BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

Dockets UE-190529 & UG-190530, et al.
Puget Sound Energy
2019 General Rate Case

BENCH REQUEST NO. 017:

On January 7, 2021, PSE filed with the Internal Revenue Service (IRS) a request for a private letter ruling (PLR). On July 30, 2021, the IRS issued a PLR in response to PSE's request. On August 24, 2021, PSE filed a redacted portion of the PLR, pages 15-27, in Dockets UE-200843 and UG-200844.

- Please provide a complete, unredacted copy of the PLR that includes pages 1-14. The filing may be made confidentially pursuant to WAC 480-07-160.

Response:

Attached as Attachment A to Puget Sound Energy's response to Bench Request No. 017 is a complete, unredacted copy of Private Letter Ruling No. 101961-21, including pages 1-14.

ATTACHMENT A to PSE's Response to Bench Request No. 017

INTERNAL REVENUE SERVICE

IRS

FAX TRANSMISSION
Cover Sheet

Date: July 30, 2021

To: Alexander Zakupowsky Jr

Address/Organization: Miller and Chevalier

Fax Number: 202-626-5801 Office Number: _____

From: Martha M. Garcia

Address/Organization: CC:PSI:B6

Fax Number: _____ Office Number: _____

Number of pages: 27 *Including cover page*

Subject: PLR-101961-21

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Index Number: 167.22-01

Alexander Zakupowsky, Jr.
Miller & Chevalier Chartered
900 Sixteenth St., NW
Washington, DC 20006

Person To Contact:
Martha M. Garcia, ID No. 0630922
Telephone Number:
(202) 317-6853
Refer Reply To:
CC:PSI:B06
PLR-101961-21
Date: July 26, 2021

Re: Puget Sound Energy, Inc.

Dear Mr. Zakupowsky:

The enclosed copy of a letter is sent to you under the provisions of a power of attorney and declaration of representative, or other proper authorization, currently on file with the Internal Revenue Service.

Sincerely yours,

Patrick S. Kirwan

Patrick S. Kirwan
Chief, Branch 6
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure:
Copy of letter ruling
Copy for § 6110 purposes

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Index Number: 167.22-01

Daniel A. Doyle
Senior Vice President and Chief Financial Officer
Puget Sound Energy, Inc.
355 110th Avenue NE
Bellevue, WA 98004

Person To Contact:
Martha M. Garcia, ID No. 0630922
Telephone Number:
(202) 317-6853
Refer Reply To:
CC:PSI:B6
PLR-101961-21
Date:
July 26, 2021

Legend

Taxpayer	=	Puget Sound Energy, Inc. (EIN: 91-0374630)
Corporation	=	Puget Holdings, LLC (EIN: 26-1273439)
State A	=	Washington
State B	=	Delaware
Commission A	=	Washington Utilities and Transportation Commission
Commission B	=	Federal Energy Regulatory Commission
Order	=	Order 08
Date 1	=	July 8, 2020
Date 2	=	May 1, 2020
Date 3	=	April 30, 2021
Date 4	=	July 1, 2020
Date 5	=	October 1, 2020
Date 6	=	October 15, 2020
Date 7	=	January 1, 2019
Date 8	=	December 31, 2020
Year 1	=	2018
Year 2	=	2019
Year 3	=	2020

Dear Mr. Doyle:

This letter responds to a request for a private letter ruling dated January 7, 2021, submitted by Taxpayer. Taxpayer requests rulings with respect to the application of § 168(i)(9) of the Internal Revenue Code, former § 167(l), and section 13001(d) of the Tax Cuts and Jobs Act, Pub. L. 115-97(the "TCJA") (together, the Normalization Rules), regarding the proper accounting and ratemaking treatment of excess deferred income taxes ("EDIT"). The relevant facts as represented in Taxpayer's submission are set forth below.

FACTS

Taxpayer is an electric and natural gas utility headquartered in State A.

Taxpayer is a wholly owned member of Corporation and Subsidiaries consolidated group. Corporation is an energy services holding company incorporated in State B. Taxpayer is included in the consolidated federal income tax return of Corporation. Taxpayer employs a calendar year reporting period and uses an accrual method of accounting. Corporation elected to be treated as a corporation for federal tax purposes. Corporation and Subsidiaries are not presently under audit by the Internal Revenue Service.

Taxpayer is engaged in the production, transmission, and distribution of electricity and the distribution of natural gas in State A. It is subject to the regulatory authority of Commission A and Commission B as to the terms and conditions of service and the rates it is permitted to charge for its service. Its rates are established or approved based on its costs of service, including a return on its capital investment (rate base).

Taxpayer's rates are established by Commission A on a "cost of service, rate-of-return" basis. Thus, Taxpayer is permitted an opportunity to recover its prudently incurred costs and earn an appropriate return on its rate base, which reflects its net invested capital. The convention employed in State A with respect to rate base is that a utility's accumulated deferred income tax balance ("ADIT") offsets gross rate base (rate base computed before reduction by ADIT). Included in Taxpayer's ADIT balance are a significant amount of deferred taxes attributable to accelerated depreciation claimed with respect to public utility property. Thus, Taxpayer's ADIT is, to a substantial extent, subject to the normalization rules contained in § 168(i)(9) and former § 167(l). Commission A uses an historical test period consisting of a 12-month period for purposes of determining Taxpayer's costs and rate base. Results of this test period are adjusted by "pro forma adjustments" to remove materially distortive items and to give effect to known and measurable changes that are not offset by other factors.

