Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Date:
May 11, 2006

Taxpayer =
Parent =
State =
A =
B =
C =

D =

E =
F =
G =
H =
I =
J =
K =
L =
M =
N =

Dear :

This letter responds to a letter dated October 15, 2002, and supplemental information, submitted on behalf of Taxpayer for a determination as to the normalization requirements under former § 46(f)(2) of the Internal Revenue Code and § 203(e) of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 63 (the "Act"), for the accumulated deferred investment tax credit ("ADITC") associated with certain generation assets that were sold by Taxpayer.

FACTS

Taxpayer represents that the facts are as follows:

Taxpayer is an investor-owned electric and gas transmission and distribution utility delivering electricity and gas to customers in State. Taxpayer is subject to the regulatory jurisdiction of the A with regards to its terms and conditions of service, including the rates it can charge for the provision of service. Taxpayer is a member of an affiliated group headed by Parent and files a consolidated federal income tax return with Parent.

Taxpayer made the election to use the ratable flow-though method of normalizing its investment tax credits under former § 46(f)(2).

On B, the A issued a C. This C, in conjunction with the resulting legislation D, strongly encouraged Taxpayer to dispose of its electric generation-related assets and liabilities as well as its wholesale power purchase contracts in order to create an industry structure that would allow for the eventual transition of the State market for electric power to a fully competitive market.

On E, Taxpayer filed a comprehensive restructuring proposal ("Proposal") with the A. On F, an Administrative Law Judge issued an Initial Decision and Report ("ID&R") in connection with the Proposal. On G, Taxpayer entered into a Stipulation with a number of the parties interested in Taxpayer's restructuring regarding certain aspects of the Proposal. On H, the A issued a Final Decision and Order ("FD&O"), which contained a number of relevant provisions. These are: (1) quantification of Taxpayer's stranded costs; (2) two mechanisms to recover Taxpayer's stranded costs; (3) quantification of the value of Taxpayer's generation assets; and (4) authorization for Taxpayer to sell its generation assets for full value, as determined by the A in its FD&O, to I, an unregulated affiliate of Taxpayer which is a disregarded entity all of whose membership interests are owned by Parent.

At the date of the Stipulation, Taxpayer had approximately $J of ADITC attributable to its generation assets. Neither the Stipulation nor the FD&O provided for the disposition of this amount upon the impending sale of the assets. Fearing such disposition may result in a violation of the investment tax credit normalization rules, the FD&O required Taxpayer to seek a ruling from the Internal Revenue Service to determine whether or not the value of the ADITC can legitimately be credited to customers without violating the tax normalization policies of the Internal Revenue Service to the detriment of the Taxpayer and the customers, and to provide a copy of that letter ruling once received from the Internal Revenue Service to the A and the K.

Pursuant to the FD&O, on L, Taxpayer sold its generation assets to I. Taxpayer's obligation to seek a ruling from the Internal Revenue Service regarding the consequences under the investment tax credit normalization rules of the sale of its generation assets was reiterated in an Order issued by the A on M in connection with Docket No. N.

RULING REQUESTED

Taxpayer requests the Internal Revenue Service to rule on the following issue:

Taxpayer will not violate the requirements of the investment tax credit normalization rules set forth in former § 46(f) if it credits to customers the ADITC associated with the generating assets that have been sold to I as a part of Taxpayer's restructuring.

LAW AND ANALYSIS

Former § 46(f) 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 ratemaking 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 ratemaking 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) 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 Income Tax Regulations, "ratable" for purposes of former § 46(f)(2) 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 depreciation expense. A method of reducing is ratable if the amount to reduce cost of service is allocated ratably 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) 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 former § 46(f)(2) 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 customers by amortizing those ADITC amounts over the period Taxpayer recovers stranded costs from its customers.

CONCLUSIONS

Hence, in the ruling requested by Taxpayer, there would be a normalization violation if the remaining unamortized ADITC balances (or a proportionate part thereof) existing at the date of sale are returned to customers by amortizing those amounts over the period Taxpayer recovers stranded costs from its customers. Because 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 customers by amortizing those ADITC amounts over the period Taxpayer recovers stranded costs from its customers.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the power of attorney, we are sending a copy of this letter to Taxpayer's authorized representatives. We are also sending a copy of this letter to the Industry Director, Natural Resources and Construction (LM:NRC).

Sincerely,

PETER C. FRIEDMAN

Peter C. Friedman
Senior Technician Reviewer, Branch 6
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
6110 copy
copy for return

cc: