Raquel Webster
Senior Counsel

September 18, 2018

BY HAND DELIVERY AND ELECTRONIC MAIL

Luly E. Massaro, Commission Clerk
Rhode Island Public Utilities Commission
89 Jefferson Boulevard
Warwick, RI 02888

RE: Docket 4682 - Fiscal Year 2018 Electric Infrastructure, Safety, and Reliability Plan Reconciliation Filing
Responses to Division Data Requests – Set 1

Dear Ms. Massaro:

On behalf of National Grid,[1] I have enclosed ten (10) copies of the Company's responses to the first set of data requests issued by the Rhode Island Division of Public Utilities and Carriers in the above-referenced matter.

Thank you for your attention to this filing. If you have any questions, please contact me at 781-907-2121.

Very truly yours,

Raquel J. Webster

Enclosures

cc: Docket 4682 Service List
Leo Wold, Esq.
John Bell, Division

[1] The Narragansett Electric Company d/b/a National Grid (National Grid or Company).

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T: 781-907-2121 ■ raquel.webster@nationalgrid.com ■ www.nationalgrid.com

Certificate of Service

I hereby certify that a copy of the cover letter and any materials accompanying this certificate was electronically transmitted to the individuals listed below.

The paper copies of this filing are being hand delivered to the Rhode Island Public Utilities Commission and to the Rhode Island Division of Public Utilities and Carriers.

Joanne M. Scanlon

September 18, 2018
Date

Docket No. 4682 National Grid's Electric Infrastructure, Safety and Reliability Plan FY 2018 - Service List as of 8/2/18

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Division 1-1

Request:

Referring to Attachment MAL-1, Page 21, is the reason for the zero NOL in FY 2017 that the Company had positive taxable income for FY 2017? If the answer is affirmative, did the positive taxable income in FY 2017 result in the usage of any net operating losses from earlier years? If so, please quantify the usage of such NOLs.

Response:

The Net Operating Loss (NOL) is zero in Fiscal Year (FY) 2017 because the Company had positive taxable income in that fiscal year. No NOLs from earlier years were utilized because the Company files as part of a U.S. consolidated Federal income tax return, which had a taxable loss in FY 2017. The consolidated return group (National Grid North America Inc., & Subsidiaries) would need to be in a taxable income position before utilization of prior NOLs could occur.

Division 1-2

Request:

Referring to Attachment MAL-1, Page 2, Line 22, why is the proration adjustment necessary for a retrospective reconciliation covering Fiscal Year 2018?

Response:

Please see Attachment DIV 1-2-1 (Private Letter Ruling (PLR) 201739001) and Attachment DIV 1-2-2 (PLR 201817006). These two private letter rulings discuss the issue of proration when a rate period is reconciled, adjusted, or trued-up. If the original revenue requirement filing includes a future period, then the Company includes a proration adjustment to the movement in deferred taxes included in rate base, as required by normalization regulations §1.167(l)-1(h)(6)(i). When an existing period that has previously set rates is subsequently reconciled to actual numbers, the PLRs state that the adjustment or true-up amount, assuming that the period is now historic, does not have a proration adjustment requirement. However, the reconciliation cannot reverse the effects of proration from the original revenue requirement even though the rate period is now historic. Therefore, in its revenue requirement calculation on actual FY 2018 ISR investment, the Company is including the same proration adjustment that was included in its revenue requirement calculation on FY 2018 ISR Plan investment to accomplish this requirement.

troutman sanders

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October 2, 2017

Ladies and Gentlemen:

Attached is PLR 201739001, which rules on the application of the depreciation normalization rules of § 168(i)(9) of the Internal Revenue Code ("Code") and § 1.167(l)-1 of the Federal Income Tax Regulations ("Regulations") (together, the "Normalization Rules") with respect to the computation of accumulated deferred federal income taxes ("ADFIT") in its calculation of rate base in a rate proceeding.

Taxpayer is an electric utility involved in the production, transmission, distribution and sale of electric energy in State A, State B, and State C.

On Date 3, Taxpayer filed a request with Commission B for an increase in revenue recoverable under general base rates in State A. At Taxpayer's option, this general rate case was based on a forecasted Year 1 test year. Rates will not be final until Year 2, after the close of the forecasted Year 1 test year. Until final rates are implemented, Taxpayer is allowed to charge interim rates. In its filing, Taxpayer also requested an interim rate increase in general base rates. An order of Commission B on Date 4 approved interim rates, which became effective on Date 5. These interim rates are subject to refund at the end of the rate case in Year 2, if final rates determined by Commission B are less than interim rates.

Through this pending rate case proceeding, Taxpayer is also proposing to recover, in base rates, revenue currently subject to recovery under riders. Decisions on recovery of costs in these riders will not be made until Year 2, when the costs proposed to be recovered will be historical.

On Date 4, Commission B issued an order suspending the effective date of Taxpayer's requested rate increase until Date 7. Commission B also issued an order approving an interim rate increase to the base rates, as modified and subject to the Interim Rate Refund. The interim increase, subject to the Interim Rate Refund, became effective Date 5, and is expected to remain in effect until Commission B makes a final determination on Taxpayer's overall request and final rates become effective.

Taxpayer computed interim rates by applying the proration methodology that is required for future test periods to its ADFIT and proposed that final rates reflect ADFIT proration. Taxpayer also asserted that, whether or not application of the proration formula to final rates is required under the normalization rules, the incremental effect of the revenue requirement on

interim rates charged during the test period should not cause or increase the Interim Rate Refund.

In its Order dated Date 4, Commission B set interim rates with ADFIT proration. Interim rates are charged from Date 5 through the date in Year 2 when final rates will be implemented.

The Department proposed that ADFIT proration not be reflected in final rates. Specifically, the Department did not oppose the use of ADFIT proration in setting the interim rates, but proposed that: (1) the level of the Interim Rate Refund for Date 5 through Date 9, be determined without reflecting any ADFIT proration for that period; (2) the level of the Interim Rate Refund for Date 10 until implementation of final rates by Taxpayer by determined without reflecting any ADFIT proration for that period; and (3) federal income tax expense used to set final rates reflect the level of federal income taxes reflected in ADFIT with no proration. Alternatively, the Department recommended that future rate cases rely solely on historical test years.

Taxpayer's revenue requirement for the Year 1 general rate case utilized calendar year, Year 1, as the test year. Amounts estimated for the Year 1 test year include, but are not limited to operating costs (including depreciation expense on Year 1 additions and income tax expense) and rate base items (including plant additions during Year 1, accumulated depreciation reflecting Year 1 depreciation and ADFIT). The Year 1 test year is the basis for both the interim rates (effective beginning on Date 5 and expected to remain in effect until Month 2 Year 2) as well as the final rates (expected to become effective in Month 2 Year 2).

The amounts estimated for the Year 1 test year are not generally "trued-up" to actual amounts after the end of Year 1 for the determination of final rates.

The Internal Revenue Service ruled as follows:

1) The computation of ADFIT for purposes of final rates (apart from consideration of an Interim Rate Refund) charged beginning in Month 2 Year 2 without applying the proration formula rules for future test periods or part-historical and part-future periods under § 1.167(l)-1(h)(6) would not violate the normalization requirements of § 168(i)(9).

2) The computation of ADFIT for purposes of interim rates charged beginning on Date 5, without applying the proration formula rules for part-historical and part-future periods under § 1.167(l)-1(h)(6) would violate the normalization requirements of § 168(i)(9).

3) The future portion of a part-historical and part-future period for purposes of interim rates charged beginning on Date 5, began on Date 5 for purposes of determining the total number of days in the future portion of the period under § 1.167(l)-1(h)(6).

With respect to rulings (1)-(3), the ruling provides that the computation of ADFIT for purposes of final rates employs an historical test period and is not subject to the proration

formula rules under § 1.167-1(h)(6) of the Regulations; there is no need to follow the proration formula rules designed for future test periods or part historical and part-future periods to calculate the differences between Taxpayer's projected ADFIT balance and the actual ADFIT balance during the period.

In contrast, Taxpayer calculates its ADFIT for purposes of interim rates charged beginning on Date 5. The rate is based on costs Taxpayer projects it will incur during the test year, Year 1. Rates go into effect as of Date 5. Therefore, rates go into effect before the end of the test period. Accordingly, the test period for Taxpayer's interim rates is a future test period, subject to the proration formula rules under § 1.167-1(h)(6) of the Regulations, and Taxpayer is required to apply the proration formula rules for part-historical and part-future periods to calculate the differences between Taxpayer's projected ADFIT balance and the actual ADFIT balance during that period.

4) The computation of an Interim Rate Refund in Year 2 such that the effects of the proration formula rules under § 1.167(l)-1(h)(6) on interim rates charged in Year 2 are returned in Year 2 (by causing or increasing an Interim Rate Refund) would not violate the normalization requirements of § 168(i)(9).

