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expensing of the asset, all timing differences would reverse and the EDFIT balance could benefit customers consistent with the ARAM.

This result is supported by the holding in Rev. Rul. 86-118. This ruling addressed whether the normalization requirements of Code §46(f)(2) were violated by a telephone company that, pursuant to a regulatory order, expensed the cost of inside wiring (a capital expenditure for federal income tax purposes) and, in the year of the expense, reduced its cost of service by the full amount of the ITC generated by the wiring. In ruling that Code §46(f)(2) was not violated, the Service acknowledged that the requirement to expense the cost of inside wiring in the year incurred for ratemaking purposes was not a method of depreciation and therefore, that it was not "immediately obvious" what period of time should be treated as being used in computing the taxpayer's regulated depreciation expense. It reasoned, however:

> ...the essence of ratable flow-through under the sections of the Code and regulations cited above is to match the periods in which the ITC reduces cost of service with the periods in which cost of service is increased by the cost of the item that gives rise to the credit. This principle can be applied not only when the item is depreciated for regulatory purposes but also when it is expensed. Therefore, the ratable flow-through limitation is satisfied if the investment tax credit is used to reduce cost of service in the same period that cost of service is increased by expensing the item that gives rise to the credit. If the cost of service is increased for ratemaking purposes by the total cost of the item in the year the item is placed in service, the full amount of the ITC may be used to reduce the cost of service in that year.

In addition, the Service has viewed certain regulatory treatment as the equivalent of regulatory depreciation for purposes of the normalization rules in several instances. In Notice 87-82, the Service used such an analysis in addressing the normalization

[5] Note that, in LTR 8735011, the Service made reference to the possibility of a "double recovery" of ADITC. This is, obviously, not a possibility in Taxpayer's context.

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requirements for CIACs made taxable by the '86 Act. For tax purposes, a utility includes taxable CIACs in income, takes a basis in the CIAC equal to the amount included in income, and depreciates it over the applicable recovery period. For regulatory purposes, a utility typically disregards the receipt of CIACs and does not include them in income, cost of service or rate base. In the Notice, the Service concluded that, for purposes of the normalization rules, this situation was the equivalent of including a CIAC in book income in the year of receipt and depreciating the related CIAC property in its entirety in the same year. Accordingly, it determined that:

> ...a utility using the noninclusion method of accounting for a CIAC will be treated for purposes of the normalization rules as if it computed its regulated tax expense by depreciating the related CIAC property in its entirety in the year in which the CIAC is received. The Internal Revenue Service believes that this treatment is consistent with the noninclusion method of accounting and is necessary in order to carry out the purpose of the normalization rules.

Thus, the Notice reflects a rather liberal view of what constitutes depreciation for purposes of the normalization rules.

A similar use of such a liberal view is reflected in LTR 8922008 - the exception referred to in footnote 4 above. In that ruling, an electric utility engaged in the sale and leaseback of a generating plant and requested guidance as to its ability to amortize the unrecaptured ADITC balance related to the plant for the benefit of customers. The Service noted that the customers continued to bear the cost of the plant through the inclusion of lease payments in the taxpayer's cost of service. It therefore concluded that, notwithstanding that the plant was no longer depreciated for regulatory purposes, for purposes of the ITC normalization rules, the lease term could be considered the regulatory

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life of the plant and the ADITC could be amortized over that term consistent with the normalization rules. In short, it viewed regulatory depreciation in a particularly liberal light to accomplish a result which was consistent with the normalization rules.

Most recently, LTRs 9852028 and 9852030 addressed a situation in which certain generation-related costs were determined by the taxpayer's regulators to be "sunk costs" (apparently conceptually identical to Taxpayer's "stranded costs"). These sunk costs were allowed to be collected from customers through a nonbypassable wires charge (again, just as in Taxpayer's situation). It appears as though the assets themselves were no longer to be depreciated for regulatory purposes. However, the "sunk costs" were to be amortized over a designated period. Notwithstanding that asset depreciation was displaced by sunk cost amortization, the Service permitted the taxpayer to amortize the ADITC associated with the generation assets for the benefit of customers. Once again, the Service did not stand on the depreciation formality.

The mere mechanical inability to pass tax benefits through to customers after the sale is, in fact, the reddest of herrings. The mechanical issues associated with asset sales can easily be addressed in such a way that the relevant tax attributes could be given to customers consistent with these mechanical provisions of the normalization rules. The sale transaction can be viewed as giving rise to instantaneous and complete depreciation of the Station assets, thereby allowing both ADITC and EDFIT balances to benefit customers immediately.