As part of this process of setting rates, Taxpayer computes its depreciation expense and its income tax expense, including both current and deferred components of income tax expense, for inclusion in its cost of service. Taxpayer also reduces its gross rate base by its ADIT balance to determine the rate base on which it is permitted to earn a return. Taxpayer's accounting treatment for depreciation expense, income tax expense, ADIT, and rate base has been consistent with the Normalization Rules.

On December 22, 2017, the TCJA was signed into law. Among other changes, the TCJA reduced the federal corporate income tax rate from 35 percent to 21 percent for tax years beginning after December 31, 2017, Taxpayer's calendar Year 1 tax year.

As a result of the tax reduction, the deferred taxes Taxpayer had accumulated at a 35 percent rate were reduced to those that would have been accumulated at a 21 percent rate had the 21 percent rate been in effect for all prior years. Because Taxpayer had a net deferred tax liability ("DTL") on December 31, 2017, the tax rate reduction resulted in EDIT, because Taxpayer now expects to pay income taxes to the Department of the Treasury at the reduced 21 percent rate, as the timing differences that gave rise to its DTL reverse. In general, Taxpayer had collected the EDIT from customers through its traditional ratemaking methodology and not on a precise dollar-for-dollar basis. The 14-percentage point reduction in the tax rate is available to reduce the tax expense that Taxpayer included in setting customer rates. It is the timing of this reduction of the EDIT that is the issue of this ruling request.

Taxpayer maintains records that include the vintage records necessary to apply the average rate assumption method ("ARAM"). The total balance of Taxpayer's EDIT is unknown. The annual amount of EDIT reversal under ARAM will vary each year, and this variance is unknown at this time. In general, this variability is caused by future events, including the time at which a vintage begins to reverse or when a vintage fully reverses. Taxpayer provides deferred taxes on plant-related timing differences whether or not those timing differences are protected by the Normalization Rules or unprotected by the Normalization Rules. Taxpayer and Commission A intend to apply ARAM to all plant-related timing differences. There is no dispute over this intent to apply ARAM. Throughout Taxpayer's general rate case ("GRC"), these balances are commonly referred to as "protected plus" or "PP" to acknowledge the fact that ARAM is being applied not only to all protected EDIT, but also unproteced plant-related EDIT.

Taxpayer has been accounting for EDIT balances in ratemaking on a consistent method since the Tax Reform Act of 1986, Pub. L. No: 99-514 ("TRA 1986"). That method has been as follows:

> Taxpayer closes its books on a monthly basis. Each resulting monthly income statement and balance sheet contains its share of book depreciation, rate base, income tax expense, and ADIT (including EDIT). Taxpayer includes the ARAM reversal of EDIT in its monthly calculation of tax expense. Its EDIT balance is included in its ADIT to ensure that rate base is reduced by the proper amount of deferred taxes. This treatment ensures that book depreciation, income tax expense, ADIT, and rate base are computed consistently.
>
> Taxpayer's rates are set periodically in a GRC using an historical test period. In a GRC, the accounting activity recorded in each month during the historical test year is the basis for setting customer rates, plus or minus any pro-forma adjustments. Once customer rates are established, they remain constant until the next GRC. At that next GRC, customer rates will be reset based on a new, different historical test year – different income and expenses (including income tax expense and book depreciation expense), different rate base, and different ADIT. The assumption underlying the use of an historical test year is that the

> costs and benefits in the historical period, plus or minus any pro-forma adjustments, will be representative of future periods during which customers will pay the rates. The process is intended to ensure that customer rates will be fair, just, reasonable, and sufficient. This is so even though the actual income and incurred costs, including EDIT reversals, for the period for which the rates are set will be different than those used to set the rates during the GRC.

In its Year 2 GRC, Taxpayer used calendar year Year 1 as the historical test year. This was its first GRC following the TCJA. In its monthly accounting activity throughout Year 1, Taxpayer recorded its EDIT reversal using ARAM. Those accounting entries had the effect of reducing Taxpayer's deferred tax expense and reduced Taxpayer's EDIT balance. No other entries were made with respect to EDIT. These entries were identical to those Taxpayer made since the tax rate reduction provided by the TRA 1986 to account for the EDIT created by the TRA 1986 tax rate reduction and used to set rates since that time.

In filing its Year 2 GRC, Taxpayper included the EDIT reversals that it recorded in calendar year Year 1, consistent with the use of Year 1 as the historical test period. In addition, its ADIT balance, including the EDIT, reflected these reversals. The accounting that occurred in calendar year Year 1 formed the basis for the amounts that Taxpayer proposed in setting rates for Year 2. In other words, the Year 1 book accounting provides the basis for ratemaking in the Year 2 GRC, which was originally intended to be effective for new rates beginning in mid-Year 3.

In response to Taxpayer's Year 2 GRC filing, Commission A issued Order on Date 1. Commission A did not follow Taxpayer's requested historical treatment. Instead, Commission A ordered the approach that raises the normalization issues that are the subject of this request.

Order requires Taxpayer to separately track EDIT on a tariff rate schedule independent of its rates set in its general rate order. In one requirement, Commission A requires the schedule to be updated annually for the reversal of the EDIT for the current year as if rates were set each year. Furthermore, in another requirement, Commission A requires Taxpayer to true-up for the difference between the EDIT amounts set in the schedule and the actual amount passed back due to volumetric variances. Commission A has ordered that the schedule must produce an annual adjustment to Taxpayer's rates for ARAM amortization of EDIT without any corresponding adjustment to Taxpayer's rates for annual changes in depreciation expense, income tax expense, rate base, or ADIT (including EDIT).