5) The computation of an Interim Rate Refund in Year 2 such that the effects of the proration formula rules under § 1.167(l)-1(h)(6) on interim rates charged in Year 1 are returned in Year 2 (by causing or increasing an Interim Rate Refund) would violate the normalization requirements of § 168(i)(9).

With respect to rulings (4)-(5), the ruling provides that Commission B will use the Interim Rate Refund to adjust Taxpayer's interim rates charged after the end of the test year. Commission B is not adjusting interim rates but is instead using the approach to reflect the Year 2 incremental effects of the proration formula on the revenue requirement on which interim rates are based in the Interim Rate Refund. Accordingly, the computation of an Interim Rate Refund in Year 2 such that the effects of the proration formula rules under § 1.167(l)-1(h)(6) of the Regulations on interim rates charged in Year 2 are returned in Year 2 (by causing or increasing an Interim Rate Refund) would not violate the normalization requirements of § 168(i)(9).

The issue of whether it is appropriate to permit the Interim Rate Refund to reverse the effects of the proration formula on interim rates charged during the Year 1 test year differs from the issue of the proration formula to interim rates charged after the Year 1 test year. The purpose of the proration formula is to prevent the immediate flow-through of the benefits of accelerated depreciation to ratepayers. The proration formula stops flow-through by limiting the deferred tax reserve accruals that may be excluded from rate base, and thus the earnings on rate base that may be disallowed according to the length of time these accruals are actually in the reserve account. To permit the effects of the proration formula on interim rates charged during the Year 1 test year to be reversed in a subsequent phase of the ratemaking would be economically equivalent to not applying the proration formula in the first place.

6) Any reduction in tax expense recoverable in final rates or the computation of any Interim Rate Refund that has the effect of offsetting some or all of the level of revenues resulting from prorated ADFIT that may be required (under the proration formula rules for future test periods or part-historical and part-future periods under § 1.167(l)-1(h)(6)), would violate the normalization requirements of § 168(i)(9).

7) Any reduction in the depreciation expense recoverable in final rates or the computation of any Interim Rate Refund that has the effect of offsetting some or all of the level of revenues resulting from prorated ADFIT that may be required (under the proration formula rules for future test periods or part-historical and part-future periods under § 1.167(l)-1(h)(6)), would violate the normalization requirements of § 168(i)(9).

With respect to rulings (6)-(7), the ruling provides that reduction of Taxpayer's tax expense or depreciation expense recoverable in final rates or the computation of any Interim Rate Refund that has the effect of offsetting some or all of the level of revenues resulting from prorated ADFIT that may be required would, in effect, flow through the tax benefits of accelerated depreciation deductions to rate payers. This is so even if the intent of such reduction is not specifically to mitigate the effects of the normalization rules. In general, taxpayers may not adopt any accounting treatment that directly or indirectly circumvents the normalization rules.

Accordingly, any reduction in tax expense or depreciation expense recoverable in final rates or the computation of any Interim Rate Refund that has the effect of offsetting some or all of the level of revenues resulting from prorated ADFIT in setting interim rates that may be required (under the proration formula rules for future test periods or part-historical and part-future test periods under § 1.167(l)-1(h)(6) of the Regulations), would violate the normalization requirements of § 168(i)(9) of the Code.

Amie Broder

Attachment(s)
32908338

Internal Revenue Service

Number: **201739001**
Release Date: 9/29/2017

Index Number: 167.22-01

In Re:

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B06
PLR-100199-17

Date:
June 20, 2017

Legend:

Parent =

Taxpayer =

State A =
State B =
State C =
Commission A =
Commission B =
Department =

OAG =

Office =
Year 1 =
Year 2 =
Director =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =
Date 9 =

Date 10 =
Date 11 =
Month 1 =
Month 2 =
Month 3 =
Month 4 =

Dear :

This letter responds to the request, filed December 28, 2016, submitted on behalf of Taxpayer for a ruling on the application of the depreciation normalization rules of § 168(i)(9) of the Internal Revenue Code ("Code") and § 1.167(l)-1 of the Federal Income Tax Regulations ("Regulations") (together, the "Normalization Rules") with respect to the computation of accumulated deferred federal income taxes ("ADFIT") in its calculation of rate base in a rate proceeding.

The representations set out in your letter follow.

Parent is the common parent of a group of affiliated corporations that includes Taxpayer and files a consolidated federal income tax return on a calendar year basis employing the accrual method of accounting. Parent and Taxpayer are incorporated in State A. Parent is currently under the audit jurisdiction of the Large Business and International Division of the Internal Revenue Service.

Taxpayer is a rate-regulated electric utility involved in the production, transmission, distribution and sale of electric energy in State A, State B, and State C. Taxpayer is subject to regulation of rates and other matters in each of the three states in which it operates and by the Commission A for certain operations. Taxpayer is subject to the jurisdiction of Commission B with respect to certain matters. Taxpayer's most recently-completed Commission B general rate case resulted in an order issued on Date 1, and effective Date 2, granting an increase in rates.

On Date 3, Taxpayer filed a request with Commission B for an increase in revenue recoverable under general base rates in State A. At Taxpayer's option, this general rate case was based on a forecasted Year 1 test year. Rates will not be final until Year 2, after the close of the forecasted Year 1 test year. Until final rates are implemented, Taxpayer is allowed to charge interim rates. In its filing, Taxpayer also requested an interim rate increase in general base rates. An order of Commission B on Date 4 approved interim rates, which became effective on Date 5. These interim rates are subject to refund at the end of the rate case in Year 2, if final rates determined by Commission B are less than interim rates.

Through this pending rate case proceeding, Taxpayer is also proposing to recover, in base rates, revenue currently subject to recovery under riders. Decisions on recovery of costs in these riders will not be made until Year 2, when the costs proposed to be recovered will be historical.

Taxpayer's request for an interim rate increase was based on the anticipated suspension by Commission B of the effective date of Taxpayer's request for an increase in revenue recoverable under general base rates in State A. Under State A law, interim rates are issued before a full review of costs is completed and are based primarily on the utility's proposed final rates. Under State A law, interim rates are subject to refund or credit to customers, plus interest (the "Interim Rate Refund"). An Interim Rate Refund results if, at the end of the contested case, amounts collected under the interim rate schedule exceed final rates and, if applicable, is typically a one-time refund/credit based on the amount of excess of interim rates over final rates and the time period from the implementation of interim rates until final rates become effective. Taxpayer's final rates are suspended until Date 6, with Commission B's final rate order (subject to reconsideration and other post order procedures) expected on or before Date 6.

On Date 4, Commission B issued an order suspending the effective date of Taxpayer's requested rate increase until Date 7, and referred the matter to the Office to receive testimony, conduct a contested case process, including potential evidentiary hearing, and issue a recommendation to Commission B. Commission B determines final rates, and they can accept, reject, or modify the recommendation from Office.

On Date 4, Commission B also issued an order approving an interim rate increase to the base rates, as modified and subject to the Interim Rate Refund. The interim increase, subject to the Interim Rate Refund, became effective Date 5, and is expected to remain in effect until Commission B makes a final determination on Taxpayer's overall request and final rates become effective. Taxpayer filed a letter on Date 8, agreeing to extend the effective date of Taxpayer's requested rate increase until Date 6.

Taxpayer computed interim rates by applying the proration methodology that is required for future test periods to its ADFIT and proposed that final rates reflect ADFIT proration. Taxpayer also asserted that, whether or not application of the proration formula to final rates is required under the normalization rules, the incremental effect of the revenue requirement on interim rates charged during the test period should not cause or increase the Interim Rate Refund.

In its Order dated Date 4, Commission B set interim rates with ADFIT proration. No party filed an objection to the interim rates set by Commission B. Interim rates are charged from Date 5 through the date in Year 2 when final rates will be implemented.

The Department proposed that ADFIT proration not be reflected in final rates. The Department stated that, because final rates in this proceeding will not go into effect until Year 2, after the forecasted test year, final rates would be based on a then-historical Year 1 test year. Specifically, the Department did not oppose the use of ADFIT proration in setting the interim rates, but proposed that: (1) the level of the Interim Rate Refund for Date 5 through Date 9, be determined without reflecting any ADFIT proration for that period; (2) the level of the Interim Rate Refund for Date 10 until implementation of final rates by Taxpayer by determined without reflecting any ADFIT proration for that period; and (3) federal income tax expense used to set final rates reflect the level of federal income taxes reflected in ADFIT with no proration. Alternatively, the Department recommended that future rate cases rely solely on historical test years.

