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PLR Allows Utility to Buy Power From Own Tax Equity Partnership

by David K. Burton

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In this article, Burton analyzes a 2019 private letter ruling addressing a structure to avoid normalization when a utility purchases power from a tax equity partnership in which it is a partner.

On November 15, 2019, the IRS released LTR 201946007, which created an opportunity for utilities to purchase power from their own tax equity partnerships. The ruling provides a partial roadmap for a utility seeking to avoid normalization of accelerated depreciation and the investment tax credit associated with projects in which the utility owns an interest, but it does not answer the question whether the tax equity investor may deduct this depreciation and other costs in a timely manner.[1]

Normalization Background

The normalization rules apply to accelerated depreciation and the ITC. The rules require that the tax depreciation life be extended to match the life used in the utility's rate-making process and that the ITC accrue over that same life. In the 1960s, the utility industry lobbied for the normalization rules to discourage public utility commissions (PUCs) from compensating utilities with tax benefits rather than cash. The rules were first effective in 1969.

Typically, a PUC aims to set the rates that a utility charges its customers to provide a utility with a stipulated after-tax return on the utility's assets. The goal is for the return to be high enough to allow the utility to provide reliable service, while not being so high that it deprives the utility's customers of reasonable value.

Transaction Steps in the LTR

The transaction addressed in the ruling involved the following steps:

1. The utility issued a request for proposal (RFP) for power purchase agreement (PPA) pricing and selected a low bid submitted by a developer.
2. The utility entered into a build transfer agreement (BTA) with that same developer whereby the developer would build and, at completion, sell a wind project to the utility or its assignee.
3. The utility entered into a partnership with an unrelated tax equity investor. The tax equity partnership acquired the wind project from the developer, as an assignee, and then the tax equity partnership sold the power from the wind project to the utility at the pricing set in the RFP process for the PPA.

[1] Although the ruling addresses the depreciation benefit associated with a wind production tax credit project, the ruling should also apply to solar and ITC projects given the similarity of the normalization rules for depreciation and the ITC. *See* LTR 201923019 ("The normalization method, which must be used for public utility property to be eligible for the depreciation allowance available under section 168, is defined in terms of the method the taxpayer uses in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account. Therefore, for purposes of application of the normalization rules, the definition of public utility property is the same for purposes of the investment tax credit and depreciation.").

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Standard for Normalization

The ruling explains that the normalization regulations require tax benefits associated with a power generation project to be "normalized" (that is, claimed over the life of the asset used for rate-making purposes), if each of the following three conditions is satisfied:

1. the asset must be predominately used in the trade or business of the furnishing or sale of electric energy;
2. the rates for the sale of electric energy must be established or approved by a PUC or instrumentality of a PUC; and
3. the rates set by that agency or instrumentality must be established or approved on a rate-of-return basis.

LTR's Normalization Analysis

The ruling concludes that:

> prices under the PPA will be set at arm's length pursuant to an RFP provided to [the utility by the developer] and under [PUC rules] will be determined on a market basis and will not be determined on a rate of return basis or cost basis. Because rates on the sale of electricity from the [wind project] will not be regulated by [the PUC] on a rate of return basis, the [project] will not be [subject to normalization].

There are four aspects of the transaction pricing that matter to the utility's economics: (1) the cost to buy the project from the developer under the BTA; (2) the value provided by the tax equity investor; (3) the cost for the utility to purchase electricity from the tax equity partnership under the PPA; and (4) the rate at which the PUC will allow the utility to sell that power to the utility's customers.

The ruling does not explain how the PUC calculates the rate the utility may charge its customers for the wind power purchased under this arrangement other than to state that the price of electricity "will not be regulated . . . on a rate of return basis."

Specifically, in setting the rate the utility may charge its customers for the wind power purchased from the tax equity partnership, the ruling does not disclose if the PUC looks at the nominal price under the PPA or the net cost of the PPA factoring in the return the utility earns as a partner in the tax equity partnership. Further, the ruling does not indicate how the PUC should characterize the portion of the price that the utility paid to the developer under the BTA for transferring the completed project. It seems likely that the PUC may consider all costs on a net basis (that is, upfront costs to the utility under the BTA, plus PPA costs to the utility, less distributions from the tax equity partnership to the utility), but the ruling does not address this issue. Presumably, the IRS would be untroubled by this issue, as long as the PUC does not regulate the rates on the sale of electricity on a rate-of-return basis.

In contrast with the utility, only one aspect of the transaction pricing matters to the PUC: the PPA rate passed on to consumers. That is because the utility is earning a return only on what it pays under the PPA. However, the ruling does not describe the relationship between the process to set the PPA price and the process to set the BTA price. The ruling provides that the PPA rate was set through an RFP process, but were the terms of the BTA part of the same RFP process or was the BTA price the result of a separate RFP? This question matters because if the developer sells the project to the utility (or to the utility's tax equity partnership), as contemplated in the ruling, it is unclear what the developer's motivation was to propose a low PPA price in its RFP response as would usually be the case for a developer seeking to have its PPA RFP accepted.

Marked Ramifications

Before the ruling, the IRS issued several private letter rulings[2] holding that a PPA based on competitive bidding is not subject to normalization. Thus, PPAs with utilities are relatively common.[3] In theory, the ruling may enable utilities to supplant the need for

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[2] *See, e.g.*, LTR 201923019.

[3] Brian R. Murphy and Michael J. Reno, "A Path for Utilities' Ownership of Wind and Solar," *Tax Notes Federal*, Oct. 21, 2019, p. 446 ("Regulated utility companies have often been forced to rely on PPAs with [independent power producers] instead of owning renewable generation themselves.").

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independent power producers (IPPs). IPPs historically have sold power to utilities pursuant to PPAs. Those PPA arrangements were often adopted because if the utility owned the project, the utility would have to normalize the depreciation and any ITC benefits associated with the project (while normalization does not apply to IPPs as they are unregulated). However, it is important to note that each PUC has different rules, so not every PUC will accept the type of arrangement described in the ruling.

Also, the IRS declined to rule on whether the tax equity investor can use the depreciation and the deductions for other costs in a timely manner. The IRS considers the sale of the electricity to be the sale of a "good." Thus, the tax equity partnership's sale of electricity is subject to inventory tax accounting requiring the depreciation (and other specific costs) to be capitalized into the "cost of goods sold."[4] For years in which there is meaningful depreciation available, the tax equity partnership would likely realize a loss on the sale of the electricity (that is, the depreciation (and other expenses) for the year exceeds the payments received from the sale of the electricity). Given that partnerships are prohibited from claiming losses on sales to related parties,[5] and that the utility is both a partner in the partnership-seller and the buyer, it is unclear whether the tax equity investor must wait until the PPA is over to use the deductions from the depreciation. Thus, the structure described in the ruling with a utility as a partner in a tax equity partnership and as off-taker is not yet fully resolved.

The production tax credit isn't tied to either the cost of the project or its life; thus the normalization rules do not affect the production tax credit and the ruling has no effect on the credit.[6] Rather, the production tax credit for wind, assuming a project started construction in 2016 or earlier, is $25 a megawatt hour for each megawatt hour produced during a project's first 10 years of operation.[7] ■

[4] *See* FFA 20062801F (citing LTR 200152012). We note that LTR 200152012 does not exist and the Office of Chief Counsel likely intended to cite CCA 200152012, published December 28, 2001. The rules for capitalizing the costs of inventory into the basis of the inventory are in section 263A.

[5] Section 707(b)(1) (1986).

[6] *See* Heather Cooper et al., "IRS Issues Private Letter Ruling Allowing Tax Equity Financing With a Regulated Utility Taxpayer," McDermott Will & Emery (Dec. 2, 2019) (discussing the ruling, the ITC, and the production tax credit, but noting only that the normalization rules apply to depreciation and the ITC).

[7] Section 45.

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