Order includes Taxpayer's depreciation expense, tax expense, ADIT (including EDIT), and rate base for the test year in the computation of the primary cost of service and base rate. Order then requries an adjustment to cost of service by removing the test year ARAM amortization of EDIT and substituting for that amount, as a reduction in cost of service, the estimated EDIT amortization for the year following the test year plus

the next year which includes part of the rate year (in total, a 24-month period). No other similar adjustments are made for depreciation expense, income tax expense, ADIT (including EDIT), or rate base, which were, instead, based on the historical test period (again, not including pro forma adjustments which are not a topic of this PLR).

Order was applied to Taxpayer as follows: The test year was calendar year Year 1. The original rate year was to be Date 2 through Date 3, but the start of that rate period was initially delayed due to Coronavirus to an effective date of Date 4. After some further delays, the rates became effective Date 5, for gas operations and Date 6, for electric operations. Taxpayer's originally proposed ARAM EDIT amortization was based on the test year (calendar year Year 1). The Order adjustment was based on an estimate of ARAM EDIT amortization for the two-year period Date 7 through Date 8, the total two-year amount to be passed back in one year.

Taxpayer has proposed corrective action if the Service concludes that the EDIT treatment in Order is not consistent with a normalization method of accounting. If that determination is made, Taxpayer will need to reestablish a normalization method of accounting. In that event, Commission A has agreed to immediately open a proceeding upon Taxpayer's receipt of a PLR from the Service and revisit its order to comply with the Normalization Rules. This agreement was a condition of Taxpayer dismissing its judicial appeal of Order.

Taxpayer has taken additional action to ensure a quick and complete correction if Order is found inconsistent with the Normalization Rules. Taxpayer filed an accounting petition with Commission A on Date 5 in which it requested that Commission A allow Taxpayer to track the difference between Taxpayer's approach and the approach required in Order. The difference between the two approaches will be recorded to Taxpayer's balance sheet as a monthly entry. Two accounts will be used – a tracking account and a contra account (collectively, the "PLR Tracker Accounts"). The two accounts will net to zero and thereby have no impact on Taxpayer's financial results, as doing otherwise would not be in compliance with Commission A's order. However, the accounts will provide contemporaneous documentation of the variance between the two approaches.

For gas customers, rates consistent with Order went into effect on Date 5. For electric customers, new rates went into effect on Date 6. For both gas and electric customers, the accounting petition will provide Commission A with the ability to correct any normalization infraction that the IRS identifies in its ruling.

Taxpayer anticipates that any correction will involve two elements. The first element is a new tariff rate that will comply with the Service's ruling, which will be a new base tariff. That rate would continue in effect until Taxpayer's next rate-setting event, which is expected to be a GRC. The second element is a temporary tariff rate to bring the EDIT balance back into alignment with a normalization method of accounting. This second component would have the effect of reversing the amounts that were tracked in

the PLR Tracker Accounts. The recovery of these balances would likely occur over a relatively short period.

RULINGS REQUESTED

Taxpayer requests rulings whether the accounting for EDIT as required by Order of Commission A is consistent with the Normalization Rules of § 168(i)(9), former § 167(l), and section 13004(d) of the TCJA. Specifically:

(1) Whether the Normalization Rules of § 168(i)(9), former § 167(l), and section 13001(d) of the TCJA permit Taxpayer to adjust its EDIT ARAM amortization based on the test year to the EDIT ARAM amortization based on one or more subsequent years without making similar adjustments to rate base, ADIT, book depreciation expense, and tax expense;

(2) Whether the Normalization Rules of § 168(i)(9), former § 167(l), and section 13001(d) of the TCJA permit Taxpayer to adjust its EDIT ARAM amortization annually without making similar adjustments to rate base, ADIT, book depreciation expense, and tax expense;

(3) Whether the Normalization Rules of § 168(i)(9), former § 167(l), and section 13001(d) of the TCJA permit Taxpayer to provide a true-up to EDIT ARAM amortization in the year following the rate year based on volume variances between the test year and the rate year without making similar adjustments to rate base, ADIT, book depreciation expense, and tax expense;

(4) Additionally, Taxpayers asks that if we determine that any of the requirements described of Order are not consistent with the Normalization Rules of § 168(i)(9), former § 167(l), and section 13001(d) of the TCJA, Taxpayer requests that we provide in the ruling that Taxpayer will not be considered to be in violation of the normalization rules if it follows the corrective actions described in its letter.

LAW AND ANALYSIS

Former section 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) 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 168(f)(2) 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) requires that a 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, 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 (hereinafter referred to as the "Consistency Rule").

Taxpayer's requests relate primarily to Taxpayer's compliance with the Consistency Rule. Taxpayer asks whether the Normalization Rules permit Taxpayer to adjust its EDIT ARAM amortization annually without making similar adjustments to rate base, ADIT, book depreciation expense, and tax expense. More specifically, Taxpayer also asks whether the Normalization Rules permit Taxpayer to adjust its EDIT ARAM amortization based on the test year to the EDIT ARAM amortization based on one or more subsequent years without making similar adjustments to rate base, ADIT, book depreciation expense, and tax expense. Lastly, Taxpayer asks whether the Normalization Rules permit Taxpayer to provide a true-up to EDIT ARAM amortization in the year following the rate year based on volume variances between the test year and the rate year without making similar adjustments to rate base, ADIT, book depreciation expense, and tax expense.

Therefore, the threshold question is whether the Consistency Rule applies to EDIT being accounted for under ARAM. Because these amounts were originally deferred pursuant to a normalization method of accounting, these amounts remain subject to the Normalization Rules of § 168(i)(9), former § 167(l), and section 13001(d)

of the TCJA. Thus, if the EDIT being accounted for under ARAM is subject to Normalization Rules, the Consistency Rule must apply to the EDIT.