An evidentiary hearing was conducted by the Office. The report and recommendation of the Office to Commission B is expected on Date 11. Oral arguments before Commission B are expected to occur in Month 1 Year 2, and Commission B's "final" rate order (subject to reconsideration and other post order procedures) is expected on or before Date 6. Final rates are expected to become effective in Month 2 Year 2 and the potential Interim Rate Refund is expected to be paid or credited in Month 3 Year 2.

Taxpayer's revenue requirement for the Year 1 general rate case utilized calendar year, Year 1, as the test year. Amounts estimated for the Year 1 test year include, but are not limited to operating costs (including depreciation expense on Year 1 additions and income tax expense) and rate base items (including plant additions during Year 1, accumulated depreciation reflecting Year 1 depreciation and ADFIT). The Year 1 test year is the basis for both the interim rates (effective beginning on Date 5 and expected to remain in effect until Month 2 Year 2) as well as the final rates (expected to become effective in Month 2 Year 2).

The amounts estimated for the Year 1 test year (including but not limited to operating revenues, costs, plant additions, ADFIT, and other factors affecting the computation of the revenue requirement) are not generally "trued-up" to actual amounts after the end of Year 1 for the determination of final rates. Final rates reflect the resolution of contested items such as the allowed return, recovery of specific categories of operating expenses or the amount of certain operating expenses and inclusion of specific investments and certain costs in rate base. In the case of the Year 1 general rate case, the final rates will also consolidate into base rates the costs and investments historically recovered as part of the riders.

The following rulings are requested on behalf of Taxpayer:

1) The computation of ADFIT for purposes of final rates (apart from consideration of an Interim Rate Refund) charged beginning in Month 2 Year 2 without applying the

proration formula rules for future test periods or part-historical and part-future periods under § 1.167(l)-1(h)(6) would not violate the normalization requirements of § 168(i)(9).

2) The computation of ADFIT for purposes of interim rates charged beginning on Date 5, without applying the proration formula rules for part-historical and part-future periods under § 1.167(l)-1(h)(6) would violate the normalization requirements of § 168(i)(9).

3) The future portion of a part-historical and part-future period for purposes of interim rates charged beginning on Date 5, began on Date 5 for purposes of determining the total number of days in the future portion of the period under § 1.167(l)-1(h)(6).

4) The computation of an Interim Rate Refund in Year 2 such that the effects of the proration formula rules under § 1.167(l)-1(h)(6) on interim rates charged in Year 2 are returned in Year 2 (by causing or increasing an Interim Rate Refund) would not violate the normalization requirements of § 168(i)(9).

5) The computation of an Interim Rate Refund in Year 2 such that the effects of the proration formula rules under § 1.167(l)-1(h)(6) on interim rates charged in Year 1 are returned in Year 2 (by causing or increasing an Interim Rate Refund) would violate the normalization requirements of § 168(i)(9).

6) Any reduction in tax expense recoverable in final rates or the computation of any Interim Rate Refund that has the effect of offsetting some or all of the level of revenues resulting from prorated ADFIT that may be required (under the proration formula rules for future test periods or part-historical and part-future periods under § 1.167(l)-1(h)(6)), would violate the normalization requirements of § 168(i)(9).

7) Any reduction in the depreciation expense recoverable in final rates or the computation of any Interim Rate Refund that has the effect of offsetting some or all of the level of revenues resulting from prorated ADFIT that may be required (under the proration formula rules for future test periods or part-historical and part-future periods under § 1.167(l)-1(h)(6)), would violate the normalization requirements of § 168(i)(9).

Law and Analysis

Issues 1, 2, and 3

Section 1.167(l)-1(h)(6) of the Regulations sets forth normalization requirements with respect to public utility property. Under § 1.167(l)-1(h)(6)(i), a taxpayer does not use a normalization method of accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes excluded from the rate base, or treated as cost-free capital, exceeds the amount of the reserve for the period used in determining the taxpayer's ratemaking tax expense. Section 1.167(l)-1(h)(6)(ii) also provides the procedure for

determining the amount of the reserve for deferred taxes to be excluded from rate base or to be included as no-cost capital.

Section 1.167(l)-1(h)(6)(ii) of the Regulations provides that for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under § 1.167(l)-1(h)(6)(i), if solely an historical period is used to determine depreciation for federal income tax expense for ratemaking purposes, then the amount of the reserve account for the period is the amount of the reserve (determined under § 1.167(l)-1(h)(2)) at the end of the historical period. Section 1.167(l)-1(h)(6)(ii) provides that if solely a future period is used for such determination, the amount of the reserve account for the period is the amount of the reserve at the beginning of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during such period.

Section 1.167(l)-1(h)(6)(ii) of the Regulations provides if, in determining depreciation for ratemaking tax expense, a period (the “test period”) is used which is part historical and part future, then the amount of the reserve account for this period is the amount of the reserve at the end of the historical portion of the period and a pro rata amount of any projected increase to be credited to the account during the future portion of the period. The pro rata amount of any increase during the future portion of the period is determined by multiplying the increase by a fraction, the numerator of which is the number of days remaining in the period at the time the increase is to accrue, and the denominator of which is the total number of days in the future portion of the period.

Section 1.167(l)-1(h)(6)(i) of the Regulations makes it clear that the reserve excluded from rate base must be determined by reference to the same period as is used in determining ratemaking tax expense. A taxpayer may use either historical data or projected data in calculating these two amounts, but it must be consistent. As explained in § 1.167(l)-1(a)(1), the rules provided in § 1.167(l)-1(h)(6)(i) are to insure that the same time period is used to determine the deferred tax reserve amount resulting from the use of an accelerated method of depreciation for cost of service purposes and the reserve amount that may be excluded from the rate base or included in no-cost capital in determining such cost of services.

If a taxpayer chooses to compute its ratemaking tax expense and rate base exclusion amount using projected data then it must use the formula provided in § 1.167(l)-1(h)(6)(ii) of the Regulations to calculate the amount of deferred taxes subject to exclusion from the rate base. This formula prorates the projected accruals to the reserve so as to account for the actual time these amounts are expected to be in the reserve. As explained in § 1.167(l)-1(a)(1), the formula in § 1.167(l)-1(h)(6)(ii) provides a method to determine the period of time during which the taxpayer will be treated as having received amounts credited or charged to the reserve account so that the disallowance of earnings with respect to such amounts through rate base exclusion or

treatment as no-cost capital will take into account the factor of time for which such amounts are held by the taxpayer.

The purpose of the proration formula is the same as that of the requirement for consistent periods discussed above: to prevent the immediate flow-through of the benefits of accelerated depreciation to ratepayers. The proration formula stops flow-through by limiting the deferred tax reserve accruals that may be excluded from rate base, and thus the earnings on rate base that may be disallowed, according to the length of time these accruals are actually in the reserve account.

The effectiveness of § 1.167(l)-1(h)(6)(ii) of the Regulations in resolving the timing issue has been limited by its failure to define some key terms. Nowhere does this provision state what is meant by the terms “historical” and “future” in relation to the test period for determining depreciation for ratemaking tax expense. How are these time periods to be measured? One interpretation focuses on the type or quality of the data used in the ratemaking process. According to this interpretation, the historical period is that portion of the test period for which actual data is used, while the portion of the period for which data is estimated is the future period. The second interpretation focuses on when the utility rates become effective. Under this interpretation, the historical period is that portion of the test period before rates go into effect, while the portion of the test period after the effective date of the rate order is the future period.

The first interpretation, which focuses on the quality of the ratemaking data, is an attractive one. It proposes a simple rule, easy to follow and to enforce: any portion of the reserve for deferred taxes based on estimated data must be prorated in determining the amount to be deducted from rate base. The actual passage of time between the date ratemaking data is submitted and the date rates become effective is of no importance. But this interpretation of the regulations achieves simplicity at the expense of precision; in other words, it is overbroad. The proration of all estimated deferred tax data does serve to magnify the benefits of accelerated depreciation to the utility, but this is not the purpose of normalization. Congress was explicit: normalization “in no way diminishes whatever power the [utility regulatory] agency may have to require that the deferred taxes reserve be excluded from the base upon which the utility’s permitted rate of return is calculated.” H.R. Rep. No. 413, 91st Cong., 1st Sess. 133 (1969).

In contrast, the second interpretation of § 1.167(l)-1(h)(6)(ii) of the Regulations is consistent with the purpose of normalization, which is to preserve for regulated utilities the benefits of accelerated depreciation as a source of cost-free capital. The availability of this capital is ensured by prohibiting flow-through. But whether or not flow-through can even be accomplished by means of rate base exclusions depends primarily on whether, at the time rates become effective, the amounts originally projected to accrue to the deferred tax reserve have actually accrued.

