EXHIBIT NO. ___(EMM-20)
DOCKET NO. UE-072300/UG-072301
2007 PSE GENERAL RATE CASE
WITNESS: ERIC M. MARKELL

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY, INC.,** **Respondent.**	**Docket No. UE-072300** **Docket No. UG-072301**

SEVENTH EXHIBIT (NONCONFIDENTIAL) TO THE PREFILED REBUTTAL TESTIMONY OF ERIC M. MARKELL ON BEHALF OF PUGET SOUND ENERGY, INC.

JULY 3, 2008

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Re: Unrelated Person Definition in Section 45(e)(4)

Gentlemen:

On behalf of the undersigned coalition of regulated utilities, I thank you in advance for your consideration of the following proposal for guidance clarifying the unrelated person requirement of section 45(e)(4) of the Internal Revenue Code.[1]

I. Industry Background

During the last several years, the generation of cost-effective renewable energy has become increasingly important to utilities all across the United States. With Congress and many of the states considering or adopting new laws requiring the

[1] All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise noted.

acquisition of renewable resources, utilities are seeking new methods for acquiring projects and structuring ownership agreements that will maximize the benefit of the REPTC for their customers and minimize energy supply costs. An important public policy goal for many regulated utilities is to be able to structure renewable projects in a variety of ways without running afoul of certain restrictions associated with the section 45 production tax credit. One such impediment is section 45(a)(2)(B), which requires electricity generated by a renewable project be sold to an unrelated person in order to qualify for the credit. In practice, this has limited the ability of regulated utilities to enter into business partnerships with other investors to develop renewable sources of energy. To address this problem, 13 investor-owned utilities representing over 20 million customers throughout the United States joined together in 2007 to seek a change to the unrelated person requirement. These utilities are AEP, Alliant Energy, Avista Corporation, MDU Resources Group, MidAmerican Energy Holdings Company, Minnesota Power, PG&E Corporation, Pinnacle West, PNM Resources, Portland General Electric, Puget Sound Energy, Wisconsin Energy, and Xcel Energy. — now more 8 others: Dominion, So Cal,

II. Overview of Issue

As a component of the general business credit in section 38, section 45(a) provides a credit for electricity that is produced by the taxpayer from certain renewable resources (the "REPTC"). In order to qualify for the credit, the electricity must be sold by the taxpayer to an unrelated person.[2] Section 45(a)(2)(B). This restriction effectively prevents regulated utilities that develop renewable energy facilities in partnership with third parties from qualifying for the credit. This is because any electricity produced by such partnerships must first be sold back to the regulated utility, *i.e.,* a related person (assuming the utility has a greater than 50% ownership interest in the partnership), before being sold to utility customers.

It is important that regulated utilities have flexibility in structuring their ownership of renewable resource facilities for a number of reasons. First, as mentioned above, regulated utilities are now subject to renewable portfolio standard ("RPS") requirements in nearly half the states, with more states, and possibly the Federal Government, likely to follow suit. Utilities need access to the REPTC to help offset the cost of more expensive renewable energy, and the ability to develop renewable energy facilities through related entities would allow utilities access to important equity capital sources to help in development of those facilities.

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[2] As discussed below, the phrase "related persons" is defined in section 45(e)(4).

Second, providing utilities with the flexibility to partner with third parties will ensure that utilities realize the full benefit of the credit, a benefit that will be passed through to utility customers. Load-serving utilities have a regulated rate of return and taxable income that grows slowly from year to year, and, as a result, the ability of such utilities to utilize the REPTC cannot keep pace with their satisfaction of RPS requirements. Such utilities must either carry such credits forward (resulting in higher power costs to utility customers today), or purchase renewable energy through long-term power purchase agreements, which are generally more expensive and less reliable for utility customers.

Third, providing such flexibility to regulated utilities achieves parity with independent developers, most of whom currently utilize partnerships to develop renewable resource facilities and then sell the electricity to utilities at a price that reflects the REPTC.

III. Discussion

A. Section 45 and the Policy Behind It

As noted above, in order for a producer to qualify for the REPTC, the producer must sell the electricity to an unrelated person. Section 45(a)(2)(B). In this regard, section 45(e)(4) provides the following definition of related persons:

> Persons shall be treated as related to each other if such persons would be treated as a single employer under the regulations prescribed under section 52(b). In the case of a corporation which is a member of an affiliated group of corporations filing a consolidated return, such corporation shall be treated as selling electricity to an unrelated person if such electricity is sold to such a person by another member of such group.

Section 45 was enacted as part of the Energy Policy Act of 1992 (P.L. 102-486). The legislative history clarifies the intent of the unrelated person provision. The Senate Finance Committee explained, "The committee intends that a public utility which owns and operates a qualified facility be able to claim the credit to the extent that the utility *ultimately* sells the electricity generated to unrelated parties." Technical Explanation of the Senate Finance Committee Amendment to Title XIX of H.R. 776 (Comprehensive National Energy Act), 138 Cong. Rec. S8486 (1992) (emphasis supplied). The Conference Report similarly provided: "[I]n order to claim the credit, a taxpayer must own the facility and sell the electricity produced by that facility to an unrelated party. Accordingly, a public utility which owns and operates a qualified facility would be able

to claim the credit to the extent that the utility *ultimately* sells the electricity generated to unrelated parties." H.R. Rep. No. 102-1018, as reprinted in Congressional Research Service, Legislative History of the Energy Policy Act of 1992 Prepared for the Senate Committee on Energy and Natural Resources 4481 (S. Prt. 103-91, Vol. 6, 1992) (emphasis supplied).

It is clear from the above that Congress intended for the REPTC to be available to utilities who own or co-own (as opposed to lease) qualified facilities as long as the utilities *ultimately* sell the electricity to unrelated parties rather than, for example, using the electricity themselves.

In situations where a utility co-owns a qualified facility with another party, such as through a partnership, the electricity that is produced must go through a preliminary step of being sold back to the utility before it can be sold to customers. However, the electricity "ultimately" is sold to unrelated parties as intended by Congress. Thus, the intermediate "related person" sale should not disqualify the energy produced from qualifying for the REPTC, and the requested clarification merely reflects Congressional intent.

B. Precedent and Support for Requested Guidance

Treasury and the Internal Revenue Service (the "Service") reached precisely this conclusion in an analogous setting in Notice 2006-40, I.R.B. 2006-18 (Apr. 11). Notice 2006-40 addressed a number of issues under section 45J, which provides a tax credit for electricity that is produced by the taxpayer at an advanced nuclear power facility (the "nuclear power credit"). As in the case of the REPTC, in order to qualify for the nuclear power credit, the electricity produced must be sold to an unrelated person. As set forth in the footnote below, the language of section 45J(a) is almost identical to the language of section 45(a).[3] Indeed, section 45J specifically cross-references the definition of "related

[3] The text of section 45(a) is as follows:

45(a) GENERAL RULE. -- For purposes of section 38, the REPTC for any taxable year is an amount equal to the product of --

45(a)(1) 1.5 cents, multiplied by

45(a)(2) the kilowatt hours of electricity --

45(a)(2)(A) produced by the taxpayer --

(... continued)

persons" in section 45(e)(4). Section 45J(e). In Notice 2006-40, Treasury and the Service provided the following with respect to the unrelated party requirement in the context of the nuclear power production credit: "Electricity will be treated as sold to an unrelated person for this purpose if the ultimate purchaser of the electricity is not related to the person that produces the electricity. The requirement of a sale to an unrelated person will be treated as satisfied in these circumstances even if the producer sells the electricity to a related person for resale by the related person to a person that is not related to the producer. For rules for determining whether a person is related to the producer of the electricity, see § 45(e)(4)."

The proposed clarification would extend the reasoning of Notice 2006-40 in an analogous context to the REPTC. There are a number of reasons this is appropriate. First, as noted above, the language of section 45 and section 45J are nearly identical. Section 45J explicitly defines related person by cross-reference to section 45(e)(4). Thus, it is reasonable to apply the same interpretation of section 45(e)(4) in the context of the REPTC as that which has been applied in the context of the advanced nuclear power facility production credit.

(... continued)

45(a)(2)(A)(i) from qualified energy resources, and

45(a)(2)(A)(ii) at a qualified facility during the 10-year period beginning on the date the facility was originally placed in service, and

45(a)(2)(B) sold by the taxpayer to an unrelated person during the taxable year.

The text of section 45J is as follows:

45J(a) GENERAL RULE. --For purposes of section 38, the advanced nuclear power facility production credit of any taxpayer for any taxable year is equal to the product of --

45J(a)(1) 1.8 cents, multiplied by

45J(a)(2) the kilowatt hours of electricity --

45J(a)(2)(A) produced by the taxpayer at an advanced nuclear power facility during the 8-year period beginning on the date the facility was originally placed in service, and

45J(a)(2)(B) sold by the taxpayer to an unrelated person during the taxable year.

