my personal knowledge and experience.

2. I filed Rebuttal Testimony and Exhibits on behalf of the Applicants in P.U.C. Docket No. 29206 (SOAH Docket No. 473-04-2459). A summary of my background and experience is provided in that testimony.

3. I attended each day of the final hearing in that docket from April 14 to April 17, 2004, and was in the hearing room when Ms. Ellen Blumethal testified on behalf of the Office of Public Utility Counsel (OPC). Ms. Blumenthal testified that the IRS has revoked a group of private letter rulings in which it held that the flowthrough of accumulated deferred investment tax credit (ADITC) reserves associated with an asset is not permitted after that asset's deregulation or disposition. Tr. at 496, lines 12-17; 497, lines 10-11; 501, line 16 – 502, line 4 (April 15, 2004).

4. Because this is an area in which I represent several clients and to which I devote a substantial amount of my time and because I had never heard any indication whatsoever of the ruling revocations to which she testified, I decided to contact the person at the IRS who was most likely to know definitively whether or not this had, in fact, occurred. This person was Mr. Charles Ramsey, the Branch Chief who leads the group (Branch 6) within the Chief Counsel's Office of the IRS National Office which issued the rulings about which Ms. Blumenthal testified. Mr. David Selig, the alleged source of Ms. Blumenthal's information, is an attorney-advisor, a line position, within Branch 5, the group to which has been assigned the drafting of the proposed normalization regulations but which had not been responsible for the issuance of the referenced private letter rulings. I considered Mr. Ramsey to be a more definitive source of information.

5. On May 5, 2004, I wrote a letter to Mr. Ramsey (Attachment A) asking if the IRS has revoked the referenced rulings. On May 13, 2004, I received a response from Mr. Ramsey (Attachment B) in which he states that the IRS "has not revoked the rulings described either as a group or individually as part of a plan to revoke all or most of them."

EXHIBIT 1

6. Based on the IRS's confirmation of the effectiveness of the private-letter rulings, it is apparent that Ms. Blumenthal was mistaken when she testified that those private-letter rulings had been revoked. As I testified, the federal tax rules in effect today prohibit the flowthrough of ADITC reserves once the associated asset is no longer regulated.

FURTHER AFFIANT SAYETH NOT.

James L Warren

JAMES L. WARREN

Subscribed and sworn to before me on this 18th day of May, 2004.

Argy Tsouklidis

Notary Public in and for the State of New York

ARGY TSOUKLIDIS
Notary Public, State of New York
No. 01TS4773608
Qualified in Queens County
Commission Expires July 31, 20 06

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May 5, 2004

Charles B. Ramsey
Chief - Branch 6 - Passthroughs &
Special Industries
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224-0002

Re: **Regulation Project REG - 104385-01**

Dear Mr. Ramsey:

The SUPPLEMENTARY INFORMATION contained in the Notice of Proposed Rulemaking associated with the above-referenced regulation project states:

> "The Service has issued a number of private letter rulings holding that flowthrough of the EDFIT and ADITC reserves associated with an asset is not permitted after the asset's deregulation, whether by disposition or otherwise. These rulings were based on the principle that flowthrough is permitted only over the asset's regulatory life and when that life is terminated by deregulation no further flowthrough is permitted."

It is my understanding that it was your branch that issued most, if not all, of the rulings described in the excerpt set out above. Could you please advise me as to whether the Service has, as of the date of this letter, revoked the described rulings.

Sincerely,

James I. Warren

James I. Warren

JIW/at

NY #594318 v1

ATTACHMENT A

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

MAY 13 2004

James I. Warren, Esq.
Thelen, Reid & Priest, LLP
875 Third Avenue
New york, NY 10022-6225

Dear Mr. Warren:

This is in response to your letter of May 5, 2004, requesting information regarding certain private letter rulings relating to the flow-through of EDFIT and ADITC reserves. In your letter you cite a provision contained in a recent notice of proposed rule-making that states:

> "The Service has issued a number of private letter rulings holding that flowthrough of the EDFIT and ADITC reserves associated with an asset is not permitted after the asset's deregulation, whether by disposition or otherwise. These ruling were based on the principle that flowthrough is permitted only over the asset's regulatory life and when that life is terminated by deregulation no further flowthrough is permitted."

You have requested information regarding whether the Service has revoked the rulings described in the notice of proposed rulemaking. I cannot discuss whether any individual ruling has been revoked. I can tell you, however, that the Service has not revoked the rulings described either as a group or individually as part of a plan to revoke all or most of them.

Sincerely,

Charles B Ramsey

Charles B. Ramsey
Branch Chief, Branch 6
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

ATTACHMENT B

TOTAL P.02

APPENDIX C

Proposed IRS Reg 104385-01

EXHIBIT
2

00043

Notice of Proposed Rulemaking and Notice of Public Hearing

Application of Normalization Accounting Rules to Balances of Excess Deferred Income Taxes and Accumulated Deferred Investment Tax Credits of Public Utilities Whose Generation Assets Cease to be Public Utility Property

REG-104385-01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that provide guidance on the normalization requirements applicable to electric utilities that benefit (or have benefitted) from accelerated depreciation methods or from the investment tax credit permitted under pre-1991 law. The proposed regulations permit a utility whose electricity generation assets cease to be public utility property to return to their ratepayers the normalization reserves for excess deferred income taxes (EDFIT) and accumulated deferred investment tax credits (ADITC) with respect to those assets. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by June 2, 2003. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for June 25, 2003, at 10 a.m. must be received by June 2, 2003.

ADDRESSES: Send submissions to: CC:PA:RU (REG-104385-01), room 5226, Internal Revenue Service, Post Office Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:PA:RU (REG-104385-01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically by submitting comments directly to the IRS Internet site at *www.irs.gov/regs*. The public hearing will be held in the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, David Selig, at (202) 622-3040; concerning submissions of comments, the hearing, or to be placed on the building access list to attend the hearing, Treena Garrett, at (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) relating to the normalization requirements of sections 168(f)(2) and 168(i)(9) of the Internal Revenue Code (Code), section 203(e) of the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2146), and former section 46(f) of the Code. The proposed regulations respond to changes in the electric power industry resulting from deregulation of electricity generation facilities.

Section 168 of the Code permits the use of accelerated depreciation methods. Section 168(f)(2) provides, however, that accelerated depreciation is permitted with respect to public utility property only if the taxpayer uses a normalization method of accounting for ratemaking purposes.

Under a normalization method of accounting, a utility calculates its ratemaking tax expense using depreciation that is no more accelerated than its ratemaking depreciation (typically straight-line). In the early years of an asset's life, this results in ratemaking tax expense that is greater than actual tax expense. The difference between the ratemaking tax expense and the actual tax expense is added to a reserve (the accumulated deferred federal income tax reserve, or ADFIT). The difference between ratemaking tax expense and actual tax expense is not permanent and reverses in the later years of the asset's life when the ratemaking depreciation method provides larger depreciation deductions and lower tax expense than the accelerated method used in computing actual tax expense.

This accounting treatment prevents the immediate flowthrough to utility ratepayers of the reduction in current taxes resulting from the use of accelerated depreciation. Instead, the reduction is treated as a deferred tax expense that is collected from current ratepayers through utility rates, and thus is available to utilities as cost-free investment capital. When the accelerated method provides lower depreciation deductions in later years, only the ratemaking tax expense is collected from ratepayers and the difference between actual tax expense and ratemaking tax expense is charged to ADFIT, depleting the utility's stock of cost-free capital.

Excess Deferred Income Tax

The Tax Reform Act of 1986 reduced the highest corporate tax rate from 46 percent to 34 percent. The excess deferred federal income tax (EDFIT) reserve is the balance of the deferred tax reserve immediately before the rate reduction over the balance that would have been held in the reserve if the 34 percent rate had been in effect for prior periods. The EDFIT reserves were amounts that utilities had collected from ratepayers to pay future taxes that, as a result of the reduction in corporate tax rates, would not have to be paid.

Section 203(e) of the Tax Reform Act of 1986 specifies the manner in which the EDFIT reserve can be flowed through to ratepayers under a normalization method of accounting. It provides that the EDFIT reserve may be reduced, with a corresponding reduction in the cost of service the utility collects from ratepayers, no more rapidly than the EDFIT reserve would be reduced under the average rate assumption method (ARAM). For taxpayers that did not have adequate data to apply the average rate assumption method, subsequent guidance permitted use of the reverse South Georgia method as an alternative. In general, both the average rate assumption method and the reverse South Georgia method spread the flowthrough of the EDFIT reserve over the remaining lives of the property that gave rise to the excess.