If rates go into effect before the end of the test period, and the rate base reduction is not prorated, the utility commission is denying a current return for accelerated depreciation benefits the utility is only projected to have. This procedure is a form of flow-through, for current rates are reduced to reflect the capital cost savings of accelerated depreciation deductions not yet claimed or accrued by the utility. Yet projected data is often necessary in determining rates, since historical data by itself is rarely an accurate indication of future utility operating results. Thus, the regulations provide that as long as the portion of the deferred tax reserve based on truly projected (future estimated) data is prorated according to the formula in § 1.167(l)-1(h)(6)(ii) of the Regulations, a regulator may deduct this reserve from rate base in determining a utility's allowable return. In other words, a utility regulator using projected data in computing ratemaking tax expense and rate base exclusion must account for the passage of time if it is to avoid flow-through.

But if rates go into effect after the end of the test period, the opportunity to flow through the benefits of future accelerated depreciation to current ratepayers is gone, and so too is the need to apply the proration formula. In this situation, the only question that is important for the purpose of rate base exclusion is the amount in the deferred tax reserve, whether actual or estimated. Once the future period, the period over which accruals to the reserve were projected, is no longer future, the question of when the amounts in the reserve accrued is no longer relevant (at the time the new rate order takes effect, the projected increases have accrued, and the amounts to be excluded from rate base are no longer projected but historical, even though based on estimates).

Taxpayer's computation of ADFIT for purposes of final rates occurs after the end of the test period on which those amounts are based. The calculation is determined by reference to a purely historical period. Thus, the test period is one that occurs prior to the effective date of the rates which result from the computation. Accordingly, the computation of ADFIT for purposes of final rates employs an historical test period and is not subject to the proration formula rules under § 1.167-1(h)(6) of the Regulations; there is no need to follow the proration formula rules designed for future test periods or part-historical and part-future periods to calculate the differences between Taxpayer's projected ADFIT balance and the actual ADFIT balance during the period.

In contrast, Taxpayer calculates its ADFIT for purposes of interim rates charged beginning on Date 5. The rate is based on costs Taxpayer projects it will incur during the test year, Year 1. Rates go into effect as of Date 5. Therefore, rates go into effect before the end of the test period. Accordingly, the test period for Taxpayer's interim rates is a future test period, subject to the proration formula rules under § 1.167-1(h)(6) of the Regulations, and Taxpayer is required to apply the proration formula rules for part-historical and part-future periods to calculate the differences between Taxpayer's projected ADFIT balance and the actual ADFIT balance during that period.

The revenue requirement for the interim rates, subject to refund, became effective Date 5, pursuant to a Commission B order issued on Date 4. The interim rates were based on a calendar year, Year 1, test year, but excluded costs and return associated with public utility property recovered through riders. Rate base for the Year 1 test year was computed as an average rate base. The average ADFIT amount was based on a simple average based on the estimate of ADFIT as of the beginning of the Year 1 test year and the estimate of ADFIT as of the end of the Year 1 test year, as prorated. The future portion of a part-historical and part-future period for purposes of interim rates charged began on Date 5, for purposes of determining the total number of days in the future portion of the period under § 1.167(l)-1(h)(6) of the Regulations.

Issues 4 and 5

The interim rates set by the order of Commission B dated Date 5, are charged during the pendency of the rate case until final rates are implemented (expected to be in Month 2 Year 2). A separate set of interim rates are not determined for Year 2. Once final rates are determined, the Interim Rate Refund is calculated, based on the difference between final rates and interim rates for the period during which interim rates have been collected.

The determination of the Interim Rate Refund includes the question of how to calculate the Interim Rate Refund for interim rates collected in Year 2 (that is, after the test year is completed.) Issue # 4 focuses on the calculation of the Interim Rate Refund based on the difference between final rates and the interim rates that are charged starting in Month 4 Year 2 and collected until final rates are implemented.

Similarly, the determination of the Interim Rate Refund includes the question of how to calculate the Interim Rate Refund for interim rates collected in Year 1. Issue # 5 focuses on the calculation of the Interim Rate Refund based on the difference between final rates and the interim rates that were charged during the Year 1 test year.

Once the future portion of the part-historical and part-future test year is no longer future (for example, for rates charged after the end of the test year), the question of when the amounts in the reserve for deferred taxes accrued is no longer relevant. Specifically, while interim rates are charged in Year 2, the projected Year 1 ADFIT increases have accrued, and the amounts to be excluded from rate base are no longer projected but historical, even though based on estimates. Thus, the purpose of the proration formula has been accomplished and associated prevention of flowthrough accounting has been avoided as of the beginning of Year 2 (that is, after the end of the Year 1 test year).

Commission B will use the Interim Rate Refund to adjust Taxpayer's interim rates charged after the end of the test year. Commission B is not adjusting interim rates but is instead using the approach to reflect the Year 2 incremental effects of the proration

formula on the revenue requirement on which interim rates are based in the Interim Rate Refund. Accordingly, the computation of an Interim Rate Refund in Year 2 such that the effects of the proration formula rules under § 1.167(l)-1(h)(6) of the Regulations on interim rates charged in Year 2 are returned in Year 2 (by causing or increasing an Interim Rate Refund) would not violate the normalization requirements of § 168(i)(9) of the Code.

The issue of whether it is appropriate to permit the Interim Rate Refund to reverse the effects of the proration formula on interim rates charged *during* the Year 1 test year differs from the issue of the proration formula to interim rates charged *after* the Year 1 test year. The purpose of the proration formula is to prevent the immediate flow-through of the benefits of accelerated depreciation to ratepayers. The proration formula stops flow-through by limiting the deferred tax reserve accruals that may be excluded from rate base, and thus the earnings on rate base that may be disallowed, according to the length of time these accruals are actually in the reserve account. To permit the effects of the proration formula on interim rates charged during the Year 1 test year to be reversed in a subsequent phase of the ratemaking would be economically equivalent to not applying the proration formula in the first place.

Accordingly, the computation of an Interim Rate Refund in Year 2 such that the effects of the proration formula rules under § 1.167(l)-1(h)(6) of the Regulations on interim rates charged in Year 1 are returned in Year 2 (by causing or increasing an Interim Rate Refund) would violate the normalization requirements of § 168(i)(9) of the Code.

Issues 6 and 7

Regarding issues six and seven, reduction of Taxpayer's tax expense or depreciation expense recoverable in final rates or the computation of any Interim Rate Refund that has the effect of offsetting some or all of the level of revenues resulting from prorated ADFIT that may be required would, in effect, flow through the tax benefits of accelerated depreciation deductions to rate payers. This is so even if the intent of such reduction is not specifically to mitigate the effects of the normalization rules. In general, taxpayers may not adopt any accounting treatment that directly or indirectly circumvents the normalization rules. See generally, § 1.46-6(b)(2)(ii) (In determining whether, or to what extent, the investment tax credit has been used to reduce cost of service, reference shall be made to any accounting treatment that affects cost of service); Rev. Proc. 88-12, 1988-1 C.B. 637, 638 (It is a violation of the normalization rules for taxpayers to adopt any accounting treatment that, directly or indirectly flows excess tax reserves to ratepayers prior to the time that the amounts in the vintage accounts reverse).

Accordingly, any reduction in tax expense or depreciation expense recoverable in final rates or the computation of any Interim Rate Refund that has the effect of offsetting

some or all of the level of revenues resulting from prorated ADFIT in setting interim rates that may be required (under the proration formula rules for future test periods or part-historical and part-future test periods under § 1.167(l)-1(h)(6) of the Regulations), would violate the normalization requirements of § 168(i)(9) of the Code.

Therefore, we rule as follows:

1) The computation of ADFIT for purposes of final rates (apart from consideration of an Interim Rate Refund) charged beginning in Month 2 Year 2 without applying the proration formula rules for future test periods or part-historical and part-future periods under § 1.167(l)-1(h)(6) would not violate the normalization requirements of § 168(i)(9).

2) The computation of ADFIT for purposes of interim rates charged beginning on Date 5, without applying the proration formula rules for part-historical and part-future periods under § 1.167(l)-1(h)(6) would violate the normalization requirements of § 168(i)(9).

3) The future portion of a part-historical and part-future period for purposes of interim rates charged beginning on Date 5, began on Date 5 for purposes of determining the total number of days in the future portion of the period under § 1.167(l)-1(h)(6).

4) The computation of an Interim Rate Refund in Year 2 such that the effects of the proration formula rules under § 1.167(l)-1(h)(6) on interim rates charged in Year 2 are returned in Year 2 (by causing or increasing an Interim Rate Refund) would not violate the normalization requirements of § 168(i)(9).

5) The computation of an Interim Rate Refund in Year 2 such that the effects of the proration formula rules under § 1.167(l)-1(h)(6) on interim rates charged in Year 1 are returned in Year 2 (by causing or increasing an Interim Rate Refund) would violate the normalization requirements of § 168(i)(9).

