

156 FERC ¶ 61,200
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Norman C. Bay, Chairman;
Cheryl A. LaFleur, Tony Clark,
and Colette D. Honorable.

PJM Interconnection, L.L.C.
Virginia Electric and Power Company

Docket No. ER14-1831-003

ORDER DENYING REHEARING

(Issued September 22, 2016)

1. On March 24, 2016, Old Dominion Electric Cooperative, the North Carolina Electric Membership Corporation, and Virginia Municipal Electric Association No. 1 (Indicated Customers) filed for rehearing of the Commission's February 23, 2016 order¹ accepting Virginia Electric and Power Company's (VEPCO) revision to its formula rate to change its methodology for calculating Accumulated Deferred Income Tax (ADIT) to accord with IRS methodology and an Internal Revenue Service (IRS) Private Letter Ruling (PLR).²

2. For the reasons discussed below, we deny rehearing.

I. Background

3. The February 23, 2016 order provides a detailed background of the proceeding. As relevant to the rehearing, the Commission adjusts for the use of accelerated methods of depreciating utility property in calculating rates through its use of tax normalization.³ Under Commission ratemaking policies, income taxes included in rates are determined based on the return on net rate base calculated using straight-line depreciation. However,

¹ *PJM Interconnection, L.L.C. & Virginia Electric & Power Co.*, 154 FERC ¶ 61,126 (2016) (February 23, 2016 order).

² I.R.S. Priv. Ltr. Rul. 143241-14 (July 6, 2015) (2015 PLR).

³ 18 C.F.R § 35.24 (2016).

in calculating the actual amount of income taxes due and payable to the IRS, companies generally are able to take advantage of accelerated depreciation methods. Accelerated depreciation will generally lower federal income taxes payable during the early years of an asset's life followed by corresponding increases in taxes payable during the later years of an asset's life.⁴ This means that a company's income taxes due and payable in a period will differ from its income tax expense in the same period for ratemaking purposes. The difference between the income taxes based on straight-line-depreciation and the actual taxes paid by the company are reflected in an account called ADIT or Accumulated Deferred Federal Income Taxes (ADFIT).⁵ A positive ADIT account reflects, in effect, taxes the customers pre-pay during the early years of an asset's life providing the company with funds to pay taxes after the accelerated depreciation period ends.⁶ Because the customers are, in effect, providing the company with cost-free capital during the period of accelerated depreciation, the Commission subtracts the ADIT balance from the company's rate base thereby lowering customer rates.⁷

4. The IRS requires that utilities seeking to claim accelerated depreciation on their federal income tax returns must compute their tax expense for ratemaking purposes using a tax normalization method of accounting. As part of the normalization, the IRS requires that utilities use a proration methodology whenever rates include future projections of rate base. The IRS explains that the "purpose of the proration formula is to prevent the

⁴ This occurs because the deductions computed using accelerated depreciation for tax purposes differ from the depreciation expense computed using straight-line depreciation on the company's books for ratemaking purposes.

⁵ Accumulated deferred income taxes are amounts that reflect the tax reduction (or increase) resulting from the differences between the periods in which transactions affect taxable income and the periods in which they enter into the determination of accounting (book) income. *See* 18 C.F.R. Part 101, General Instruction 18 (2016).

⁶ After accelerated depreciation of an asset ends, the Commission's use of straight-line depreciation would not provide sufficient revenue to cover the extra taxes owed. The ADIT account records the pre-paid taxes that provide the amount needed to pay the higher taxes when accelerated depreciation has ended.

⁷ The ADIT balance may become negative when the depreciation expense based on straight-line depreciation expense included in rates exceeds the depreciation expenses, based on accelerated depreciation, allowed for tax purposes. Amounts recorded as ADIT, therefore, reverse in later years and rate base will increase, with a consequent increase in rate base and higher customer rates.

immediate flow-through of the benefits of accelerated depreciation to ratepayers.”⁸ Utilities that do not employ the proration formula may not be permitted to take advantage of accelerated depreciation.