As described in § 168(i)(9)(B)(ii), the use of a procedure or adjustment that uses an estimate or projection of any of (1) the taxpayer's tax expense, (2) depreciation expense, or (3) reserve for deferred taxes under § 168(i)(9)(A)(ii), does not comply with the Consistency Rule 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. Therefore, generally, the Normalization Rules do not permit Taxpayer to adjust its EDIT ARAM amortization without making similar adjustments to rate base, ADIT, book depreciation expense, and tax expense. More specifically, in regard to request (1), the Normalization Rules do not allow Taxpayers to make an adjustment to cost of service by removing the test year ARAM amortization of EDIT and substituting for that amount, as a reduction in cost of service, the estimated EDIT amortization for the year following the test year plus the next year which includes part of the rate year (in total, a 24-month period) while also making no similar adjustments for depreciation, expense, income tax expense, ADIT (including EDIT), or rate base, which were based on the historical test period. In regard to request (2), the Normalization Rules do not allow Taxpayer to adjust its EDIT ARAM amortization annually without making similar adjustments to rate base, ADIT, book depreciation expense, and tax expense.

Additionally, in response to request (3), providing a true-up to EDIT ARAM amortization in the year following the rate year based on volume variances between the test year and the rate year without making similar adjustments to rate base, ADIT, book depreciation expense, and tax expense likewise is not in compliance with the Consistency Rule. The true-up mechanism adjusts for volume differences only with respect to one item, EDIT amortization. This results in the use of estimated volumes in setting rates for all items other than EDIT reversal which uses actual volumes. This treatment is an inconsistent use of estimates or projects not allowed by section 168(i)(9)(B).

The Normalization Rules were enacted in response to Congressional concerns over the growing number of public utility commissions that were mandating investor-owned regulated utilities to not retain these tax benefits from accelerated depreciation, but, instead, to immediately flow-through all of these tax incentives to ratepayers in the form of lower income tax expense in regulated cost of service rates. Congress' response was to enact legislation that would preclude regulated investor-owned utilities from utilizing accelerated depreciation methods of tax purposes if the related tax benefits were immediately flowed-through to ratepayers in rates or were flowed-through to ratepayers faster than permitted under the Normalization Rules.

The underlying concept and purpose of the Normalization Rules is to prevent the flow-through of these accelerated depreciation-related tax benefits to ratepayers in regulated rates any faster than permitted by the Normalization Rules. Thus, the flow-through of these tax benefits to ratepayers faster than permitted by the Normalization

Rules would result in a normalization violation that would preclude the taxpayer from using any of the accelerated tax depreciation methods on public utility property and, instead, require the taxpayer to use the same depreciation method and period as those used to compute depreciation expense in its cost of service for ratemaking purposes. Conversely, a taxpayer that flows through these tax benefits to ratepayers slower than permitted by the Normalization Rules, or that never flows through any of the tax benefits from accelerated depreciation to ratepayers, would not be in violation of those rules.

By removing EDIT amortization for the test year and including the estimated EDIT amortization for the two following years, the EDIT amortization on the cost of service is higher than allowed under the ARAM limitation for the test year. This acceleration of the EDIT amortization occurs under the Order without any reduction to the EDIT balance which is taken into account in determining rate base. This provides customers not only with a lower cost of service through the acceleration of EDIT amortization but also a rate base which is artificially low because the EDIT credit balance included in rate base has not been reduced by the EDIT reversal that has been accelerated. This incorrectly provides customers with the double benefit of lower cost of service and lower rate base for the same EDIT.

Section 168(f)(2) 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. However, in the legislative history to the enactment of the normalization requirements of the Investment Tax Credit (ITC), Congress stated that it hopes that sanctions will not have to be imposed and that disallowance of the tax benefit (there, the ITC) should be imposed only after a regulatory body has required or insisted upon such treatment by a utility. See Senate Report No. 92-437, 92nd Cong., 1st Sess. 40-41 (1971), 1972-2 C.B. 559, 581. See also, Rev. Proc. 2017-47, 2017-38 I.R.B. 233, September 18, 2017.

Commission A has, at all times, required that utilities under its jurisdiction use normalization methods of accounting. Further, Commission A has agreed to immediately open a proceeding upon receipt of Taxpayer's receipt of a PLR from the Service and revisit its order to comply with the Normalization Rules if the Service concludes that Order results in a rate calculation that is not consistent with the Normalization rules.

Taxpayer also intended at all times to comply with the Normalization Rules. Taxpayer has initiated the measures necessary to conform to the Normalization Rules. As noted, Taxpayer filed an accounting petition with Commission A in which it requested that Commission A allow Taxpayer to track the difference between Taxpayer's approach and the approach required in Order. The difference between the two approaches will be recorded to Taxpayer's balance sheet as a monthly entry identified as "the PLR Tracker Accounts." For both gas and electric customers, the accounting petition provides Commission A with the ability to correct any normalization infraction that the IRS identifies in this ruling.

Taxpayer's failure to comply with the Normalization Rules was inadvertent. Because the Commission, as well as Taxpayer, at all times sought to comply, and because corrective actions will be taken at the earliest available opportunity, it is not appropriate to conclude that the failure to follow the Consistency Rule for the EDIT that is a part of ADIT and calculated according to ARAM constituted a normalization violation and apply the sanction of denial of accelerated depreciation to Taxpayer.

CONCLUSION

Accordingly, we rule as follows:

(1) The Normalization Rules of § 168(i)(9), former § 167(l), and section 13001(d) of the TCJA do not permit Taxpayer to adjust its EDIT ARAM amortization based on the text year to the EDIT ARAM amortization based on one or more subsequent years without making similar adjustments to rate base, ADIT, book depreciation expense, and tax expense;

(2) The Normalization Rules of § 168(i)(9), former § 167(l), and section 13001(d) of the TCJA do not permit Taxpayer to adjust its EDIT ARAM amortization annually without making similar adjustments to rate base, ADIT, book depreciation expense, and tax expense.

(3) The Normalization Rules of § 168(i)(9), former § 167(l), and section 13001(d) of the TCJA do not permit Taxpayer to provide a true-up to EDIT ARAM amortization in the year following the rate year based on volume variances between the test year and the rate year without making similar adjustments to rate base, ADIT, book depreciation expense, and tax expense.

(4) While we have determined that the described requirements of Order are not consistent with the Normalization Rules of § 168(i)(9), former § 167(l), and section 13001(d) of the TCJA, Taxpayer will not be considered to be in violation of the normalization rules if it follows the corrective actions described in its letter.

Except as specifically set forth above, no opinion is expressed or implied concerning the federal income tax consequences of the above described facts under any other provision of the Code or regulations.

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

This ruling is based upon information and representations submitted by Taxpayer and accompanied by penalty of perjury statements executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the LB&I Policy Office.

Sincerely,

Patrick S. Kirwan

Patrick S. Kirwan
Chief, Branch 6
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

cc: Alexander Zakupowsky, Jr.
Miller & Chevalier Chartered
900 Sixteenth St., NW
Washington, DC 20006

Melanie Chivers,
LB&I Policy Office
eFax number: 1-855-853-9287

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Index Number: 167.22-01

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B6
PLR-101961-21

Date:
July 26, 2021

Legend
Legend

Taxpayer	=
Corporation	=
State A	=
State B	=
Commission A	=
Commission B	=
Order	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Year 1	=
Year 2	=
Year 3	=

Dear :

This letter responds to a request for a private letter ruling dated January 7, 2021, submitted by Taxpayer. Taxpayer requests rulings with respect to the application of § 168(i)(9) of the Internal Revenue Code, former § 167(l), and section 13001(d) of the Tax Cuts and Jobs Act, Pub. L. 115-97(the "TCJA") (together, the Normalization Rules), regarding the proper accounting and ratemaking treatment of excess deferred income

taxes ("EDIT"). The relevant facts as represented in Taxpayer's submission are set forth below.

FACTS

Taxpayer is an electric and natural gas utility headquartered in State A.

Taxpayer is a wholly owned member of Corporation and Subsidiaries consolidated group. Corporation is an energy services holding company incorporated in State B. Taxpayer is included in the consolidated federal income tax return of Corporation. Taxpayer employs a calendar year reporting period and uses an accrual method of accounting. Corporation elected to be treated as a corporation for federal tax purposes. Corporation and Subsidiaries are not presently under audit by the Internal Revenue Service.

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Taxpayer's rates are established by Commission A on a "cost of service, rate-of-return" basis. Thus, Taxpayer is permitted an opportunity to recover its prudently incurred costs and earn an appropriate return on its rate base, which reflects its net invested capital. The convention employed in State A with respect to rate base is that a utility's accumulated deferred income tax balance ("ADIT") offsets gross rate base (rate base computed before reduction by ADIT). Included in Taxpayer's ADIT balance are a significant amount of deferred taxes attributable to accelerated depreciation claimed with respect to public utility property. Thus, Taxpayer's ADIT is, to a substantial extent, subject to the normalization rules contained in § 168(i)(9) and former § 167(l). Commission A uses an historical test period consisting of a 12-month period for purposes of determining Taxpayer's costs and rate base. Results of this test period are adjusted by "pro forma adjustments" to remove materially distortive items and to give effect to known and measurable changes that are not offset by other factors.

As part of this process of setting rates, Taxpayer computes its depreciation expense and its income tax expense, including both current and deferred components of income tax expense, for inclusion in its cost of service. Taxpayer also reduces its gross rate base by its ADIT balance to determine the rate base on which it is permitted to earn a return. Taxpayer's accounting treatment for depreciation expense, income tax expense, ADIT, and rate base has been consistent with the Normalization Rules.

On December 22, 2017, the TCJA was signed into law. Among other changes, the TCJA reduced the federal corporate income tax rate from 35 percent to 21 percent for tax years beginning after December 31, 2017, Taxpayer's calendar Year 1 tax year.

As a result of the tax reduction, the deferred taxes Taxpayer had accumulated at a 35 percent rate were reduced to those that would have been accumulated at a 21 percent rate had the 21 percent rate been in effect for all prior years. Because Taxpayer had a net deferred tax liability ("DTL") on December 31, 2017, the tax rate reduction resulted in EDIT, because Taxpayer now expects to pay income taxes to the Department of the Treasury at the reduced 21 percent rate, as the timing differences that gave rise to its DTL reverse. In general, Taxpayer had collected the EDIT from customers through its traditional ratemaking methodology and not on a precise dollar-for-dollar basis. The 14-percentage point reduction in the tax rate is available to reduce the tax expense that Taxpayer included in setting customer rates. It is the timing of this reduction of the EDIT that is the issue of this ruling request.