6) Any reduction in tax expense recoverable in final rates or the computation of any Interim Rate Refund that has the effect of offsetting some or all of the level of revenues resulting from prorated ADFIT that may be required (under the proration formula rules for future test periods or part-historical and part-future periods under § 1.167(l)-1(h)(6)), would violate the normalization requirements of § 168(i)(9).

7) Any reduction in the depreciation expense recoverable in final rates or the computation of any Interim Rate Refund that has the effect of offsetting some or all of the level of revenues resulting from prorated ADFIT that may be required (under the proration formula rules for future test periods or part-historical and part-future periods under § 1.167(l)-1(h)(6)), would violate the normalization requirements of § 168(i)(9).

These rulings are based on the representations submitted by Taxpayer and are only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above. 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. 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 Director.

Sincerely,

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

cc:

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April 30, 2018

Ladies and Gentlemen:

Attached is LTR 201817006, in which the Internal Revenue Service ("Service") ruled on the application of the Normalization Rules of the Internal Revenue Code to certain accounting and regulatory procedures, as described below.

Taxpayer is a regulated public utility engaged in the provision of natural gas distribution services in State B, State C, State D, State E, State F, and State G. The businesses in these states are conducted through unincorporated divisions (local distribution companies, "LDCs"). Taxpayer normalizes the federal income taxes deferred as a result of its claiming accelerated depreciation deductions in accordance with the Normalization Rules.

While State E law allows utilities to use either historical or forecasted test periods, the LDC has chosen to file its past several general rate cases using a fully forecasted test period. State E law provides that the Commission must issue its final determination within ten months of the initial filing date unless it has extended that time by up to ninety days due to its need to act on other pending rate cases. After the issuance of a final order, additional procedures may include a request for reconsideration and will always include the submission by the subject utility of a compliance filing which is typically made within thirty days of the date of an order. In LDC's most recent general rate case final rates were not implemented until after the forecasted test period had ended.

As part of the general rate case process and consistent with State E law, the LDC has also been allowed recovery of "interim rates." Interim rate recovery begins no later than sixty days from the initial filing, meaning it generally coincides with the start of the forecasted test period (Date 2). Interim rates are based primarily on the data used to support the utility's proposed final rate request with the following differences: (1) the rate of return on common equity used is equal to that authorized by the Commission in the utility's most recent general rate case, (2) the utility may include in interim rates only rate base or expense items that are the same in nature and kind as those allowed in that most recent general rate case, and (3) interim rates may not reflect any change in existing rate design.

Interim rates are subject to refund (plus interest) if, at the end of the contested case, amounts collected under the interim rate schedule exceed the Commission-approved final rates (Interim Rate Refund). When an Interim Rate Refund is required, the percentage difference between the final and the interim rates is calculated after the end of the test year. A bill credit is then computed for each customer by applying that percentage to the amounts paid by that customer while interim rates were in effect. The credit is posted in full to each customer's next bill.

In determining its revenue requirement for the projected test period (including in determining the appropriate level of interim rate recovery), the LDC calculates the net plant component of rate base using a simple average of the beginning of test period and end of the test period balances. All other elements of rate base, including accumulated deferred federal income tax ("ADFIT") balances, are calculated using a 13-month average. Rate base is reduced by the ADFIT balance so computed.

There is no conventional true-up procedure applicable to rates established in the LDC's general rate cases. The final order establishes final rates based on representative levels of costs and revenues for the test year. The interim rate refund reconciles the differential between the interim rates and the final rates and is implemented only after the rate case is completed. Final rates remain in effect until the utility chooses to file its next general rate case proceeding and any interim rates that may be put into effect pursuant to that proceeding.

Previously, when the LDC has projected the changes in its ADFIT balances for purposes of estimating its revenue requirement for the projected test period (whether for the establishment of interim or final rates), it has not used the proration formula provided in Treas. Reg. § 1.167(l)-1(h)(6) ("Proration Methodology").

In its general rate case filing, the LDC did not utilize the Proration Methodology in its ADFIT calculation. Since a revision to reflect the Proration Methodology after the LDC had filed its request would have increased the requested revenue requirement, the LDC could not take corrective action at that time. Additionally, Taxpayer considered whether a normalization issue may arise in the LDC's general rate case filing because ADFIT was averaged using a 13-month average while other components of rate base were averaged using a simple beginning and ending balance average. Both averages were over the same period of time. Taxpayer represents that if required, the LDC will take all necessary corrective actions in its next general rate case.

Taxpayer requested eleven rulings. In response to Requested Ruling 1, the Service concludes that the test period for LDC's interim rates is a future test period, subject to the proration formula rules under § 1.167-1(h)(6). Therefore, Taxpayer is required to apply the

proration formula rules as they apply to part-historical and part-future periods to calculate the amount of ADFIT by which LDC may reduce rate base in establishing interim rates.

In response to Requested Ruling 2, the Service concludes that the effective date of the differential between the interim rates and the final rates established for the Interim Rate Refund process calculated at the end of the rate proceeding is the effective date for the final rates established by the final order. Accordingly, Requested Ruling 4 (which would have applied if the effective date for the differential was the effective date for the interim rates), is moot.

In response to Requested Ruling 3, the Service concludes that because the Interim Rate Refund process uses an historical test period it is not required to employ the Proration Methodology described in Treas. Reg. § 1.167(l)-1(h)(6)(i).

In response to Requested Ruling 5, the Service concludes that the effective date of the final rates established by the final order and implemented subsequent to the rate case proceeding is the effective date for the final rates established by the final order. Accordingly, Requested Ruling 7 (which would have applied if the effective date of the final rates was the effective date for the interim rates), is moot.

The LDC's computation of ADFIT for purposes of the final rates occurs after the end of the test period on which those amounts are based. Thus, the calculation is determined by reference to a purely historical period. Accordingly, in response to Requested Ruling 6, the Service concludes that the computation of ADFIT for purposes of final rates is not subject to the proration formula rules under § 1.167-1(h)(6); there is no need to follow the proration formula rules designed for future test periods or part-historical and part-future periods to calculate the differences between Taxpayer's projected ADFIT balance and the actual ADFIT balance during the period.

In response to Requested Ruling 8, the Service concludes that the Proration Requirement does not apply only to the difference between (1) the ADFIT balance used to set the interim rates, and (2) the ADFIT balance used in the final rates to establish the Interim Rate Refund. The Proration Requirement continues to apply to the changes in ADFIT balances reflected in setting the interim rates.

In response to Requested Rulings 9 and 10, the ruling provides that in order to satisfy the requirements of § 168(i)(9)(B), there must be consistency in the treatment of costs for rate base, regulated depreciation expense, tax expense, and deferred tax revenue purposes. In this case, ADFIT was averaged using a 13-month average while other components of rate base were averaged using a simple beginning and ending balance average, but all are calculated in consistent fashion and all are averaged over the same period. While there are minor differences in the convention used to average all elements of rate base including depreciation expense on the one hand, and ADFIT on the other, for purposes of § 168(i)(9)(B), it is sufficient

that both are determined by averaging and both are determined over the same period of time. Thus, the calculation of average rate base and ADFIT as described above complies with the consistency requirement of § 168(i)(9)(B). Accordingly, in response to Requested Ruling 9, the Service concludes that the Consistency Rule does not require that the LDC apply to its prorated ADFIT balance the precise regulatory averaging procedure it applies to its other components of rate base in the relevant computation. Similarly, in response to Requested Ruling 10, the Service concludes that the Taxpayer's use of a simple average for certain components of rate base in conjunction with its use of a 13-month average for ADFIT is not violative of the Consistency Rule of § 168(i)(9)(B).

In response to Requested Ruling 11 (regarding corrective action), because the Service has ruled affirmatively with respect to Requested Ruling 1, prospectively adhering to the Service's interpretation of § 1.167(l)- 1(h)(6)(ii) may require adjustments to conform to this ruling. Any rates that have been calculated using procedures inconsistent with this ruling ("nonconforming rates") which are or which have been in effect and which, under applicable state or federal regulatory law, can be adjusted or corrected to conform to the requirements of this ruling, must be so adjusted or corrected. Where nonconforming rates cannot be adjusted or corrected to conform to the requirements of this ruling due to the operation of state or federal regulatory law, then such correction must be made in the next regulatory filing or proceeding in which Taxpayer's rates are considered.

Taxpayer's failure to comply with the Normalization Rules in its general rate case was inadvertent. It was not an inconsistency with the Normalization Rules that Taxpayer, any participant in any of the proceedings, or the regulator in any of the proceedings recognized. No potential proration-related normalization issue was ever identified. Thus, there was clearly no required treatment that was inconsistent with the Normalization Rules. Therefore, there was no determination made with respect to Taxpayer's calculation of its ADFIT balance by the Commission. Because the Commission, as well as Taxpayer, at all times sought to comply, and because the LDC will take corrective actions at the earliest available opportunity, it is not appropriate to conclude that the failure to use the Proration Formula constituted a normalization violation and apply the sanction of denial of accelerated depreciation to Taxpayer.

Accordingly, in response to Requested Ruling 11, the Service concludes that in any year prior to the LDC taking the necessary corrective action Taxpayer's relevant regulatory practices were not a violation of the Normalization Rules.

Amie Broder

Internal Revenue Service

Number: **201817006**
Release Date: 4/27/2018

Index Number: 167.22-01

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B06
PLR-123443-17

Date:
January 25, 2018

LEGEND:
Parent =
Holdco =
Taxpayer =
State A =
State B =
State C =
State D =
State E =
State F =
State G =
Commission =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
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Date 6 =
Date 7 =
Director =

Dear :

This letter responds to Parent's request dated July 28, 2017, filed on behalf of Taxpayer, for a ruling on the application of the Normalization Rules of the Internal Revenue Code to certain accounting and regulatory procedures, as described below.

The representations set out in your letter follow.

Taxpayer is wholly owned by Holdco, a State A limited liability company that is disregarded for federal income tax purposes. Holdco, is wholly owned by Parent, a

corporation organized under the laws of State B. Parent is the common parent of an affiliated group of corporations that includes Holdco and Taxpayer. Parent files a consolidated federal income tax return on a calendar year basis employing the accrual method of accounting. Parent is currently under the audit jurisdiction of the Large Business and International Division of the Internal Revenue Service.

Taxpayer is a regulated public utility engaged in the provision of natural gas distribution services in State B, State C, State D, State E, State F, and State G. The businesses in these states are conducted through unincorporated divisions (local distribution companies). Taxpayer's State E local distribution company (LDC) is subject to regulation as to rates and conditions of service by the Commission.

Taxpayer has claimed (and continues to claim) accelerated depreciation on all of its public utility property to the full extent those deductions are available under the Code. Taxpayer normalizes the federal income taxes deferred as a result of its claiming these deductions in accordance with the Normalization Rules. As a consequence, Taxpayer has a substantial balance of accumulated deferred federal income tax (ADFIT) that is attributable to accelerated depreciation reflected on its regulated books of account.

While State E law allows utilities to use either historical or forecasted test periods, the LDC has chosen to file its past several general rate cases using a fully forecasted test period. Generally, the LDC has filed in Date 1, with a test period running from Date 2 of that year through Date 3 of the following year. State E law provides that the Commission must issue its final determination within ten months of the initial filing date unless it has extended that time by up to ninety days due to its need to act on other pending rate cases. After the issuance of a final order, additional procedures ensue. These procedures may include a request for reconsideration and will always include the submission by the subject utility of a compliance filing which is typically made within thirty days of the date of an order. Parties to the proceeding then have thirty days to submit comments on that filing. The rates established in that final order are typically not put into effect prior to the end of the projected test period. In LDC's most recent general rate case final rates were not implemented until after the forecasted test period had ended.

As part of the general rate case process and consistent with State E law, the LDC has also been allowed recovery of "interim rates." Interim rate recovery begins no later than sixty days from the initial filing, meaning it generally coincides with the start of the forecasted test period (Date 2). The Commission sets interim rates through an interim rate order. Consequently, interim rates are established before a full review of the utility's proposed costs is completed and are based primarily on the data used to support the utility's proposed final rate request with the following differences: (1) the rate of return on common equity used is equal to that authorized by the Commission in the utility's most recent general rate case, (2) the utility may include in interim rates only rate base or expense items that are the same in nature and kind as those allowed in

that most recent general rate case, and (3) interim rates may not reflect any change in existing rate design. Each of these factors may differ from the ones incorporated into the rates established in the final order that results from the conduct of the current proceeding.

Interim rates are subject to refund (plus interest) if, at the end of the contested case, amounts collected under the interim rate schedule exceed the Commission-approved final rates (Interim Rate Refund). Any Interim Rate Refund occurs only with the effective date of the final rates, which, as indicated above, typically occurs after the end of the projected test period, even when there are no time extensions in a general rate proceeding.

When an Interim Rate Refund is required, the percentage difference between the final and the interim rates is calculated after the end of the test year. A bill credit is then computed for each customer by applying that percentage to the amounts paid by that customer while interim rates were in effect. The credit is posted in full to each customer's next bill. As a result, customers who receive gas service during the projected test period collectively pay the allowed revenue level established in the final order for that service regardless of when the final order is issued or when the rates established by that order go into effect.

In determining its revenue requirement for the projected test period (including in determining the appropriate level of interim rate recovery), the LDC calculates the net plant component of rate base using a simple average of the beginning of test period and end of the test period balances. All other elements of rate base, including ADFIT balances, are calculated using a 13-month average. Rate base is reduced by the ADFIT balance so computed.

There is no conventional true-up procedure applicable to rates established in the LDC's general rate cases. Hence there is no procedure by which rates established in its general rate case (whether interim or final) and based on a projected test period are trued-up to a revenue requirement for that period which is calculated by reference to the actual results of LDC's activities during the test period. Rather, the final order establishes final rates based on representative levels of costs and revenues for the test year. The interim rate refund reconciles the differential between the interim rates and the final rates and is implemented only after the rate case is completed. Final rates remain in effect until the utility chooses to file its next general rate case proceeding and any interim rates that may be put into effect pursuant to that proceeding. As a result, the general rate case may be seen as comprised of three elements: (1) setting interim rates established by the interim rate order, (2) setting final rates established by the final order subsequent to the rate case proceeding, and (3) calculating an Interim Rate Refund subsequent to the rate case proceeding based on the difference between the interim rates paid and the amount that would have been paid had final rates been in effect for the same period.

Previously, when the LDC has projected the changes in its ADFIT balances for purposes of estimating its revenue requirement for the projected test period (whether for the establishment of interim or final rates), it has not used the proration formula provided in Treas. Reg. § 1.167(l)-1(h)(6) (Proration Methodology). Prior to and including its most recent general rate case, this lack of the use of the Proration Methodology has not been challenged or even commented upon by the Commission or any party in any of the LDC's proceedings.

The LDC filed its most recent general rate case with the Commission on Date 4. The test period in the case ran from Date 5 through Date 7 with interim rates going into effect on Date 6. In its general rate case filing, the LDC did not utilize the Proration Methodology in its ADFIT calculation. After filing, Taxpayer considered whether it would be possible to revise its pending rate request to incorporate the impact of the Proration Methodology and determined that State E law provides that "in no event shall the rates [approved by the Commission] exceed the level of rates requested by the public utility." Since a revision to reflect the Proration Methodology after the LDC had filed its request would have increased the requested revenue requirement, the LDC could not take corrective action at that time.

Additionally, Taxpayer considered whether a normalization issue may arise in the LDC's general rate case filing because ADFIT was averaged using a 13-month average while other components of rate base were averaged using a simple beginning and ending balance average. Both averages were over the same period of time.

Both Taxpayer and the Commission have at all times endeavored to use a proper normalization method of accounting for the LDC's public utility property. Notwithstanding this intent, Taxpayer is now concerned that its prior LDC general rate case filings may have been inconsistent with the Normalization Rules insofar as they did not employ the Proration Methodology. Further, Taxpayer believes that there may be an issue regarding the LDC's practice of applying two different averaging conventions to different components of its rate base calculation. Taxpayer represents that if required, the LDC will take all necessary corrective actions in its next general rate case.