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E. Because Customers Will Bear The Costs Of Restructuring, The Normalization Rules Permit The Assignment Of EDFIT And ADITC To Them:

GCM 39656 goes beyond an analysis of the mechanics of the normalization rules and references (albeit, in a footnote) the policy consideration which governs the asset sale situation. The footnote states:

> Flowing the remaining accumulated investment tax credits through to the transferor's customers immediately after the transfer might avoid this statutory problem, but it would be contrary to the purposes of the normalization rules. That is, the company would no longer receive any benefit from the credits.

Of course, this prohibition is implicit in the conclusions of all of the other rulings which denied benefits to customers. Code §§203(e) and 46(f) impose limitations on how *rapidly* the benefit can be provided to customers. There is never a restriction on how *slowly* these benefits can be provided (or, indeed, if the benefits have to be provided to customers at all). Thus, if a seller of assets could provide the benefit of EDFIT and ADITC balances to customers immediately, clearly it would have to be permissible to provide those benefits over time. By repeatedly ruling that this latter could not be accomplished consistent with the normalization rules, the Service must have implicitly concluded that it can't be accomplished over any more rapid time framework.

Unfortunately, the GCM 39656 footnote never explicitly explains *why* it is that providing EDFIT and ADITC benefits to customers after an asset sale produces an unacceptable result under the normalization rules. However, the explanation can be extracted from elsewhere in the document. In this regard, the GCM states:

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> Further, it is appropriate to end the flow-through to the transferor's customers when the property is transferred because the transferor's customers no longer bear the cost of the property once it is transferred. The cost of the property is no longer taken into account in determining the rate base. The remaining accumulated investment tax credits relate to property that is no longer regulated utility property of the transferor utility. Since the remaining accumulated investment tax credits do not relate to regulated utility property owned by the transferor, the transferor should not be required to pass the credits through to its customers by reducing the regulated rate.

In short, the customers can't get the benefits because they do not bear the continuing cost of the asset. This notion of continued cost responsibility is also at the heart of the rationale reached in LTR 8922008. In that ruling, the Service explicitly contrasted the sale/leaseback situation in which the customers continued to support the plant through lease payments with an outright sale where this would not be the case.

The significance of cost responsibility is well developed within the normalization rules. The Service has issued a number of letter rulings addressing the extent to which tax benefits associated with costs which have been disallowed in the ratemaking process (and are, therefore, borne by shareholders, not customers) can nevertheless be passed through to customers. Most of these rulings have been issued in the context of disallowances of generation plant costs. The Service has consistently ruled that the tax benefits flowing from public utility property must be allocated to those, and only to those, who bear the costs of that property. To do otherwise would constitute a violation of the normalization rules. *See,* LTRs 9613004, 9552007, 9547008, 9312007, 90445014.

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Similarly, in several rulings regarding the consequences under the normalization rules of asset deregulation, the Service has ruled that the deferred tax benefits associated with the assets deregulated must not be provided to customers - ever. Again, where assets are removed from the regulated books of account, customers bear no continuing cost responsibility. *See*, LTRs 8920025, 8828005, 8730013.

In fact, regulatory depreciation represents the hallmark of cost responsibility. So long as the asset is being depreciated for regulatory purposes, customers are clearly funding at least the capital costs of the asset. The leap that the Service has made in its ruling posture is that, where there is no further regulatory depreciation, customers are not bearing such costs as would allow them access to the related tax benefits. This is not an accurate premise, particularly in the context of Taxpayer's overall restructuring.

For normalization purposes, the sale of an asset where it constitutes a single component of the computation of stranded costs which will be borne by customers is analogous neither to the regulatory disallowance of plant costs nor to the deregulation of assets (*i.e.*, their complete removal from the regulatory books of account). In the case of a cost disallowance, asset costs that were previously being borne by customers are transferred *in toto* to shareholders. Thus, the tax benefits flowing from disallowed costs are clearly allocable to shareholders and only shareholders because they are the only ones bearing the costs of the associated assets. Removal of the costs of an asset from the regulated books of account by virtue of the asset's deregulation presents precisely the same economic situation.

By contrast, Taxpayer's sale of the Stations in the context of its restructuring merely substitutes one asset (cash or whatever the consideration is) for another (the asset sold). The shareholders shoulder no incremental cost by virtue of the sale.[6] Thus, there exists no reason to employ the normalization rules to deny customers these benefits.

