Avista Corp.
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January 26, 2011 **SENT VIA OVERNIGHT MAIL**

Public Utility Commission of Oregon
Attn: Filing Center
550 Capitol St NE #215
Salem, OR 97308-2148

Re: Docket UG 171, Private Letter Ruling from the Internal Revenue Service

Enclosed is Avista Corporation's Private Letter Ruling from the Internal Revenue Service dated January 8, 2008. On January 25, 2011, Carla Bird of the Commission Staff requested in an e-mail that each utility file a copy of the rulings in their respective UE/UG Senate Bill 408 dockets.

If you have any questions, please contact Ron McKenzie at (509) 495-4320.

Sincerely,

Kelly Norwood

Kelly Norwood, Vice President, State and Federal Regulation
Enclosure

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Index Number: 167.22-01

Mr. Don M. Falkner, Assistant Treasurer
Avista Corporation
1411 East Mission Avenue
Spokane, WA 99202

Person To Contact:
Patrick S. Kirwan, ID No. 50-03986
Telephone Number:
(202) 622-3110
Refer Reply To:
CC:PSI:B06
PLR-100960-07
Date: JAN 8 2008

LEGEND:

Taxpayer	=	Avista Corporation EIN: 91-0462470
State	=	Oregon
Commission	=	Oregon Public Utility Commission
Act	=	Senate Bill 408
Amount	=	$100,000
Permanent Rules	=	Order No. 06-532, issued September 14, 2006
Order A	=	Order No. 06-400, AR 499
Order B	=	Order No. 07-401, AR 517
Director	=	Industry Director, Natural Resources and Construction (LM:NRC)

Dear Mr. Falkner:

This letter responds to the request, dated December 29, 2006, of Taxpayer for a ruling on whether a rulemaking procedure in State under the Act is consistent with the normalization rules under former §§ 167(l) and 46(f) of the Internal Revenue Code.

The representations set out in your letter follow.

Taxpayer is the parent of an affiliated group of corporations, a subsidiary of which provides, *inter alia*, retail electric and natural gas service to customers in State. These retail operations are subject to the jurisdiction of Commission with respect to rates, accounting, and other matters. Taxpayer's rates are determined using a cost of service basis that allow Taxpayer to earn a reasonable rate of return on "rate base." Rate base is determined generally by reference to the original cost of the asset, net of accumulated depreciation and adjusted for deferred taxes and other items. The assets included in the rate base calculation are subject to the depreciation and Investment Tax Credit (ITC) normalization rules set forth in § 168(i)(9) and former §§ 167(l) and 46(f).

State enacted the Act, providing for determining the tax element of cost of service under a new method. The legislature intended to ensure that the taxes collected from ratepayers by utilities in State were more closely aligned with the taxes paid to governmental entities by the collecting utilities. This new method applied to all taxes used as part of the tax element in determining rates, not just Federal taxes. The Act requires that the utility report to the Commission each year regarding (1) the amount of taxes paid by the utility (or its affiliated group) that were "properly attributed" to the regulated operations and (2) the amount of taxes "authorized to be collected" in rates. If the difference between these two amounts was greater than Amount in any of the immediately preceding three years, the Commission would order the utility to implement a rate schedule that would either credit the relevant amount to ratepayers or impose a surcharge.

Commission established Permanent Rules for implementing the Act, including procedures for determining what taxes were properly attributable to the regulated operations. The methodology for calculating the amount of taxes authorized to be collected was set forth by Commission in Order A. In general, using data from the most recent rate case, the utility calculates the percentage of the amount it was permitted to recover from ratepayers that represented tax expense. That percentage is then multiplied by the amount of revenue actually collected in the relevant period to give the amount of taxes deemed "authorized to be collected" as a result of the provision of regulated operations in that period.

The determination of taxes properly attributed to the regulated operations is determined by the lowest amount using three alternative calculations. The first method uses the stand-alone tax liability of the utility, the second uses the total tax liability of the consolidated group to which the utility belongs (with adjustments), and the third method also uses the total tax liability of the affiliated group (as adjusted in the second method) apportioned as provided in the Permanent Rules. The first and second methods both rely on the actual tax data from the utility (method 1) or the consolidated group (method 2). The third method adjusts the tax liability by apportioning the consolidated group total for plant, wages, and sales to the percentage of operations in State. Commission, in Order B, provided that the total tax expense apportioned in the third method could not be less than the deferred tax element of cost of service. In each of the three methods, the tax liability of the utility (or affiliated group in the second and third methods) is adjusted to remove the benefits of the accelerated depreciation and ITC claimed with respect to all public utility property. In all three methods, the accelerated depreciation and ITC-related tax benefits are isolated and separate calculations are made to ensure that the effects of these tax benefits on current and deferred taxes are accurately reflected. On page 4 of the Permanent Rules, the Commission states that:

> [W]e will modify the definition of 'taxes paid' to remove all tax effects resulting from accelerated depreciation on public utility property. To accomplish this, the utility, in reporting taxes paid, will first remove the tax benefits of depreciation and federal investment tax credits by adding back the related tax effects to the

> amount of taxes paid to each taxing authority. ... When the final taxes paid amounts are calculated, an adjustment will be made to reflect the proper amount of current and deferred taxes related to [State] related operations. These steps should ensure that no tax benefits flow to [State] customers that would cause a violation of normalization requirements.

Law and Analysis

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, 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 section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that-would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of section 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 section 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 section 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.

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 section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(1)-1(a)(1) of the Income Tax Regulations 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 section 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 1.167(l)-1(h)(1)(i) of the regulations provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

Section 1.167(1)-1(h)(1)(iii) of the regulations provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used.

Section 1.167(1)-1(h)(2)(i) of the regulations provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under section 1.167(1)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under section 167(a).

Former section 46(f) of the Code provides an election for ratable flow through under which an elector may flow through the investment tax credit to cost of service. However, former 46(f)(2)(A) provides that no investment tax credit is available if the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the credit determined under former 46(a) and allowable by section 38. Also, under former section 46(f)(2)(B) no investment tax credit is available if the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit determined under former 46(a) and allowable by section 38.

Former section 46(f)(6) of the Code provides that for purposes of determining ratable portions under former section 46(f)(2)(A), the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account shall be used.

Under section 1.46-6(g)(2) of the regulations, "ratable" for purposes of former section 46(f)(2) of the Code is determined by considering the period of time actually used in computing the taxpayer's regulated depreciation expense for the property for which a credit is allowed. Regulated depreciation expense is the depreciation expense for the property used by a regulatory body for purposes of establishing the taxpayer's

cost of service for ratemaking purposes. Such period of time shall be expressed in units of years (or shorter periods), units of production, or machine hours and shall be determined in accordance with the individual useful life or composite (or other group asset) account system actually used in computing the taxpayer's regulated expense. A method of reducing is ratable if the amount to reduce cost of service is allocated ratable in proportion to the number of such units. Thus, for example, assume that the regulated depreciation expense is computed under the straight line method by applying a composite annual percentage rate to original cost (as defined for purposes of computing depreciation expense). If cost of service is reduced annually by an amount computed by applying a composite annual percentage rate to the amount of the credit, cost of service is reduced by a ratable portion. If such composite annual percentage rate were revised for purposes of computing depreciation expense beginning with a particular accounting period, the computation of ratable portion must also be revised beginning with such period. A composite annual percentage rate is determined solely by reference to the period of time actually used by the taxpayer in computing its regulated depreciation expense without reduction for salvage or other items such as over and under accruals.

The method prescribed by section 1.46-6(g)(2) of the regulations for determining whether the taxpayer's cost of service for ratemaking is reduced by more than a ratable portion of the investment tax credit depends upon correlating the credit with the regulatory depreciable useful life actually used for the property that generated the credit. That the correlation must remain constant and current is illustrated by the requirement that the ratable portion must be adjusted to reflect correspondingly any revision to the composite annual percentage rate applied for purposes of computing regulated depreciation expense.

Under the first method, the calculation of taxes properly attributed to the regulated activity using just the tax liability of the utility and isolating the effects of accelerated depreciation and ITC-related tax benefits to ensure that the effects of these tax benefits on current and deferred taxes is consistent with the normalization requirements of § 168(i)(9) and former §§ 167(l) and 46(f). The second method, calculating taxes properly attributed to the regulated activity using the tax liability of the consolidated group to which the utility belongs, is also consistent with the normalization requirements of § 168(i)(9) and former §§ 167(l) and 46(f) due to the isolation of the effects of accelerated depreciation and ITC-related tax benefits to ensure that the effects of these tax benefits on current and deferred taxes is consistent with the normalization requirements. The third method is also consistent with the normalization requirements of § 168(i)(9) and former §§ 167(l) and 46(f) due to the isolation of the effects of accelerated depreciation and ITC-related tax benefits to ensure that the effects of these tax benefits on current and deferred taxes is consistent with the normalization requirements. Both the second and third methods, without the protective isolation of the tax benefits from accelerated depreciation and the ITC, would probably violate the normalization requirements because they would result in the possible flow-through of tax benefits to ratepayers more rapidly than under those normalization rules. The automatic adjustment provision, requiring the Commission to order a rebate or an

increase in rates if the difference between taxes paid by the utility properly attributed to the regulated operations and the amount of taxes authorized to be collected in rates exceeds Amount, is also consistent with the normalization requirements of § 168(i)(9) and former §§ 167(l) and 46(f) because it simply adjust rates based on the calculations described above.

We note that this ruling is based on representations of the anticipated effects of the isolating provisions of the Permanent Rules and theoretical examples of how the provisions discussed herein are expected to apply. Thus its applicability is limited to situations in which the effects of accelerated depreciation and ITC-related tax benefits are isolated to ensure that the effects of these tax benefits on current and deferred taxes is consistent with the normalization requirements as represented. While it appears that the Act and Permanent Rules are designed to preclude violation of the normalization provisions, this ruling does not hold that, in its application, no normalization violation is possible for any utility operating in State under these provisions.

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,

Peter C Friedman

Peter C. Friedman
Senior Technican Reviewer, Branch 6
(Passthroughs & Special Industries)

cc: Industry Director, Natural Resources and Construction (LM:NRC)
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