Taxpayer requests that we rule as follows:

1) In order to comply with the Normalization Rules, whether, in determining the maximum amount of ADFIT by which the LDC can reduce rate base in establishing the interim rates, it must employ the Proration Methodology described in Treas. Reg. § 1.167(l)-1(h)(6)(i);

2) Whether, for purposes of the Normalization Rules, the effective date of the differential between the interim rates and the final rates established for the Interim Rate Refund process calculated at the end of the rate proceeding is the effective

date for the interim rates established in the interim rate order or the effective date for final rates established by the final order;

3) If, with respect to Requested Ruling 2, the Service rules that the effective date of the differential between the interim rates and the final rates established by the Interim Rate Refund process calculated at the end of the rate proceeding is the effective date for final rates established by the final order, whether the Interim Rate Refund process uses an historical test period and therefore, is not required to employ the Proration Methodology described in Treas. Reg. § 1.167(l)-1(h)(6)(i);

4) If, with respect to Requested Ruling 2, the Service rules that the effective date of the differential between the interim rates and the final rates established by the Interim Rate Refund process is the effective date for the interim rates that were established in the interim rate order, whether the Interim Rate Refund process uses a future test period and must, therefore, employ the Proration Methodology described in Treas. Reg. § 1.167(l)-1(h)(6)(i);

5) Whether, for purposes of the Normalization Rules, the effective date of the final rates established by the final order and implemented subsequent to the rate case proceeding is the effective date for the interim rates that were established by an interim rate order or the effective date for the final rates established by the final order;

6) If, with respect to Requested Ruling 5, the Service rules that the effective date of the final rates established by the final order and implemented subsequent to the rate case proceeding is the effective date of the final rates established by the final order, whether the computation of these rates uses an historical test period and, therefore, is not required to employ the Proration Methodology described in Treas. Reg. § 1.167(l)-1(h)(6)(i);

7) If, with respect to Requested Ruling 5, the Service rules that the effective date of the final rates established by the final order is the effective date for the interim rates established by the interim rate order, whether the computation of the final rates implemented subsequent to the rate case proceeding uses a future test period and must, therefore, employ the Proration Methodology described in Treas. Reg. § 1.167(l)-1(h)(6)(i);

8) If the Service rules in the affirmative with respect to Requested Ruling 3, in computing the Interim Rate Refund, whether the Proration Requirement does not apply only to the difference between (1) the ADFIT balance used to set interim rates, and (2) the ADFIT balance used in the final rates to establish the Interim Rate Refund (that is, the Proration Requirement would continue to apply to the changes in ADFIT balances reflected in setting the interim rates);

9) If the Service rules that the Proration Methodology applies to any of the three elements of Taxpayer's base rate process (interim rates, Interim Rate Refund, and final rates) the Consistency Rule does not require that the LDC apply to its prorated ADFIT balance the regulatory averaging procedure it applies to its other components of rate base in the relevant computation;

10) The Taxpayer's use of a simple average for certain components of rate base in conjunction with its use of a 13-month average for ADFIT is not violative of the Consistency Rule of § 168(i)(9)(B); and

11) In the event that the Service concludes with respect to Requested Rulings 1, 4, or 7 that the LDC must use the Proration Methodology to comply with the Normalization Rules and/or concludes with respect to Requested Ruling 10 that the LDC's use of differing averaging conventions is violative of the Consistency Rule, Taxpayer requests a ruling that, in any year prior to its taking the necessary corrective action, Taxpayer's relevant regulatory practice were not a violation of the Normalization Rules.

Law and Analysis

Requested Rulings 1 - 7

Section 1.167(l)-1(h)(6) of the Regulations sets forth normalization requirements with respect to public utility property. Under § 1.167(l)-1(h)(6)(i), a taxpayer does not use a normalization method of accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes excluded from the rate base, or treated as cost-free capital, exceeds the amount of the reserve for the period used in determining the taxpayer's ratemaking tax expense. Section 1.167(l)-1(h)(6)(ii) also provides the procedure for determining the amount of the reserve for deferred taxes to be excluded from rate base or to be included as no-cost capital.

Section 1.167(l)-1(h)(6)(ii) provides that for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under § 1.167(l)-1(h)(6)(i), if solely an historical period is used to determine depreciation for federal income tax expense for ratemaking purposes, then the amount of the reserve account for the period is the amount of the reserve (determined under § 1.167(l)-1(h)(2)) at the end of the historical period. Section 1.167(l)-1(h)(6)(ii) provides that if solely a future period is used for such determination, the amount of the reserve account for the period is the amount of the reserve at the beginning of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during such period.

Section 1.167(l)-1(h)(6)(ii) provides if, in determining depreciation for ratemaking tax expense, a period (the "test period") is used which is part historical and part future, then

the amount of the reserve account for this period is the amount of the reserve at the end of the historical portion of the period and a pro rata amount of any projected increase to be credited to the account during the future portion of the period. The pro rata amount of any increase during the future portion of the period is determined by multiplying the increase by a fraction, the numerator of which is the number of days remaining in the period at the time the increase is to accrue, and the denominator of which is the total number of days in the future portion of the period. This is generally referred to as "the proration formula" or the "proration methodology."

Section 1.167(l)-1(h)(6)(i) makes it clear that the reserve excluded from rate base must be determined by reference to the same period as is used in determining ratemaking tax expense. A taxpayer may use either historical data or projected data in calculating these two amounts, but it must be consistent. As explained in § 1.167(l)-1(a)(1), the rules provided in § 1.167(l)-1(h)(6)(i) are to insure that the same time period is used to determine the deferred tax reserve amount resulting from the use of an accelerated method of depreciation for cost of service purposes and the reserve amount that may be excluded from the rate base or included in no-cost capital in determining such cost of services.

If a taxpayer chooses to compute its ratemaking tax expense and rate base exclusion amount using projected data then it must use the formula provided in § 1.167(l)-1(h)(6)(ii) to calculate the amount of deferred taxes subject to exclusion from the rate base. This formula prorates the projected accruals to the reserve so as to account for the actual time these amounts are expected to be in the reserve. As explained in § 1.167(l)-1(a)(1), the formula in § 1.167(l)-1(h)(6)(ii) provides a method to determine the period of time during which the taxpayer will be treated as having received amounts credited or charged to the reserve account so that the disallowance of earnings with respect to such amounts through rate base exclusion or treatment as no-cost capital will take into account the factor of time for which such amounts are held by the taxpayer.

The purpose of the proration formula is the same as that of the requirement for consistent periods discussed above: to prevent the immediate flow-through of the benefits of accelerated depreciation to ratepayers. The proration formula stops flow-through by limiting the deferred tax reserve accruals that may be excluded from rate base, and thus the earnings on rate base that may be disallowed, according to the length of time these accruals are actually in the reserve account.

The effectiveness of § 1.167(l)-1(h)(6)(ii) in resolving the timing issue has been limited by its failure to define some key terms. Nowhere does this provision state what is meant by the terms "historical" and "future" in relation to the test period for determining depreciation for ratemaking tax expense. How are these time periods to be measured? One interpretation focuses on the type or quality of the data used in the ratemaking process. According to this interpretation, the historical period is that portion of the test period for which actual data is used, while the portion of the period for which data is

estimated is the future period. The second interpretation focuses on when the utility rates become effective. Under this interpretation, the historical period is that portion of the test period before rates go into effect, while the portion of the test period after the effective date of the rate order is the future period.

The first interpretation, which focuses on the quality of the ratemaking data, is an attractive one. It proposes a simple rule, easy to follow and to enforce: any portion of the reserve for deferred taxes based on estimated data must be prorated in determining the amount to be deducted from rate base. The actual passage of time between the date ratemaking data is submitted and the date rates become effective is of no importance. But this interpretation of the regulations achieves simplicity at the expense of precision; in other words, it is overbroad. The proration of all estimated deferred tax data does serve to magnify the benefits of accelerated depreciation to the utility, but this is not the purpose of normalization. Congress was explicit: normalization "in no way diminishes whatever power the [utility regulatory] agency may have to require that the deferred taxes reserve be excluded from the base upon which the utility's permitted rate of return is calculated." H.R. Rep. No. 413, 91st Cong., 1st Sess. 133 (1969).

In contrast, the second interpretation of § 1.167(l)-1(h)(6)(ii) is consistent with the purpose of normalization, which is to preserve for regulated utilities the benefits of accelerated depreciation as a source of cost-free capital. The availability of this capital is ensured by prohibiting flow-through. But whether or not flow-through can even be accomplished by means of rate base exclusions depends primarily on whether, at the time rates become effective, the amounts originally projected to accrue to the deferred tax reserve have actually accrued.

If rates go into effect before the end of the test period, and the rate base reduction is not prorated, the utility commission may be denying a current return for accelerated depreciation benefits the utility is only projected to have. This procedure is a form of flow-through, for current rates are reduced to reflect the capital cost savings of accelerated depreciation deductions not yet claimed or accrued by the utility. Yet projected data is often necessary in determining rates, since historical data by itself is rarely an accurate indication of future utility operating results. Thus, the regulations provide that as long as the portion of the deferred tax reserve based on truly projected (future estimated) data is prorated according to the formula in § 1.167(l)-1(h)(6)(ii), a regulator may deduct this reserve from rate base in determining a utility's allowable return. In other words, a utility regulator using projected data in computing ratemaking tax expense and rate base exclusion must account for the passage of time if it is to avoid flow-through.

But if rates go into effect after the end of the test period, the opportunity to flow-through the benefits of future accelerated depreciation to current ratepayers is gone, and so too is the need to apply the proration formula. In this situation, the only question that is important for the purpose of rate base exclusion is the amount in the deferred tax

reserve, whether actual or estimated. Once the period over which accruals to the reserve were projected is completed and the final rates are in effect, the question of when the amounts in the reserve accrued is no longer being estimated or projected (at the time the new rate order takes effect, the projected increases have accrued, and the amounts to be excluded from rate base are no longer projected but historical, even though based initially on estimates).