F. **A Fresh Analysis Of The Normalization Rules Is Required Because Those Rules Have Never Previously Been Applied To A Situation Like The Taxpayer's:**

The normalization rules were promulgated the better part of thirty years ago. They were designed in the context of a regulatory and a business environment which, to a significant extent, no longer exists. The several changes to these rules made over time (*e.g.*, Act §203(e), the "inconsistent estimates" language of §168(I)(9)(B) added in 1982) were little more than "spot repairs". They were necessary to incorporate certain regulatory and tax law changes into the mix, but they failed to foresee the basic changes now underway in the electric industry and inadequately positioned the rules for application to these changes. These changes go well beyond the disposition of an asset or two. Taxpayer's situation is, in fact, qualitatively different from those "sale" transactions addressed by the Service in prior rulings. The application of the normalization rules in this instance must recognize this.

Even as "repaired", the normalization rules continue to serve a single, fundamental purpose. They are intended to control the regulatory extraction of the benefits of

[6] The disallowance of stranded costs would, however, represent a situation which *would* be analogous to a regulatory cost disallowance.

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accelerated depreciation and ITC in ways that defeat the purposes of these capital formation incentives. Now, as always, these purposes are accomplished so long as (1) cost responsibility continues to govern the extent to which benefits can be provided to customers and (2) those benefits that can be provided must be provided in designated ways and over designated periods of time. Application of the normalization rules to Taxpayer's situation should be viewed with these purposes clearly in mind.

Throughout their entire productive lives while owned by Taxpayer, customers supported the Stations. Why, then, should the normalization rules operate to restrict their access to the associated tax benefits? The tax policy considerations that operate in the disallowance and deregulation context are simply not relevant in Taxpayer's restructuring context. Taxpayer has applied to the DPUC to have its customers support *all* net stranded costs related to its generation assets. Stranded costs are determined through a regulatory proceeding in which the fair market values (positive or negative) of all of Taxpayer's generation-related costs and commitments (including the generating assets it owns outright, the generating assets in which it owns an interest, its contractual obligations to purchase power and its generation-related regulatory assets) are determined based on the evidence presented. These values are measured against the "book costs" of those costs and commitments.[7] Taxpayer is, by statute, permitted to recover the net shortfall through the rate regulation process. An unnecessarily narrow reading of the normalization rules would place Taxpayer in the position of requesting recovery of hundreds of millions of dollars of such costs but, at the same time, denying customers the tax benefits of at least

[7] In the case of the Stations, the sales price determined the value.

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some of these costs. So long as the recovery of stranded costs remains an obligation of Taxpayer's customers pursuant to cost based rates, then amortization of the EDFIT and ADITC over the stranded cost recovery period does not represent an appropriate circumstance for the normalization rules to impinge upon appropriate ratemaking practices. Such an incursion would be gratuitous where there is no tax policy which requires it. And there is none.

The Service has started down the appropriate path by its issuance of LTRs 9852028 and 9852030. In those rulings, customers who were bearing full responsibility for the generation-related costs determined to be "sunk" were given access to the tax benefits (specifically, the ADITC) generated by those costs. This result represents yet another example of the primacy of cost responsibility and the harmonious workings of the principles of regulation and the normalization rules. Taxpayer proposes to provide the EDFIT and ADITC benefits to its customers ratably over the period during which it amortizes its net stranded costs. This would be entirely consistent with the fundamental premise of the normalization rules - both as to availability and timing of benefits.

G. Conclusion:

For the reasons stated above, the Service should grant Taxpayer's rulings in the forms requested.

H. PROCEDURAL MATTERS REQUIRED BY REV. PROC. 99-1

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Statement pursuant to Sec. 8.01(4):

To the best of the knowledge of Taxpayer and its representatives, the identical issues are not in an earlier return of Taxpayer (or in a return for any year of a related taxpayer within the meaning of §267 or a member of an affiliated group of which Taxpayer is also a member within the meaning of §1504).

Statements pursuant to Sec 8.01(5):

(a) - To the best of the knowledge of Taxpayer and its representatives, the Service has not previously ruled on the same or a similar issue for Taxpayer, a related taxpayer (within the meaning of §267 or a member of an affiliated group of which Taxpayer is also a member within the meaning of §1504) or a predecessor.

(b) - To the best of the knowledge of Taxpayer and its representatives, Taxpayer, a related taxpayer or a predecessor or any representatives have not previously submitted a request (including an application for change in accounting method) involving the same or a similar issue to the Service but withdrew the request before a letter ruling or determination letter was issued.

(c) - To the best of the knowledge of Taxpayer and its representatives, Taxpayer, a related taxpayer or a predecessor have not previously submitted a request (including an application for change in accounting method) involving the same or a similar issue that is currently pending with the Service.