Taxpayer maintains records that include the vintage records necessary to apply the average rate assumption method ("ARAM"). The total balance of Taxpayer's EDIT is unknown. The annual amount of EDIT reversal under ARAM will vary each year, and this variance is unknown at this time. In general, this variability is caused by future events, including the time at which a vintage begins to reverse or when a vintage fully reverses. Taxpayer provides deferred taxes on plant-related timing differences whether or not those timing differences are protected by the Normalization Rules or unprotected by the Normalization Rules. Taxpayer and Commission A intend to apply ARAM to all plant-related timing differences. There is no dispute over this intent to apply ARAM. Throughout Taxpayer's general rate case ("GRC"), these balances are commonly referred to as "protected plus" or "PP" to acknowledge the fact that ARAM is being applied not only to all protected EDIT, but also unproteced plant-related EDIT.

Taxpayer has been accounting for EDIT balances in ratemaking on a consistent method since the Tax Reform Act of 1986, Pub. L. No: 99-514 ("TRA 1986"). That method has been as follows:

> Taxpayer closes its books on a monthly basis. Each resulting monthly income statement and balance sheet contains its share of book depreciation, rate base, income tax expense, and ADIT (including EDIT). Taxpayer includes the ARAM reversal of EDIT in its monthly calculation of tax expense. Its EDIT balance is included in its ADIT to ensure that rate base is reduced by the proper amount of deferred taxes. This treatment ensures that book depreciation, income tax expense, ADIT, and rate base are computed consistently.
>
> Taxpayer's rates are set periodically in a GRC using an historical test period. In a GRC, the accounting activity recorded in each month during the historical test year is the basis for setting customer rates, plus or minus any pro-forma adjustments. Once customer rates are established, they remain constant until the next GRC. At that next GRC, customer rates will be reset based on a new, different historical test year – different income and expenses (including income tax expense and book depreciation expense), different rate base, and different

> ADIT. The assumption underlying the use of an historical test year is that the costs and benefits in the historical period, plus or minus any pro-forma adjustments, will be representative of future periods during which customers will pay the rates. The process is intended to ensure that customer rates will be fair, just, reasonable, and sufficient. This is so even though the actual income and incurred costs, including EDIT reversals, for the period for which the rates are set will be different than those used to set the rates during the GRC.

In its Year 2 GRC, Taxpayer used calendar year Year 1 as the historical test year. This was its first GRC following the TCJA. In its monthly accounting activity throughout Year 1, Taxpayer recorded its EDIT reversal using ARAM. Those accounting entries had the effect of reducing Taxpayer's deferred tax expense and reduced Taxpayer's EDIT balance. No other entries were made with respect to EDIT. These entries were identical to those Taxpayer made since the tax rate reduction provided by the TRA 1986 to account for the EDIT created by the TRA 1986 tax rate reduction and used to set rates since that time.

In filing its Year 2 GRC, Taxpayper included the EDIT reversals that it recorded in calendar year Year 1, consistent with the use of Year 1 as the historical test period. In addition, its ADIT balance, including the EDIT, reflected these reversals. The accounting that occurred in calendar year Year 1 formed the basis for the amounts that Taxpayer proposed in setting rates for Year 2. In other words, the Year 1 book accounting provides the basis for ratemaking in the Year 2 GRC, which was originally intended to be effective for new rates beginning in mid-Year 3.

In response to Taxpayer's Year 2 GRC filing, Commission A issued Order on Date 1. Commission A did not follow Taxpayer's requested historical treatment. Instead, Commission A ordered the approach that raises the normalization issues that are the subject of this request.

Order requires Taxpayer to separately track EDIT on a tariff rate schedule independent of its rates set in its general rate order. In one requirement, Commission A requires the schedule to be updated annually for the reversal of the EDIT for the current year as if rates were set each year. Furthermore, in another requirement, Commission A requires Taxpayer to true-up for the difference between the EDIT amounts set in the schedule and the actual amount passed back due to volumetric variances. Commission A has ordered that the schedule must produce an annual adjustment to Taxpayer's rates for ARAM amortization of EDIT without any corresponding adjustment to Taxpayer's rates for annual changes in depreciation expense, income tax expense, rate base, or ADIT (including EDIT).

Order includes Taxpayer's depreciation expense, tax expense, ADIT (including EDIT), and rate base for the test year in the computation of the primary cost of service and base rate. Order then requries an adjustment to cost of service by removing the test year ARAM amortization of EDIT and substituting for that amount, as a reduction in

cost of service, the estimated EDIT amortization for the year following the test year plus the next year which includes part of the rate year (in total, a 24-month period). No other similar adjustments are made for depreciation expense, income tax expense, ADIT (including EDIT), or rate base, which were, instead, based on the historical test period (again, not including pro forma adjustments which are not a topic of this PLR).

Order was applied to Taxpayer as follows: The test year was calendar year Year 1. The original rate year was to be Date 2 through Date 3, but the start of that rate period was initially delayed due to Coronavirus to an effective date of Date 4. After some further delays, the rates became effective Date 5, for gas operations and Date 6, for electric operations. Taxpayer's originally proposed ARAM EDIT amortization was based on the test year (calendar year Year 1). The Order adjustment was based on an estimate of ARAM EDIT amortization for the two-year period Date 7 through Date 8, the total two-year amount to be passed back in one year.

Taxpayer has proposed corrective action if the Service concludes that the EDIT treatment in Order is not consistent with a normalization method of accounting. If that determination is made, Taxpayer will need to reestablish a normalization method of accounting. In that event, Commission A has agreed to immediately open a proceeding upon Taxpayer's receipt of a PLR from the Service and revisit its order to comply with the Normalization Rules. This agreement was a condition of Taxpayer dismissing its judicial appeal of Order.