Moreover, there is no discernible policy reason for treating renewable energy production facilities differently from advanced nuclear power facilities. The policy underlying section 45 was explained by the Senate Finance Committee as follows: "The committee believes that the development and utilization of certain renewable energy resources should be encouraged through the tax laws...The credit is intended to enhance the development of technology to utilize the specified renewable energy sources and to promote competition between renewable energy sources and conventional energy sources." Technical Explanation of the Senate Finance Committee Amendment to Title XIX of H.R. 776 (Comprehensive National Energy Act), 138 Cong. Rec. S8486 (1992). When the credit for electricity produced from an advanced nuclear facility (section 45J) was enacted in 2005, it similarly was intended to provide an incentive for the production of nuclear power as an alternative to fossil fuels, and the legislative history suggested it was specifically patterned after the REPTC in section 45. *See, e.g.,* Description and Technical Explanation of the Conference Agreement of H.R. 6, Title XIII, The "Energy Tax Incentives Act of 2005 (JCX-60-05, July 28, 2005). The proposed clarification would simply afford utilities the same flexibility in structuring renewable energy sales that is available for sales of energy produced by advanced nuclear facilities, thus maximizing the credit available under section 45. As the underlying policy of sections 45 and 45J is the same, parity of treatment is appropriate.

Indeed, there is perhaps an even stronger case to be made for the proposed clarification of the related person rule in the case of the REPTC in light of the explicit language of the legislative history quoted above – requiring that the renewable electricity "ultimately" be sold to unrelated parties – language very similar to that used in the Notice 2006-40 with respect to the unrelated persons requirement for advanced nuclear facilities but which does *not* appear in the legislative history for section 45J.

The requested change would also be consistent with section 45(e)(4)'s current treatment of sales within a consolidated group as unrelated party sales. The sale by the development partnership to the utility is analogous to the intermediate intragroup sales that may take place in the consolidated group context and should be treated the same.

IV. Requested Guidance

We believe that the above presents a compelling case for issuing guidance clarifying section 45(e)(4) in a manner that both furthers Congressional intent and is consistent with the similar provision of Notice 2000-40. We would like to work with Treasury to achieve such a clarification in the most efficient manner possible. The ability of some members of this coalition to meet their RPS requirements and fully utilize the

REPTC for taxable year 2008 will depend on their ability to structure joint ventures with third parties for the development of renewable resource projects this year.

As you know, Treasury and the Service recently issued Rev. Proc. 2007-65, 2007-45 I.R.B. 1, dealing with the allocation of section 45 wind energy production tax credits by partnerships in accordance with section 704(b). We respectfully suggest that a simple and efficient vehicle to address this issue would be to issue an Announcement modifying Rev. Proc. 2007-65. (There has already been one previous modification of Rev. Proc. 2007-65, Announcement, 2007-112, 2007-50 I.R.B. 1175 (Dec. 6, 2007).) Specifically:

- Section 1 would be modified by adding the following sentence: "This revenue procedure also clarifies the definition of "related person" in section 45(e)(4)."

- Section 4.10 would be modified to read as follow: "For purposes of the revenue procedure and section 45(e)(4) in general as it applies to renewable energy sources including wind, electricity will be treated as sold to an unrelated person if the ultimate purchaser of the electricity is not related to the person that produces the electricity. The requirement of a sale to an unrelated person will be treated as satisfied in these circumstances even if the producer sells the electricity to a related person for resale by the related person to a person that is not related to the producer."

Alternatively, the guidance could take the form of a simple revenue ruling, announcement, or notice on this specific point.

V. Support for Legislative Solution

Although we believe that an administrative clarification is both appropriate and the simplest way to address this issue, a proposal to resolve this legislatively is under active consideration on the Hill. We respectfully request that Treasury communicate its support for such a proposal to the tax-writing committees and their staffs. Obviously it is also important that the proposed extension of section 45, which is currently scheduled to expire at the end of this year, also be swiftly enacted to afford the industry greater certainty in its planning for upcoming renewable energy projects.

Because of both the uncertainty of the timing of an appropriate vehicle for a legislative clarification of the related person requirement and the importance of obtaining such clarification as soon as possible, we respectfully request that Treasury issue the guidance requested herein at its earliest convenience.

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We look forward to meeting with you to discuss this issue. Please do not hesitate to call me in the meantime at (202) 663-8387 if you have any questions.

Sincerely,

Elizabeth P. Askey

Cc: William P. Bowers, Esq.
Senior Counsel
Office of Tax Legislative Counsel