(d) - To the best of the knowledge of Taxpayer and its representatives, neither Taxpayer nor a related taxpayer is presently submitting another request (including an application for change in accounting method) involving the same or a similar issue to the Service.

Statement pursuant to Sec. 8.01(6):

The law in connection with this request is uncertain and the issues described herein are not adequately addressed by relevant authorities.

Statement pursuant to Sec. 8.01(7):

Taxpayer has referenced and/or discussed all known authorities relevant to the issue presented.

Statement pursuant to Sec. 8.01(8):

There is no pending legislation that may affect the proposed transaction.

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Request for a Conference pursuant to Sec. 8.02(6):

A conference is requested should your office tentatively conclude that any of the requested rulings may not be granted.

Statement pursuant to Sec. 9(01):

The regulatory authority responsible for establishing or approving Taxpayer's rates has reviewed this request and believes that it is adequate and complete (See Exhibit E) and Taxpayer will permit the regulatory authority to participate in any national office conference concerning this request.

Taxpayer has no objection to the participation of the OCC and the CIEC in any National Office conference held concerning this request to the extent permitted by law and will undertake any procedural steps necessary to facilitate such participation.

Power of Attorney:

An executed Form 2848, Power of Attorney and Declaration of Representative, authorizing the undersigned to represent Taxpayer in connection with this ruling request is attached as Exhibit C.

If further information is required, or if any questions should arise, please call James I. Warren at (212) 259-5290.

Respectfully submitted,

James I. Warren
PricewaterhouseCoopers LLP
Counsel for The United Illuminating Company

Enclosures

PENALTIES OF PERJURY STATEMENT

Revenue Procedure Sec. 8.01(13)

Under penalties of perjury, I declare that I have examined this request, including accompanying documents, and, to the best of my knowledge and belief, the request contains all the relevant facts relating to the request, and such facts are true, correct, and complete.

The United Illuminating Company

By: James L. Benjamin

Title: Controller

Date: 7/15/99

SOAH DOCKET NO. 473-05-7455
PUC DOCKET NO. 31056

APPLICATION OF AEP TEXAS	§	**PUBLIC UTILITY COMMISSION**
CENTRAL COMPANY AND CPL	§	
RETAIL ENERGY, LP TO DETERMINE	§	
TRUE-UP BALANCES PURSUANT TO	§	**OF**
PURA §39.262 AND PETITION TO	§	
DETERMINE AMOUNT OF EXCESS	§	
MITIGATION CREDITS TO BE	§	**TEXAS**
REFUNDED AND RECOVERED	§	

AEP TEXAS CENTRAL COMPANY'S RESPONSE TO CITIES' THIRTY-SECOND REQUEST FOR INFORMATION

Question No. 32-MA-11:

Referring to TCC's response to AVH 3-36, provide the date of the United Illuminating PLR request.

Response No. 32-MA-11:

See copy of ruling request submitted in Cities' Thirty-Second Request for Information, Question No. 32-MA-10.

Prepared By: James I. Warren Title: Attorney
Sponsored By: James I. Warren Title: Attorney

SOAH DOCKET NO. 473-05-7455
PUC DOCKET NO. 31056

APPLICATION OF AEP TEXAS CENTRAL COMPANY AND CPL RETAIL ENERGY, LP TO DETERMINE TRUE-UP BALANCES PURSUANT TO PURA §39.262 AND PETITION TO DETERMINE AMOUNT OF EXCESS MITIGATION CREDITS TO BE REFUNDED AND RECOVERED	§ § § § § § § §	PUBLIC UTILITY COMMISSION OF TEXAS

AEP TEXAS CENTRAL COMPANY'S RESPONSE TO CITIES' THIRTY-SECOND REQUEST FOR INFORMATION

Question No. 32-MA-12:

Referring to TCC's response to AVH 3-36 and the Texas-New Mexico Power case, is it correct that the utility has an obligation to report to the IRS if it thinks a normalization violation has occurred? If not, why not? If yes, why hasn't TNMP reported a normalization violation to the IRS if it feels that the PUC's ruling represents a normalization violation?

Response No. 32-MA-12:

Regulations section 1.46-6, the regulation that applies in the case of a violation of the ITC normalization rules, provides in pertinent part:

(f) *Limitations*

(1) *In general.* --This paragraph provides rules relating to limitations on the disallowance of credits under section 46(f)(4). Key terms are defined in paragraphs (f)(7), (8), and (9) of this section.

(2) *Disallowance postponed.* --There is no disallowance of a credit before the first final inconsistent determination is put into effect for the taxpayer's section 46(f) property.

(3) *Time of disallowance.* --A credit is disallowed --

(i) When the first final inconsistent determination is put into effect and

(ii) When any inconsistent determination (whether or not final) is put into effect after the first final inconsistent determination is put into effect.

(4) *Credits disallowed.* --A credit is disallowed for section 46(f) property placed in service (within the meaning of §1.46-3(d)) by the taxpayer --

(i) Before the date any inconsistent determination described in paragraph (f)(2) of this section is put into effect and

(ii) On or after such date and before the date a subsequent consistent determination (whether or not final) is put into effect.

(5) *Barred years.* --No amount of credit for a taxable year is disallowed under paragraph (f)(3) of this section if, for such year, assessment of a deficiency is barred by any law or rule of law.

(6) *Notification and other requirements.* --The taxpayer shall notify the district director of a disallowance of a credit under paragraph (f)(3) of this section within 30 days of the date that the applicable determination is put into effect. In the case of such a disallowance, the taxpayer shall recompute its tax liability for any affected taxable year, and such recomputation shall be made in the form of an amended return where necessary.

(7) *Determinations.* --For purposes of this paragraph, the term "determination" refers to a determination made with respect to section 46(f) property (other than property to which an election under section 46(f)(3) applies) by a regulatory body described in section 46(c)(3)(B) that determines the effect of the credit --

(i) For purposes of section 46(f)(1), on the taxpayer's cost of service or rate base for ratemaking purposes or

(ii) In the case of a taxpayer that made an election under section 46(f)(2), on the taxpayer's cost of service, for ratemaking purposes or in its regulated books of account, or on the taxpayer's rate base for ratemaking purposes.

A regulatory body does not have to take affirmative action to make a determination. Thus, a regulatory body's failure to take action on a rate schedule filed by a taxpayer is a determination if the rates can be put into effect without further action by the regulatory body.

(8) *Types of determinations.* --For purposes of this paragraph --

(i) The term "inconsistent" refers to a determination that is inconsistent with section 46(f)(1) or (2) (as the case may be). Thus, for example, a determination to reduce the taxpayer's cost of service by more than a ratable portion of the credit would be a determination that is inconsistent with section 46(f)(2). As a further example, such a determination would also be inconsistent if section 46(f)(1) applied because no reduction in cost of service is permitted under section 46(f)(1).

(ii) The term "consistent" refers to a determination that is consistent with section 46(f)(1) or (2) (as the case may be).

(iii) The term "final determination" means a determination with respect to which all rights to appeal or to request a review, a rehearing, or a redetermination have been exhausted or have lapsed.

(iv) The term "first final inconsistent determination" means the first final determination put into effect after December 10, 1971, that is inconsistent with section 46(f)(1) or (2) (as the case may be).

(9) *Put into effect*. --A determination is put into effect on the later of --

(i) The date it is issued (or, if a first final inconsistent determination, the date it becomes final) or

(ii) The date it becomes operative.

Thus, there is a notice requirement - under certain circumstances.

Mr. Warren does not know enough regarding the status of Texas-New Mexico Power's current situation to ascertain whether or not it has an obligation to provide notice under the above-cited regulation.

Prepared By:	James I. Warren	Title:	Attorney
Sponsored By:	James I. Warren	Title:	Attorney

SOAH DOCKET NO. 473-05-7455
PUC DOCKET NO. 31056

APPLICATION OF AEP TEXAS CENTRAL COMPANY AND CPL RETAIL ENERGY, LP TO DETERMINE TRUE-UP BALANCES PURSUANT TO PURA §39.262 AND PETITION TO DETERMINE AMOUNT OF EXCESS MITIGATION CREDITS TO BE REFUNDED AND RECOVERED	§ § § § § § § §	**PUBLIC UTILITY COMMISSION OF TEXAS**

AEP TEXAS CENTRAL COMPANY'S RESPONSE TO CITIES' THIRTY-SECOND REQUEST FOR INFORMATION

Question No. 32-MA-13:

Referring to TCC's response to Staff DT 1-2, what is the basis for the statement that final regulations are expected to be issued shortly? Provide copies of any IRS correspondence or other documentation supporting this assertion.

Response No. 32-MA-13:

The issuance of the final normalization regulations was reflected on the IRS/Treasury Guidance plan for the period 7/1/04 through 6/30/05. This indicates that their own internal target date for finalization of the regulations was on or before June 30, 2005. Obviously, this deadline was missed. The finalization has now been placed on the IRS/Treasury Guidance Plan for the period 7/1/05 through 6/30/06.

Prepared By: James I. Warren Title: Attorney
Sponsored By: James I. Warren Title: Attorney