Taxpayer has taken additional action to ensure a quick and complete correction if Order is found inconsistent with the Normalization Rules. Taxpayer filed an accounting petition with Commission A on Date 5 in which it requested that Commission A allow Taxpayer to track the difference between Taxpayer's approach and the approach required in Order. The difference between the two approaches will be recorded to Taxpayer's balance sheet as a monthly entry. Two accounts will be used – a tracking account and a contra account (collectively, the "PLR Tracker Accounts"). The two accounts will net to zero and thereby have no impact on Taxpayer's financial results, as doing otherwise would not be in compliance with Commission A's order. However, the accounts will provide contemporaneous documentation of the variance between the two approaches.

For gas customers, rates consistent with Order went into effect on Date 5. For electric customers, new rates went into effect on Date 6. For both gas and electric customers, the accounting petition will provide Commission A with the ability to correct any normalization infraction that the IRS identifies in its ruling.

Taxpayer anticipates that any correction will involve two elements. The first element is a new tariff rate that will comply with the Service's ruling, which will be a new base tariff. That rate would continue in effect until Taxpayer's next rate-setting event, which is expected to be a GRC. The second element is a temporary tariff rate to bring the EDIT balance back into alignment with a normalization method of accounting. This

second component would have the effect of reversing the amounts that were tracked in the PLR Tracker Accounts. The recovery of these balances would likely occur over a relatively short period.

RULINGS REQUESTED

Taxpayer requests rulings whether the accounting for EDIT as required by Order of Commission A is consistent with the Normalization Rules of § 168(i)(9), former § 167(l), and section 13004(d) of the TCJA. Specifically:

(1) Whether the Normalization Rules of § 168(i)(9), former § 167(l), and section 13001(d) of the TCJA permit Taxpayer to adjust its EDIT ARAM amortization based on the test year to the EDIT ARAM amortization based on one or more subsequent years without making similar adjustments to rate base, ADIT, book depreciation expense, and tax expense;

(2) Whether the Normalization Rules of § 168(i)(9), former § 167(l), and section 13001(d) of the TCJA permit Taxpayer to adjust its EDIT ARAM amortization annually without making similar adjustments to rate base, ADIT, book depreciation expense, and tax expense;

(3) Whether the Normalization Rules of § 168(i)(9), former § 167(l), and section 13001(d) of the TCJA permit Taxpayer to provide a true-up to EDIT ARAM amortization in the year following the rate year based on volume variances between the test year and the rate year without making similar adjustments to rate base, ADIT, book depreciation expense, and tax expense;

(4) Additionally, Taxpayer asks that if we determine that any of the requirements described of Order are not consistent with the Normalization Rules of § 168(i)(9), former § 167(l), and section 13001(d) of the TCJA, Taxpayer requests that we provide in the ruling that Taxpayer will not be considered to be in violation of the normalization rules if it follows the corrective actions described in its letter.

LAW AND ANALYSIS

Former section 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) 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 168(f)(2) 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) requires that a 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, 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 (hereinafter referred to as the "Consistency Rule").

Taxpayer's requests relate primarily to Taxpayer's compliance with the Consistency Rule. Taxpayer asks whether the Normalization Rules permit Taxpayer to adjust its EDIT ARAM amortization annually without making similar adjustments to rate base, ADIT, book depreciation expense, and tax expense. More specifically, Taxpayer also asks whether the Normalization Rules permit Taxpayer to adjust its EDIT ARAM amortization based on the test year to the EDIT ARAM amortization based on one or more subsequent years without making similar adjustments to rate base, ADIT, book depreciation expense, and tax expense. Lastly, Taxpayer asks whether the Normalization Rules permit Taxpayer to provide a true-up to EDIT ARAM amortization in the year following the rate year based on volume variances between the test year and the rate year without making similar adjustments to rate base, ADIT, book depreciation expense, and tax expense.

Therefore, the threshold question is whether the Consistency Rule applies to EDIT being accounted for under ARAM. Because these amounts were originally deferred pursuant to a normalization method of accounting, these amounts remain

subject to the Normalization Rules of § 168(i)(9), former § 167(l), and section 13001(d) of the TCJA. Thus, if the EDIT being accounted for under ARAM is subject to Normalization Rules, the Consistency Rule must apply to the EDIT.

As described in § 168(i)(9)(B)(ii), the use of a procedure or adjustment that uses an estimate or projection of any of (1) the taxpayer's tax expense, (2) depreciation expense, or (3) reserve for deferred taxes under § 168(i)(9)(A)(ii), does not comply with the Consistency Rule 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. Therefore, generally, the Normalization Rules do not permit Taxpayer to adjust its EDIT ARAM amortization without making similar adjustments to rate base, ADIT, book depreciation expense, and tax expense. More specifically, in regard to request (1), the Normalization Rules do not allow Taxpayers to make an adjustment to cost of service by removing the test year ARAM amortization of EDIT and substituting for that amount, as a reduction in cost of service, the estimated EDIT amortization for the year following the test year plus the next year which includes part of the rate year (in total, a 24-month period) while also making no similar adjustments for depreciation, expense, income tax expense, ADIT (including EDIT), or rate base, which were based on the historical test period. In regard to request (2), the Normalization Rules do not allow Taxpayer to adjust its EDIT ARAM amortization annually without making similar adjustments to rate base, ADIT, book depreciation expense, and tax expense.

Additionally, in response to request (3), providing a true-up to EDIT ARAM amortization in the year following the rate year based on volume variances between the test year and the rate year without making similar adjustments to rate base, ADIT, book depreciation expense, and tax expense likewise is not in compliance with the Consistency Rule. The true-up mechanism adjusts for volume differences only with respect to one item, EDIT amortization. This results in the use of estimated volumes in setting rates for all items other than EDIT reversal which uses actual volumes. This treatment is an inconsistent use of estimates or projects not allowed by section 168(i)(9)(B).

The Normalization Rules were enacted in response to Congressional concerns over the growing number of public utility commissions that were mandating investor-owned regulated utilities to not retain these tax benefits from accelerated depreciation, but, instead, to immediately flow-through all of these tax incentives to ratepayers in the form of lower income tax expense in regulated cost of service rates. Congress' response was to enact legislation that would preclude regulated investor-owned utilities from utilizing accelerated depreciation methods of tax purposes if the related tax benefits were immediately flowed-through to ratepayers in rates or were flowed-through to ratepayers faster than permitted under the Normalization Rules.

The underlying concept and purpose of the Normalization Rules is to prevent the flow-through of these accelerated depreciation-related tax benefits to ratepayers in regulated rates any faster than permitted by the Normalization Rules. Thus, the flow-

through of these tax benefits to ratepayers faster than permitted by the Normalization Rules would result in a normalization violation that would preclude the taxpayer from using any of the accelerated tax depreciation methods on public utility property and, instead, require the taxpayer to use the same depreciation method and period as those used to compute depreciation expense in its cost of service for ratemaking purposes. Conversely, a taxpayer that flows through these tax benefits to ratepayers slower than permitted by the Normalization Rules, or that never flows through any of the tax benefits from accelerated depreciation to ratepayers, would not be in violation of those rules.

By removing EDIT amortization for the test year and including the estimated EDIT amortization for the two following years, the EDIT amortization on the cost of service is higher than allowed under the ARAM limitation for the test year. This acceleration of the EDIT amortization occurs under the Order without any reduction to the EDIT balance which is taken into account in determining rate base. This provides customers not only with a lower cost of service through the acceleration of EDIT amortization but also a rate base which is artificially low because the EDIT credit balance included in rate base has not been reduced by the EDIT reversal that has been accelerated. This incorrectly provides customers with the double benefit of lower cost of service and lower rate base for the same EDIT.

Section 168(f)(2) 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. However, in the legislative history to the enactment of the normalization requirements of the Investment Tax Credit (ITC), Congress stated that it hopes that sanctions will not have to be imposed and that disallowance of the tax benefit (there, the ITC) should be imposed only after a regulatory body has required or insisted upon such treatment by a utility. See Senate Report No. 92-437, 92nd Cong., 1st Sess. 40-41 (1971), 1972-2 C.B. 559, 581. See also, Rev. Proc. 2017-47, 2017-38 I.R.B. 233, September 18, 2017.

Commission A has, at all times, required that utilities under its jurisdiction use normalization methods of accounting. Further, Commission A has agreed to immediately open a proceeding upon receipt of Taxpayer's receipt of a PLR from the Service and revisit its order to comply with the Normalization Rules if the Service concludes that Order results in a rate calculation that is not consistent with the Normalization rules.

Taxpayer also intended at all times to comply with the Normalization Rules. Taxpayer has initiated the measures necessary to conform to the Normalization Rules. As noted, Taxpayer filed an accounting petition with Commission A in which it requested that Commission A allow Taxpayer to track the difference between Taxpayer's approach and the approach required in Order. The difference between the two approaches will be recorded to Taxpayer's balance sheet as a monthly entry identified as "the PLR Tracker Accounts." For both gas and electric customers, the accounting petition provides

Commission A with the ability to correct any normalization infraction that the IRS identifies in this ruling.

Taxpayer's failure to comply with the Normalization Rules was inadvertent. Because the Commission, as well as Taxpayer, at all times sought to comply, and because corrective actions will be taken at the earliest available opportunity, it is not appropriate to conclude that the failure to follow the Consistency Rule for the EDIT that is a part of ADIT and calculated according to ARAM constituted a normalization violation and apply the sanction of denial of accelerated depreciation to Taxpayer.

CONCLUSION

Accordingly, we rule as follows:

(1) The Normalization Rules of § 168(i)(9), former § 167(l), and section 13001(d) of the TCJA do not permit Taxpayer to adjust its EDIT ARAM amortization based on the text year to the EDIT ARAM amortization based on one or more subsequent years without making similar adjustments to rate base, ADIT, book depreciation expense, and tax expense;

(2) The Normalization Rules of § 168(i)(9), former § 167(l), and section 13001(d) of the TCJA do not permit Taxpayer to adjust its EDIT ARAM amortization annually without making similar adjustments to rate base, ADIT, book depreciation expense, and tax expense.

(3) The Normalization Rules of § 168(i)(9), former § 167(l), and section 13001(d) of the TCJA do not permit Taxpayer to provide a true-up to EDIT ARAM amortization in the year following the rate year based on volume variances between the test year and the rate year without making similar adjustments to rate base, ADIT, book depreciation expense, and tax expense.

(4) While we have determined that the described requirements of Order are not consistent with the Normalization Rules of § 168(i)(9), former § 167(l), and section 13001(d) of the TCJA, Taxpayer will not be considered to be in violation of the normalization rules if it follows the corrective actions described in its letter.

Except as specifically set forth above, no opinion is expressed or implied concerning the federal income tax consequences of the above described facts under any other provision of the Code or regulations.

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

This ruling is based upon information and representations submitted by Taxpayer and accompanied by penalty of perjury statements executed by an appropriate party.

While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the LB&I Policy Office.

Sincerely,

Patrick S. Kirwan
Chief, Branch 6
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

cc:

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