Accumulated Deferred Investment Tax Credits (ADITC)

Former section 46 of the Code similarly limited the ability of ratepayers to benefit from the investment tax credit determined under that section. Under former section 46(f)(2), an electing utility could flow through the investment credit ratably (that is, could reduce the cost of service collected from ratepayers by a ratable portion of the credit) over the investment's regulatory life. The balance of the credit remaining to be flowed through to ratepayers would be held in a reserve for accumulated deferred investment tax credits (ADITC). If the utility elected ratable flowthrough of the credit, the rate base (the amount on which the utility is permitted to collect a return from ratepayers) could not be reduced by reason of any portion of the credit.

Deregulation of Generation Assets

When the normalization provisions were added to the Internal Revenue Code, electric utilities were vertically integrated to include generation, transmission, and distribution functions. Accelerated depreciation, investment credits, and normalization enhanced the cash flow needed to acquire and construct new generation assets. Driven by changes in technology and economics, however, the electric industry has been undergoing substantial changes. Many utilities have been selling generation assets to new entities that are not subject to rate of return regulation and are becoming transmission and distribution (or distribution-only) companies. In many cases, the deregulation of generation assets is occurring before the EDFIT and ADITC reserves associated with those assets have been flowed through to ratepayers.

The Service has issued a number of private letter rulings holding that flowthrough of the EDFIT and ADITC reserves associated with an asset is not permitted after the asset's deregulation, whether by disposition or otherwise. These rulings were based on the principle that flowthrough is permitted only over the asset's regulatory life and when that life is terminated by deregulation no further flowthrough is permitted. After further consideration, the Service and Treasury have concluded that neither former section 46(f)(2) nor section 203(e) of the Tax Reform Act suggests that the EDFIT and ADITC reserves should not ultimately be flowed through to ratepayers. Instead, Congress provided a schedule for flowing through the reserves so that utilities would have the benefit of cost-free capital for a predictable period.

The proposed regulations provide that utilities whose generation assets cease to be public utility property, whether by disposition, deregulation, or otherwise, may continue to flow through EDFIT and ADITC reserves associated with those assets without violating the normalization rules. The rate of flowthrough is limited, however, to the rate that would have been permitted if the assets had remained public utility property and the taxpayer had continued to use a normalization method of accounting (or ratable flowthrough of the credit) with respect to the assets. This result does not impose on utilities any burden unanticipated prior to deregulation and provides the flowthrough originally anticipated by ratepayers, utility commissions, and utilities.

Comments Requested

In addition to comments relating to this notice of proposed rulemaking, comments are requested on the proper disposition of tax reserves (ADFIT, EDFIT, and ADITC) under the following set of facts. Regulated transmission assets from several public utilities (related or otherwise) are transferred to a utility partnership. This partnership is created solely as a transmission company. The transaction is subject to section 721 of the Code. The transmission assets are public utility property before the transfer and will be public utility property after the transfer. Is there a normalization violation if the deferred tax reserves are transferred to the new transmission company's regulated books and are considered in setting rates for the new transmission company? Alternatively, is there a normalization violation if the deferred tax reserves remain on the transferors' regulated books and are considered in setting their rates?

In addition, the proposed regulations do not address the treatment of deregulated assets under former section 46(f)(1) (relating to the use of the investment credit to reduce the rate base of electing taxpayers). Comments are also requested on this issue.

Proposed Effective Date

The regulations are proposed to apply to property that becomes deregulated generation property after March 4, 2003. In addition, a utility may elect to apply the proposed rules to property that becomes deregulated generation property on or before March 4, 2003. The election is made by attaching a written statement to the utility's return for the tax year in which the proposed rules are published as final regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted (in the manner described in the ADDRESSES caption) timely to the IRS. All comments will be available for public inspection and copying. Treasury and IRS specifically request comments on the clarity of the proposed regulations and how they may be made clearer and easier to understand.

A public hearing has been scheduled for June 25, 2003, at 10 a.m. in the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 30 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit comments and submit an outline of the topics to be discussed and the time to be devoted to each topic by June 2, 2003.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is David Selig, Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.46–6 is amended by adding paragraph (k) to read as follows:

§1.46–6 Limitation in case of certain regulated companies.

* * * * *

(k) Treatment of accumulated deferred investment tax credits upon the deregulation of regulated generation assets—(1) *Scope.* This paragraph (k) provides rules for the application of former section 46(f)(2) of the Internal Revenue Code with respect to public utility property that is used in electric generation and ceases, whether by disposition, deregulation, or otherwise, to be public utility property (deregulated generation property).

(2) *Amount of reduction.* If public utility property of a taxpayer becomes deregulated generation property to which this section applies, the reduction in the taxpayer's cost of service permitted under former section 46(f)(2) is equal to the amount by which the cost of service could be reduced under that provision if all such property had remained public utility property of the taxpayer and the taxpayer had continued to reduce its cost of service by a ratable portion of the credit with respect to such property.

(3) *Cross reference.* See §1.168(i)–(3) for rules relating to the treatment of balances of excess deferred income taxes when utilities dispose of regulated generation assets.

(4) *Effective date*—(i) *General rule.* This paragraph (k) applies to property that becomes deregulated generation property after March 4, 2003.

(ii) *Election for retroactive application.* A utility may elect to apply this paragraph (k) to property that becomes deregulated generation property on or before March 4, 2003. The election is made by attaching the statement "ELECTION UNDER §1.46–6(k)" to the taxpayer's return for the tax year in which this paragraph (k) is published as a final regulation.

Par. 3. Section 1.168(i)–3 is added to read as follows:

§1.168(i)–(3) Treatment of excess deferred income tax reserve upon disposition of regulated generation assets.

(a) *Scope.* This section provides rules for the application of section 203(e) of the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2146) with respect to public utility property that is used in electric generation and ceases, whether by disposition, deregulation, or otherwise, to be public utility property (deregulated generation property).

(b) *Amount of reduction.* If public utility property of a taxpayer becomes deregulated generation property to which this section applies, the reduction in the taxpayer's excess tax reserve permitted under section 203(e) of the Tax Reform Act of 1986 is equal to the amount by which the reserve could be reduced under that provision if all such property had remained public utility property of the taxpayer and the taxpayer had continued use of its normalization method of accounting with respect to such property.

(c) *Cross reference.* See §1.46–6(k) for rules relating to the treatment of accumulated deferred investment tax credits when utilities dispose of regulated generation assets.

(d) *Effective date*—(1) *General rule.* This section applies to property that becomes deregulated generation property after March 4, 2003.

(2) *Election for retroactive application.* A taxpayer may elect to apply this section to property that becomes deregulated generation property on or before March 4, 2003. The election is made by attaching the statement "ELECTION UNDER §1.168(i)–3" to the taxpayer's return for the tax year in which this section is published as a final regulation.

David Mader,
Assistant Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on March 3, 2003, 8:45 a.m., and published in the issue of the Federal Register for March 4, 2003, 68 F.R. 10190)

FIGURE RWH-R23
PLR 8828005

Westlaw.

Internal Revenue Service (I.R.S.)

Private Letter Ruling

Issue: July 15, 1988

Section 46 -- Amount of Credit

46.00-00 Amount of Credit

46.07-00 Alternative Limitations

Section 168 -- (Repealed-1976 Act) Amortization of Emergency Facilities

168.00-00 (Repealed-1976 Act) Amortization of Emergency Facilities

In re: * * *

Dear * * *

In a previous letter we modified a private letter ruling originally issued to the taxpayer on * * * (No.: 8730013). The modified letter ruled that where 'public utility property is removed from Affiliates' regulatory books of account, the deferred tax reserve attributable to such property must also be removed from the regulatory books, and no final regulatory order may be used, directly or indirectly, to reduce Affiliates' rate base or cost of service (or treat it as no cost capital).' Your letter dated * * * indicates that a state regulatory commission has argued that, under this ruling, the excess tax reserve created by the rate change (from 46 percent to 34 percent) in the Tax Reform Act of 1986 (Act) may be immediately flowed through without violating the normalization requirements of the Internal Revenue Code. However, this would be an incorrect interpretation of the ruling. The ruling is intended to apply to the entire deferred tax reserve attributable to the public utility property removed from the Affiliates' regulatory books of account. This would include the 'excess tax reserve,' as defined by section 203(e)(2)(A) of the Act. Accordingly, we are clarifying ruling 1 on page 8 of the * * * ruling letter, as modified by our previous letter, to provide as follows:

1. Where, as the result of deregulation legislation in States A through J, public utility property is removed from Affiliates' regulatory books of account, the entire deferred tax reserve attributable to such property, accumulated pursuant to sections 167(l) and 168(e)(3) of the Code, including the 'excess tax reserve' as defined by section 203(e)(2)(A) of the Tax Reform Act of 1986, must