5. The IRS requires that when a utility’s test period for determining rates is part historical and part projected, the amount of the ADIT reserve is the ADIT 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.⁹ In effect, the IRS requires that increases and decreases in the future projection of rate base be determined based on the number of days remaining in the period at the time of the increase or decrease. The purpose of the proration requirement is to prevent the immediate flow-through of the benefits of accelerated depreciation to ratepayers based on the actual time these amounts are expected to be in the ADIT account, thereby allowing funds provided by accelerated depreciation to be used for investments.

6. VEPCO uses a formula rate to determine the rates it will charge for an upcoming year and relies on projected investments for the upcoming year in calculating that rate. VEPCO’s formula rate includes a true-up mechanism through which it calculates adjustments to its formula, for example, for the differences from investments that did not occur when projected or for investments which occurred at a different period than projected.

7. Because VEPCO was concerned its prior formula rate did not comply with the IRS’s proration requirement, it filed in this docket to revise its formula rate to reflect the IRS’s policy and also filed in the various states in which it operates. The Commission established a hearing, but held the hearing in abeyance while VEPCO received guidance from the IRS through a private revenue ruling regarding its proposed method of prorating its projected investment.¹⁰ Based on the VEPCO filing and the 2015 PLR, VEPCO revised its prior methodology for using the proration methodology for ADIT, which the Commission accepted.

⁸ 2015 PLR at 6. As the IRS explains, proration ensures that the subtraction of ADIT from rate base for projected investments takes “into account the factor of time for which such amounts are held by the taxpayer.” *Id.*

⁹ Treas. Reg. § 1.167(l)-1(h)(6)(ii).

¹⁰ One of the states in which VEPCO operates required that it obtain such guidance. 2015 PLR at 3.

8. Indicated Customers object to the use of the proration methodology to determine the rate to be charged by VEPCO for the projected year. Indicated Customers seek rehearing only as to VEPCO's methodology for determining the true-up.

9. VEPCO's initial proposal applied the proration requirement both to the projected rates and to the true-up mechanism. Based on the 2015 PLR, VEPCO revised its approach for the true-up to retain the IRS's proration methodology for the originally projected ADIT amount, but not for differences in ADIT resulting from the true-up. In support of its proposed changes to the true-up calculation, VEPCO refers to the 2015 PLR's finding that "in calculating the true-up, proration applies to the original projection amount but the actual amount added to the ADFIT over the test year is not modified by application of the proration formula."¹¹ VEPCO contended that its approach to proration "preserves both the economic effect of the [Internal Revenue Code]-required proration and the definitions of 'future' and 'historical' test periods provided in the PLR."¹² VEPCO stated that it confirmed those conclusions with IRS.¹³ In the February 23, 2016 order, the Commission accepted VEPCO's approach to the true-up mechanism finding its "treatment is consistent with the PLR," which states "in calculating the true-up, proration

¹¹ 2015 PLR at 7 (cited in VEPCO October 30, 2015 Filing at 7).

¹² VEPCO October 30, 2015 Filing at 7. VEPCO's witness, James I. Warren, provided an example of the logic of VEPCO's proposal.

The situation that most clearly illustrates the logic of this holding would be where the Company sets projection-based formula rates in one period and, when it proceeds to calculate true-up-based formula rates, determines that each and every projection, including deferred tax balances, was 100% accurate. Under the IRS holding, there would be no true-up. The proration used in the calculation of projection-based rates would be preserved. The alternative would be to calculate a true-up based exclusively on reversing the effect of the proration that had been used to calculate the projection-based rates. This alternative conclusion would, as a practical matter, emasculate the proration requirement.

Ex. DVP 6 at 10.

¹³ Ex. DVP at 10.

applies to the original projection amount but the actual amount added to the ADFIT over the test year is not modified by application of the proration formula.”¹⁴

II. Rehearing Request

10. Indicated Customers contend the Commission erred in accepting VEPCO’s true-up proposal as it is “in direct contradiction with the PLR.”¹⁵ They argue that the true-up is calculated after the future period has ended and is therefore based on purely historical information. They cite to statements in the 2015 PLR which they believe indicate that proration should not be used for historical values.

III. Procedural Matters

11. VEPCO filed a motion requesting leave to file an answer to Indicated Customers rehearing request. Rule 713(d) of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.713(d)(1)(2016), prohibits an answer to a request for rehearing. Accordingly, we deny VEPCO’s motion to answer and reject VEPCO’s answer to the rehearing request.

IV. Discussion

12. We deny rehearing. The Commission’s policy is to encourage utilities to use accelerated depreciation, because it provides the utility with cost free capital during the early years of the investment, which redounds to the benefit of utility customers. Taking accelerated depreciation benefits customers by lowering the utility’s taxes, thereby providing the utility with cost-free capital for investment.¹⁶ Here, VEPCO seeks to retain accelerated depreciation and made this filing to ensure that it satisfies the IRS requirements.

¹⁴ February 23, 2016 order, 154 FERC ¶ 61,126, at P 21; 2015 PLR at 7 (cited in VEPCO October 30, 2015 Filing at 7).

¹⁵ Rehearing Request at 5.

¹⁶ *Midcontinent Indep. Sys. Operator, Inc. & ITC Midwest LLC*, 154 FERC ¶ 61,187 (finding imprudent a utility’s decision not to avail itself of bonus depreciation), *reh’g denied*, 155 FERC ¶ 61,248 (2016). *See also, Midwestern Gas Transmission Co. v. FPC*, 388 F.2d 444 (7th Cir. 1968) (affirming a Commission determination to determine rates using a depreciation approach that maximizes tax savings), *cert. denied*, 392 U.S. 928 (1968).

13. Indicated Customers contend VEPCO's true-up proposal (to retain the IRS's proration methodology for the originally projected ADIT amount during the true-up and apply actual ADIT values for any changes in ADIT resulting from the true-up) is "in direct contradiction" to the 2015 PLR.¹⁷ We find that, based on the 2015 PLR, VEPCO's filing is based on a reasonable interpretation of the positions taken by the IRS and is just and reasonable. Both VEPCO and Indicated Customers rely on many of the same statements in the 2015 PLR. In particular, they both cite to this statement in the 2015 PLR:

In contrast to the projections discussed above, the true-up component is determined by reference to a purely historical period and there is no need to use the proration formula to calculate the differences between Taxpayer's projected ADFIT balance and the actual ADFIT balance during the period. In calculating the true-up, proration applies to the original projection amount but the actual amount added to the ADFIT over the test year is not modified by application of the proration formula.¹⁸

14. The purpose of having a true-up as part of formula rates is to reconcile the amounts projected with the actual amounts incurred, so that ratepayers pay accurate rates.¹⁹ In its filing, VEPCO maintains that its true-up formula complies with the 2015 PLR as it uses actual ADIT values for the reconciled amounts (the differences between the projected amounts and the actuals).

15. The 2015 PLR states "there is no need to use the proration formula to calculate the differences between Taxpayer's projected ADFIT balance and the actual ADFIT balance

¹⁷ Rehearing Request at 5. Other than the 2015 PLR, Indicated Customers cite no other IRS material to support their position.

¹⁸ 2015 PLR at 8.

¹⁹ The 2015 PLR describes the true-up similarly as recording a "reconciliation" of the differences between the projected values and the actual values. The 2015 PLR states that "*any differences* between anticipated amounts and actual amounts are reconciled by a 'true-up' mechanism at the end of the test year" under which "the *reconciliation amount* is either charged to ratepayers (if actual revenues are below estimates) or credited to ratepayers (if actual revenues exceed estimates) as part of the rates established for the forthcoming rate year" (emphasis added). 2015 PLR at 2.

during the period.”²⁰ VEPCO’s proposal appears to comply with this requirement as it does not use the proration formula for the reconciled differences. In its filing, VEPCO also points to the statement in the 2015 PLR that “in calculating the true-up, proration applies to the original projection amount but the actual amount added to the ADFIT over the test year is not modified by application of the proration formula.”²¹ This statement also supports VEPCO’s approach of not modifying the prorated ADIT for the projection and using un-prorated values for the differences in ADIT resulting from changes in the projections. VEPCO further relies on the statement in the 2015 PLR that “the addition of the true up increases the ultimate accuracy of the rates but does not convert a future test period into a historical test period as those terms are used in the normalization regulations.”²² As VEPCO maintains, this statement reasonably may be interpreted as requiring the retention of proration for the projected amounts while the differences from the projected amounts are used for the true-up reconciliation.

16. Indicated Customers argue that VEPCO’s approach is inconsistent with the conclusion of the 2015 PLR, which states: “the true-up component of both the stand-alone rate adjustment ratemaking and the formula rate does not employ a future test period within the meaning of § 1.167(l)-1(h)(6)(ii) and therefore Taxpayer is not required to use the proration methodology in order to comply with the normalization rules.”²³ But this statement can be read consistently with VEPCO’s interpretation of the other statements in the 2015 PLR, as under VEPCO’s proposal, the “true-up component” reflects the differences between the projected and actual ADIT, and VEPCO does not prorate that difference.

17. Indicated Customers also maintain that the Commission erred in stating that their position is to use “unweighted values” in calculating the true-up. They assert their position is that the required proration had already been made when the VEPCO projected rates are calculated and, therefore, should not be duplicated in the true-up calculation. VEPCO’s proposal, however, does not duplicate the proration of the ADIT in the true-up;

²⁰ 2015 PLR at 8.

²¹*Id.*

²² 2015 PLR at 7.

²³ 2015 PLR at 11.

rather, it applies the true-up only to the adjustment in ADIT that results from incorrect projections.²⁴

18. We recognize that other utilities may have come to different interpretations of the IRS requirements and the meaning of the 2015 PLR as it applies to the true-up.²⁵ The IRS, not the Commission, however, should be the party interpreting the Internal Revenue Code. VEPCO requested a letter ruling from the IRS, and based its filing on the PLR and meetings with the IRS. In reviewing VEPCO's filing, Indicated Customers have not shown that VEPCO's interpretation of the 2015 PLR is in direct contradiction or inconsistent with the 2015 PLR, or that VEPCO's interpretation of the 2015 PLR will result in the IRS denying its use of accelerated depreciation based on the formula it has proposed.²⁶ In these circumstances, we cannot find that VEPCO has failed to support its proposed treatment of the true-up or that its proposed true-up mechanism is unjust and unreasonable. Should either party seek further IRS guidance, or if the IRS provides such guidance in another case, the Commission can revisit this issue upon a proper filing.²⁷

²⁴ In its filing, VEPCO maintains that if end of year values were used in the true-up, it would negate the use of proration for the projected year by restating the rates as if proration had not been used. It maintains that could not logically have been the intent of the IRS in requiring the use of proration. VEPCO Transmittal Letter, Docket No. ER14-1831-001, at 7 (10/30/2015), Ex. DVP 6 at 1, VEPCO Answer, Docket No. ER14-1831-000, at 9 (12/8/2015).

²⁵ *Compare Pub. Serv. Co. of Colorado*, 155 FERC ¶ 61,028 (2016) (interpreting the 2015 PLR as does VEPCO) *with Midcontinent Indep. Sys. Operator, Inc.*, 153 FERC ¶ 61,371 (2015) (did not retain proration in the true-up), *on reh'g*, Request for Clarification or, in the Alternative, Rehearing, Docket No. ER16-197-002 (1/29/2016) (Clarification request that parties may make a future filing if the IRS rules that proration methodology must continue to be applied to the originally projected ADIT in performing the annual true-up calculations) *and* Docket Nos. ER16-2378-000 at Transmittal Letter, at 4-5 (8/5/2016) and ER16-2386-000, Transmittal Letter, at 4-5 (8/5/2016) (tariff revisions to use proration, but continuing to use actual data in the true-up).

²⁶ The IRS may find that both approaches are reasonable means of implementing its regulations. Indicated Customers in its rehearing contends only that VEPCO's approach is in direct contradiction to the 2015 PLR.

²⁷ Parties seeking further IRS clarification could ask specifically whether a company would comply with the proration requirements if the company used proration in Year 1 in calculating its ADIT for prospective investments (and rates) for Year 2, and then used the actual beginning and end of year balances of ADIT (or a 13 month average

(continued ...)

However, based on the record here, we continue to find VEPCO's proposal just and reasonable and deny rehearing.

The Commission orders:

Rehearing is denied as discussed in the body of the order.

By the Commission.

(S E A L)

Kimberly D. Bose,
Secretary.

of ADIT values) as part of the true-up in Year 3, with the effect of restating Year 2 rates as if proration has not been used.