In the LDC's general rate case, the interim rates, subject to refund, became effective Date 6. The interim rates were based on test year from Date 5 through Date 7. The net plant component of rate base is calculated by using a simple average of the beginning of test period and end of the test period balances. All other elements of rate base, including ADFIT balances, are calculated using a 13-month average. Rate base is reduced by the ADFIT balance so computed. The averages were each over the same period of time. The future portion of a part-historical and part-future period for purposes of interim rates charged began on Date 6, for purposes of determining the total number of days in the future portion of the period under § 1.167(l)-1(h)(6).

In response to Requested Ruling 1, we conclude that the test period for LDC's interim rates is a future test period, subject to the proration formula rules under § 1.167-1(h)(6). Therefore, Taxpayer is required to apply the proration formula rules as they apply to part-historical and part-future periods to calculate the amount of ADFIT by which LDC may reduce rate base in establishing interim rates.

In response to Requested Ruling 2, we conclude that the effective date of the differential between the interim rates and the final rates established for the Interim Rate Refund process calculated at the end of the rate proceeding is the effective date for the final rates established by the final order. Accordingly, Requested Ruling 4, above, is moot.

In response to Requested Ruling 3, we also conclude that because the Interim Rate Refund process uses an historical test period it is not required to employ the Proration Methodology described in Treas. Reg. § 1.167(l)-1(h)(6)(i).

In response to Requested Ruling 5, we conclude that the effective date of the final rates established by the final order and implemented subsequent to the rate case proceeding is the effective date for the final rates established by the final order. Accordingly, Requested Ruling 7, above**,** is moot.

The LDC's computation of ADFIT for purposes of the final rates occurs after the end of the test period on which those amounts are based. Thus, the calculation is determined by reference to a purely historical period. Accordingly, in response to Requested Ruling 6, we conclude that the computation of ADFIT for purposes of final rates is not subject to the proration formula rules under § 1.167-1(h)(6); there is no need to follow the proration formula rules designed for future test periods or part-historical and part-future

periods to calculate the differences between Taxpayer's projected ADFIT balance and the actual ADFIT balance during the period.

Requested Ruling 8

We have concluded above that the interim rates charged during the pendency of the rate case until final rates are implemented, because they are in effect before the end of the test period, are considered calculated using a future test period. Once final rates are determined, the Interim Rate Refund is calculated, based on the difference between the interim rates and the final rates. As discussed above, the Interim Rate Refund is in effect after the conclusion of the test year and thus, the Interim Rate Refund is not considered calculated using a future test period. Requested Ruling 8 requires that we apply the proration formula rules of § 1.167(l)-1(h)(6) to these situations.

The proration formula stops flow-through by limiting the deferred tax reserve accruals that may be excluded from rate base, and thus the earnings on rate base that may be disallowed, according to the length of time these accruals are actually in the reserve account. Specifically, while interim rates are charged during the test year, the projected test year ADFIT increases have accrued only as allowed using the proration formula. Once the test year has ended and the Interim Rate Refund is calculated and is in effect, the amounts to be excluded from rate base are no longer projected but historical, even though based on estimates. At this point, the purpose of the proration formula has been accomplished and associated prevention of flow-through accounting has been avoided by its application during the future test period. To permit the effects of the proration formula on interim rates charged during the test year to be reversed in a subsequent phase of the ratemaking would be economically equivalent to not applying the proration formula in the first place.

In response to Requested Ruling 8, we conclude that the Proration Requirement does not apply only to the difference between (1) the ADFIT balance used to set the interim rates, and (2) the ADFIT balance used in the final rates to establish the Interim Rate Refund. The Proration Requirement continues to apply to the changes in ADFIT balances reflected in setting the interim rates.

Requested Rulings 9 & 10

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(1)-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 of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under § 168(i)(9)(A)(ii), if the amount allowable as a deduction under § 168 differs from the amount that-would be allowable as a deduction under § 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under § 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) 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.

In order to satisfy the requirements of § 168(i)(9)(B), there must be consistency in the treatment of costs for rate base, regulated depreciation expense, tax expense, and deferred tax revenue purposes. In this case, ADFIT was averaged using a 13-month average while other components of rate base were averaged using a simple beginning and ending balance average. But are all calculated in consistent fashion - all are averaged over the same period. While there are minor differences in the convention used to average all elements of rate base including depreciation expense on the one hand, and ADFIT on the other, for purposes of § 168(i)(9)(B), it is sufficient that both are determined by averaging and both are determined over the same period of time. Thus, the calculation of average rate base and ADFIT as described above complies with the consistency requirement of § 168(i)(9)(B).

Accordingly, in response to Requested Ruling 9, we conclude that the Consistency Rule does not require that the LDC apply to its prorated ADFIT balance the precise

regulatory averaging procedure it applies to its other components of rate base in the relevant computation.

Similarly, in response to Requested Ruling 10, we conclude that the Taxpayer's use of a simple average for certain components of rate base in conjunction with its use of a 13-month average for ADFIT is not violative of the Consistency Rule of § 168(i)(9)(B).

Requested Ruling 11

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 has 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.

Because the Service has ruled affirmatively with respect to Requested Ruling 1, prospectively adhering to the Service's interpretation of § 1.167(l)- 1(h)(6)(ii) may require adjustments to conform to this ruling. Any rates that have been calculated using procedures inconsistent with this ruling ("nonconforming rates") which are or which have been in effect and which, under applicable state or federal regulatory law, can be adjusted or corrected to conform to the requirements of this ruling, must be so adjusted or corrected. Where nonconforming rates cannot be adjusted or corrected to conform to the requirements of this ruling due to the operation of state or federal regulatory law, then such correction must be made in the next regulatory filing or proceeding in which Taxpayer's rates are considered.

Taxpayer's failure to comply with the Normalization Rules in its general rate case was inadvertent. It was not an inconsistency with the Normalization Rules that Taxpayer, any participant in any of the proceedings, or the regulator in any of the proceedings recognized. No potential proration-related normalization issue was ever identified. Thus, there was clearly no required treatment that was inconsistent with the Normalization Rules. Therefore, there was no determination made with respect to Taxpayer's calculation of its ADFIT balance by the Commission. Because the Commission, as well as Taxpayer, at all times sought to comply, and because the LDC will take corrective actions at the earliest available opportunity, it is not appropriate to conclude that the failure to use the Proration Formula constituted a normalization violation and apply the sanction of denial of accelerated depreciation to Taxpayer.

Accordingly, in response to Requested Ruling 11, we conclude that in any year prior to the LDC taking the necessary corrective action Taxpayer's relevant regulatory practices were not a violation of the Normalization Rules.

Conclusions

1) In order to comply with the Normalization Rules, the LDC must employ the Proration Methodology described in Treas. Reg. § 1.167(l)-1(h)(6)(i) to determine the maximum amount of ADFIT by which the LDC can reduce rate base in establishing the interim rates.

2) For purposes of the Normalization Rules, the effective date of the differential between the interim rates and the final rates established for the Interim Rate Refund process calculated at the end of the rate proceeding is the effective date for the final rates established by the final order.

3) The Interim Rate Refund process uses an historical test period and therefore, is not required to employ the Proration Methodology described in Treas. Reg. § 1.167(l)-1(h)(6)(i).

4) As a result of our conclusion for Requested Ruling 2 the issue is moot.

5) For purposes of the Normalization Rules, the effective date of the final rates established by the final order and implemented subsequent to the rate case proceeding is the effective date for the final rates established by the final order.

6) The computation of the final rates uses an historical test period and, therefore, is not required to employ the Proration Methodology described in Treas. Reg. § 1.167(l)-1(h)(6)(i).

7) As a result of our conclusion for Requested Ruling 5 the issue is moot.

8) The Proration Requirement does not apply only to the difference between (1) the ADFIT balance used to set the interim rates, and (2) the ADFIT balance used in the final rates to establish the Interim Rate Refund. The Proration Requirement continues to be reflected in the changes in ADFIT balances reflected in setting the interim rates.

9) The Consistency Rule does not require that the LDC apply to its prorated ADFIT balance the regulatory averaging procedure it applies to its other components of rate base in the relevant computation.

10) The Taxpayer's use of a simple average for certain components of rate base in conjunction with its use of a 13-month average for ADFIT is not violative of the Consistency Rule of § 168(i)(9)(B).

11) In any year prior to Taxpayer taking the necessary corrective action Taxpayer's

relevant regulatory practices were not a violation of the Normalization Rules.

These rulings are based on the representations submitted by Taxpayer and are only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

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. 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 Director.

Sincerely,

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

cc: