REPORT OF THE COMMITTEE ON TAX DEVELOPMENTS

The following reflects a summary of the energy-related tax issues addressed by the courts, the Federal Energy Regulatory Commission (FERC or Commission), and the Internal Revenue Service (IRS) during the calendar year 1994.1

I. DEVELOPMENTS AFFECTING REGULATED ELECTRIC UTILITIES AND NATURAL GAS COMPANIES

A. Court Decisions

1. Claims for Cushion Gas and Line Pack Costs as Investment Tax Credits and Depreciation: Arkla, Inc. v. United States

Arkla, Inc. appealed a Court of Claims ruling denying investment tax credits and depreciation deductions for recoverable cushion gas and line pack. The Federal Circuit held that Arkla was collaterally estopped from bringing those claims by an earlier Fifth Circuit decision,2 which held that recoverable cushion gas and line pack were not depreciable property because they could be recovered and sold when the facilities containing them were abandoned. Since costs for investment tax credits must be expended on depreciable property, the costs could not be the subject of investment tax credits or depreciation deductions. The Federal Circuit rejected Arkla’s claims that the fact situations in the two cases were materially different and that the legal climate had changed in the time between the two decisions.


In the context of a claim for refunds in the tax years 1975-79 and 1981, the Seventh Circuit held that expenditures by a utility to extend electrical service to new customers were “excluded additions” that had to be capitalized under the asset depreciation range (ADR) system of depreciation, rather than deducted as repair allowances. During the years in question,

1. For much of the natural gas industry affected by FERC Order 636 and the restructuring of the natural gas pipeline industry, 1994 saw the first full year of a completely restructured regulatory environment. So, too, much of the electric power industry (as well as the FERC) is only now beginning to experience the new regulatory environment brought about by FERC’s pro-competition initiatives in the bulk power markets. In light of the dearth of experience in these new regulatory environments, notable tax-related questions potentially bearing on companies’ operations on a going-forward basis—e.g., questions regarding taxable income and deductions associated with Order 636 transition costs and/ or stranded utility investment costs, the tax treatment of gas storage inventory, etc.—have yet to be raised, as evidenced herein.
2. 37 F.3d 621 (Fed. Cir. 1994).
4. 38 F.3d 329 (7th Cir. 1994).
Wisconsin Power and Light Company recorded its "customer service drops," the costs of extending service to new customers, on quarterly work orders. The issue in the case was whether these costs had to be capitalized or expensed. The court held that the customer service drops were properly classified as additions to property rather than repair or replacement of property. The court relied heavily on Revenue Ruling 78-67 which was precisely on point. The court also held that classifying the costs as excluded additions was consistent with the plain meaning of the words "repair" and "replacement," which connote maintenance of existing property rather than additions to property.

B. FERC Decisions

1. Partnership's Rate Treatment of Amounts Related to Alternative Minimum Tax: Northern Border Pipeline Co.

In Northern Border Pipeline Co. (Northern Border),\(^5\) the FERC addressed the issue of how and the extent to which a pipeline partnership subject to its jurisdiction (Northern Border) should record in its accounts, and include in its rates, amounts related to the Alternative Minimum Tax (AMT). The FERC ruled that the pipeline could include AMT amounts in its Deferred Tax Account 190 (and thus in its rate base), but only if and to the extent its partners, which filed consolidated income tax returns,\(^6\) actually paid AMT attributable to the pipeline's operations. In so ruling, the FERC made the following findings: (1) FERC's "stand-alone" tax allocation policy, as applied to entities (including the pipeline's partners) filing consolidated tax returns, was the appropriate methodology by which to determine the pipeline's AMT for ratemaking purposes; and, (2) proper application of the "stand-alone" policy required that a determination be made as to whether the pipeline's partners actually paid AMT attributable to the pipeline's operations (i.e., through an examination of the partner's consolidated income tax returns) during the relevant period. In the latter regard, the FERC pointed out "important distinctions" between "regular" income taxes (the determination of which involves calculations based on the regulated company's allowed return) and AMT, which justified the need to examine the partners' consolidated income tax returns in determining AMT for ratemaking purposes.\(^7\)

6. As a partnership, Northern Border is not subject to federal taxation. The federal tax obligations of the partnership are reported on the tax returns of the partners.
7. Specifically, the FERC pointed out that, with respect to the regular income taxes of a regulated company filing a consolidated tax return, "every dollar of tax liability generated by the regulated company affects the consolidated tax," and thus constitutes "a real cost of providing service." 67 F.E.R.C. at 61,611. Accordingly, the FERC was assured, without examining the company's actual consolidated return, that the income tax allowance it provided the company reflected the latter's actual tax expense. Id. However, unlike regular income tax, the AMT liability of one company in a group filing a consolidated return does not necessarily have a cost impact on the consolidated group or any of its members. Id. FERC's decision provides instructive examples of these distinctions.
2. Treatment of "Local Furnishings" Exemption when Utilities Qualifying for the Exemption Become Members of a Regional Transmission Group: PacifiCorp and Southwest Regional Transmission Ass'n

The IRS has placed certain restrictions on utilities that own facilities financed by tax-exempt debt. Basically, the IRS does not allow the "local furnishing" tax exemption where facilities are part of a system used regularly to transmit power for consumption outside of a small geographic area.

Utilities with tax-exempt facilities feared that their obligations as members of a Regional Transmission Group (RTG) would jeopardize the tax-exempt status of the facilities. After examining the by-laws of both the Western Regional Transmission Association (WRTA) and the Southwestern Regional Transmission Association (SWRTA), the FERC concluded that the by-laws provided members with adequate protection. Specifically, no member was required to provide transmission if such transmission would threaten the loss of tax-exempt status. If the member requesting transmission service chooses to do so, that member may file a request for transmission service pursuant to section 211 of the Federal Power Act. Since the Energy Policy Act of 1992 amended the Internal Revenue Code (I.R.C. or Code) to preserve the "local furnishings" exemption for transmission provided pursuant to section 211 of the Federal Power Act, the by-laws of both RTGs protect the tax exemption while also providing an opportunity for parties to obtain needed transmission service.

C. IRS Rulings

1. Project Financing For Capacity Expansions: Private Letter Ruling 93-48-017

An interstate pipeline agreed to act as agent for a partnership formed between two of its local distribution company customers to facilitate financing in connection with the construction of additional pipeline capacity on behalf of the partnership. In a private letter ruling dated September 1, 1993, the IRS ruled that, in this factual context, the pipeline was not required to report as income the value of the expansion. The IRS noted that, although the pipeline would retain legal title to the expansion, it would not include the costs associated therewith in the rate base, and therefore, would earn no return on the additional capacity (i.e., proceeds from the sale of the incremental capacity belonged solely to the partnership).

10. 69 F.E.R.C. at 61,385-86; 69 F.E.R.C. at 61,404-06.
12. Ordinarily, when a company receives assets from a customer in connection with the construction and/or enhancement of facilities, the assets are deemed a contribution in aid of construction under section 118(b) of the Internal Revenue Code, and the company must report the fair market value of the assets as income.
2. Pipeline Interconnection with Local Utility: Private Letter Ruling 93-52-025

A group of municipalities constructed a natural gas distribution system and contracted with various producers for natural gas supplies to serve their end-use markets. To effect delivery of the gas, the municipalities constructed a transportation line to the pipeline facilities of an interstate pipeline company, and thereafter agreed to reimburse the pipeline for costs incurred by the latter in installing the equipment necessary to interconnect the facilities, including any "gross up" for income taxes in the event the pipeline was required to report as income the value of the equipment.

In a private letter ruling dated October 5, 1993, the IRS ruled that, although the municipalities effectively transferred the interconnection equipment to the pipeline, the transfer was not a contribution in aid of construction (under I.R.C. Section 118(b)); therefore, the pipeline was not required to report the fair market value of the equipment as income. The IRS reasoned that, in this context, the municipalities were not customers or potential customers of the pipeline, rather, they were customers of the producers. Moreover, the pipeline had not included any portion of the municipalities' payments in the rate base, and therefore had earned no return on such payments.


Pursuant to an agreement reached with a partnership engaged in the sale of electricity (and steam output) from qualified cogeneration facilities, a public utility subject to FERC's jurisdiction constructed interconnection facilities sufficient to allow the partnership to effect delivery of electricity to third-party purchasers through the utility's transmission system. The partnership reimbursed the utility in full for such facilities. In a letter ruling dated July 20, 1994, the IRS ruled that neither the value of the interconnection facilities nor the payments the utility received from the partnership would be considered a contribution in aid of construction under I.R.C. Section 118(b) and, accordingly, would not be includable in the utility's gross income for tax purposes. In so ruling, the IRS reasoned that (1) the interconnection facilities would not increase the net capacity of the utility's transmission system (i.e., the facilities would be used only to effect delivery of electricity from the partnership's cogeneration facilities to third-parties, and would not allow the utility to serve increased customer load); and, (2) the utility would not earn a return on or of the facilities by including the costs associated therewith in its cost-of-service.\(^\text{15}\)

---


\(^{14}\) Priv. Ltr. Rul. 94-44-006 (July 20, 1994).

\(^{15}\) For a similar ruling with respect to a utility's receipt of system upgrades from an unaffiliated partnership, see Priv. Ltr. Rul. 94-20-012 (Feb. 15, 1994).
4. Deduction Associated with Utility’s Closure of Nuclear Power Plant: Private Letter Rulings 94-38-005\textsuperscript{16} and 94-38-006\textsuperscript{17}

A public utility shut down a nuclear power plant in which it owned an eighty percent interest (removing the spent fuel from the reactor) but continued to maintain the plant and utilize certain structures and materials therein. In a private letter ruling dated December 17, 1993 (reported in October 1994), the IRS concluded that the utility sustained a deductible loss not compensated by insurance or otherwise under I.R.C. Section 165(a) when it closed the plant (although the deductible loss could not reflect the value of structures/materials slated for continued use). In so ruling, the IRS reaffirmed its position that (1) legal restrictions (such as those imposed for safety reasons by the Nuclear Regulatory Commission) which delay plant dismantlement do not preclude a finding of abandonment under section 165 if all other facts demonstrate an intention to retire irrevocably the property; and, (2) rate increases received by the utility in connection with the abandonment of the plant do not constitute compensation for purposes of section 165.

5. Pipeline Acquisition: Effect of Accounting Changes on IRS Normalization Requirements: Private Letter Ruling 94-47-009\textsuperscript{18}

An interstate pipeline sold for cash all of its issued and outstanding stock to a third-party corporation, becoming a wholly-owned subsidiary of the latter. However, by virtue of the parties’ election under I.R.C. Section 338, the stock sale was deemed a sale of assets for federal income tax purposes. Because of changes in its method of accounting (brought about by FAS 109), the pipeline’s account balances did not take into account its acquisition or the parties’ election under section 338. Accordingly, the pipeline proposed to adjust its accounts to reflect these events and their effect, \textit{inter alia}, on the depreciable cost basis of its assets and requested a ruling from the IRS that such accounting entries would not violate the normalization requirements of I.R.C. Section 168(i)(9).

In a private letter ruling dated August 4, 1994, the IRS ruled that the pipeline’s proposed accounting entries, which reflected a rate base reduction equal to the accumulated deferred income taxes attributable to accelerated depreciation claimed before the acquisition date, violated the Code’s normalization requirements.\textsuperscript{19} The IRS reasoned that, by virtue of the parties’ election under section 338 to treat the acquisition as a sale of assets, the pipeline’s deferred tax reserve was reduced (and, in fact, eliminated) to reflect the retirement of the pipeline’s assets upon sale. Thus, according to the IRS, the deferred tax reserve should be removed from the

\textsuperscript{17} Priv. Ltr. Rul. 94-38-006 (Dec. 17, 1993).
\textsuperscript{18} Priv. Ltr. Rul. 94-47-009 (Aug. 4, 1994).
\textsuperscript{19} The IRS recognized that its ruling contradicted an earlier decision by the FERC to allow the pipeline to retain accumulated deferred income taxes on its books as a reduction to the rate base.
pipeline's accounts "and not flowed through to ratepayers" (i.e., as a credit to rate base).20


A regulated utility incurred substantial costs in applying for and obtaining a license to operate a nuclear plant from the Nuclear Regulatory Commission (NRC). Such costs included, but were not limited to, legal fees, public information costs, the cost of the license itself, and the costs of contractor licensing support services. The utility capitalized the costs to the tangible property of the plant, claiming ACRS deductions and an investment credit under sections 168 and 46 of the Code. The utility's position was that the license was inseparable from the physical plant for tax purposes, because the license has no value apart from the plant. The IRS ruled in a technical advice memorandum that most of the costs must be capitalized to the license (an intangible asset) and amortized over the license's 40-year term.

The IRS ruled that the costs of obtaining the license were analogous to easements obtained by natural gas pipelines,22 and that the license is a separate, intangible asset for purposes of depreciation and investment credit. The Service refused to be bound by the FERC and state commission treatment of the license in their respective Uniform Systems of Accounts. Also, the IRS found that the NRC license is similar for tax purposes to a broadcasting license issued by the FCC.

II. DEVELOPMENTS AFFECTING ELECTRIC GENERATION

A. FERC Decisions

1. Exempt Wholesale Generator Status Unaffected by "Material Changes in Fact" Designed to Generate Tax Benefits: Vista Energy, L.P.23

In reassessing the Exempt Wholesale Generator (EWG) status of a limited partnership after the latter acquired indirectly the land and buildings surrounding its eligible facility,24 the FERC determined that the EWG’s indirect ownership of such property did not jeopardize or otherwise affect its EWG status under PUHCA, as amended by the EPAct. In so ruling, the FERC noted that the EWG’s indirect ownership of the land and buildings would allow it “to capture tax benefits that could not be

22. See Tenneco, Inc. v. United States, 433 F.2d 1345 (5th Cir. 1970); Panhandle E. Pipe Line Co. v. United States, 408 F.2d 690 (Cl. Ct. 1969).
24. Under the Public Utility Holding Company Act (PUHCA), as amended by the Energy Policy Act of 1992 (EPAct), an EWG must be engaged exclusively in the business of developing/constructing facilities ("eligible facilities") used for the generation of electric energy for sale at wholesale.
obtained if [the EWG] directly owned" the property, and expressly found no inconsistency with the intent of the statute in permitting EWGs to take advantage of such tax benefits.  

**B. IRS Rulings**

1. **Renewable Electricity Production Credit: Private Letter Ruling 94-17-040**

A corporation formed a partnership in which it was the general partner to own and operate two projects for the generation of electricity from wind energy. Pursuant to a series of agreements between the corporation and the partnership, the corporation would construct the projects, maintain and repair the same, and manage related administrative matters. The partnership would sell the electric power generated from the projects to two unrelated utilities.

In a private letter ruling dated February 1, 1994, the IRS ruled that the electricity generated by the projects and sold by the partnership to the utilities would qualify for the renewable electricity production credit under I.R.C. Section 45 (as amended by section 1914 of the Energy Policy Act of 1992). Further, citing the "principles" of I.R.C. Section 702(a)(7), the IRS concluded that the credit could be flowed through to and allocated among the partners in accordance with their respective interests in the partnership as of the time the tax credit arose.

**III. DEVELOPMENTS AFFECTING OIL AND GAS PRODUCTION**

**A. Court Decisions**

1. **Royalty Deductions: Sondrol v. Placid Oil Co.**

Described as another case arising "from the natural gas industry's stunning miscalculation of the effects of federal deregulation of natural gas producers," the Eighth Circuit in *Sondrol v. Placid Oil Co.* addressed various issues related to a lessor's claim that its producer-lessee (which operated natural gas wells on land leased from the former) had underpaid royalties due under the parties' oil and gas lease. The alleged underpayments related to natural gas which, although sold at the wellhead in its "wet" state by the producer-lessee to a third-party natural gas proces-

---

25. 69 F.E.R.C. at 61,863.
27. I.R.C. § 45 provides a credit for electricity produced from certain renewable resources. Under § 45(a), the credit equals the product of 1.5 cents and the kilowatt hours of electricity (1) produced at the qualified resource facility during the first 10 years after the facility's in-service date; and, (2) sold to an unrelated person during the tax year.
28. I.R.C. § 702(a)(7) "provides that each partner determines his income tax by taking into account separately his distributive share of the partnership's other items of income, gain, loss, deduction, or credit . . . ." 8 TAX ANALYSTS LETTER RULING SERVICE 2570 (May 9, 1994).
29. 23 F.3d 1341 (8th Cir. 1994).
30. Id. at 1342.
31. 23 F.3d 1341 (8th Cir. 1994).
sor, was placed into and maintained in storage after the processor-purchaser's sales market dissipated. The court affirmed the lower court's order granting summary judgment in favor of the producer-lessee, rejecting the lessor's argument that, although the producer-lessee sold all the gas at the wellhead, royalties were due on the gas held in storage under the "market value" clause of the parties' oil and gas lease.32

The tax issue addressed by the court related to deductions taken by the producer-lessee with respect to gas produced under the parties' lease. Although finding that, "[t]o a large extent, the allegations of improper deductions are conclusory in nature and therefore will not defeat [the lessee's] motion for summary judgment,"33 the court nonetheless expressly rejected the lessor's claim in this regard, namely, that the lessee breached the lease by attributing a higher value to the gas for tax (depreciation/deduction) purposes than for purposes of determining its royalty payment obligation to the lessor.34

2. Indian Tribes Authority To Tax Oil and Gas Production: Duncan Energy Co. v. Three Affiliated Tribes35

On June 8, 1994, the Eighth Circuit reversed a lower court order granting summary disposition in favor of a group of oil companies challenging an Indian tribe's authority to impose taxes on oil and gas produced from wells operated by non-tribe members on non-Indian fee lands within the tribe's reservation. Although recognizing that the power of Indian tribes to regulate the activities of non-tribe members within their reservation is "limited,"36 the court nonetheless concluded that the lower court erred in failing to examine whether the tribe's imposition of oil and gas production taxes in the instant case fell within its limited powers, as defined by the Supreme Court.37

32. The decision provides a useful description of the distinction between this and another common royalty payment clause in oil and gas leases, the "proceeds" clause.
33. 23 F.3d at 1344.
34. In short, the lessee took a tax deduction in connection with the stored gas based on the contract price of the gas under the lessee's contract with its processor-purchaser. For royalty purposes, the lessee valued the gas at the amount realized from sales of the stored gas ultimately made to third-parties.
35. 27 F.3d 1294 (8th Cir. 1994).
36. Id. at 1298.
37. Id. at 1299. Specifically, the court ruled that the lower court failed to analyze the applicability of the "exceptions" set forth in another Supreme Court case:

A tribe may regulate, through taxation . . . the activities of nonmembers who enter [into] consensual relationships with the tribe . . . [and] may also retain inherent power to exercise civil authority over the conduct of non-Indians on fee lands within its reservation when that conduct threatens or has some direct effect on the political integrity, the economic security, or the health or welfare of the tribe.

Id. at 1298 (citing Montana v. United States, 450 U.S. 544, 565-66 (1981)).
B. FERC Decisions


On May 19, 1994, the FERC denied rehearing of an earlier order issued in response to the court's remand in Colorado Interstate Gas Co. v. FERC (CIG), regarding the issue of whether the Kansas ad valorem tax qualifies as an add-on to the maximum lawful price of "first sale" gas under section 110 of the Natural Gas Policy Act (NGPA). The FERC rejected the arguments of affected producers in ruling that the Kansas ad valorem tax was not sufficiently similar to a severance or production tax to fall within the scope of NGPA Section 110 and thus qualify as an "add-on" to the price of gas thereunder. In affirming its earlier ruling, the FERC reiterated its new "well defined" standard of what constitutes a tax similar to a severance or production tax:

[To be deemed similar to a severance tax, a tax must have the substantive characteristics of a severance tax, and not a property tax.... First, a severance tax is a tax on the act of severing, i.e., removing a commodity from the earth. Consequently... a tax on property such as the remaining gas reserves, does not qualify. Second... a severance tax in its purest sense is a tax on each Mcf or MMbtu of gas production, or the value thereof, at the time of production, although the state may bill the tax on a monthly or annual basis or may use some form of averaging of the production over the tax period.]

The FERC further ruled that it would apply its order retroactively to the date of the court's decision in CIG, namely, June 28, 1988. FERC's order includes an instructive discussion of the factors the FERC will consider in deciding whether and the extent to which retroactive application of "new" rulings is appropriate.

C. IRS Rulings

1. Non-Conventional Source Fuel Credit: Revenue Ruling 94-48

In a revenue ruling reported July 18, 1994, the IRS ruled that if a taxpayer holds a net profits interest in property that produces a "qualified fuel" under I.R.C. Section 29 (e.g., gas produced from coal seams), the portion of the property's total production attributable to the net profits interest is determined by multiplying the total production by the taxpayer's interest in the gross sales from the property. In turn, the taxpayer's interest

---

40. 850 F.2d 769 (D.C. Cir. 1988).
42. 67 F.E.R.C. at 61,656.
43. 67 F.E.R.C. at 61,653.
44. See 67 F.E.R.C. at 61,656-60.
in the gross sales from the property is determined by dividing the amount of the taxpayer's net profits payment by the gross sales from the property.

2. State Transfer of Royalty Interests Qualifies as Transfer of Economic Interests: Private Letter Ruling 94-37-006

A state proposed to transfer to a private third-party all of its royalty interests in completed wells on certain properties. (The wells produced coal seam gas, for which the buyer proposed to seek a nonconventional fuel credit under I.R.C. Section 29). Under state law, the state's mineral interest in the subject production properties would remain reserved to the state. Under the proposed sales agreement, the buyer would make a cash downpayment and give the state a recourse promissory note payable as production occurred. Upon transfer of the properties, the state would retain a "production payment" equal to a percentage share of the net proceeds of the royalty interest. After production reached a certain level, the production payment would terminate, and the buyer would be entitled to a share of the production attributable to the royalty interest until estimated reserves were produced. If actual production exceeded estimates, the state would be entitled to a percentage of the net proceeds attributable to the royalty interests associated with the additional production.

In a private letter ruling dated June 10, 1994, the IRS ruled that the proposed sale would effect a transfer of the state's economic interest to the buyer. In so ruling, the IRS reasoned that the buyer's promissory note to the state, although resembling a royalty interest, was not an economic interest in a mineral in place because it entitled the state to a specified payment, regardless of the sales price for the gas. Similarly, the buyer's production payment was not an economic interest in a mineral in place, but instead resembled a mortgage loan insofar as it was payable solely from production from the royalty. Finally, the IRS noted that although the state's retention of a percentage interest in "excess" production gave the transaction the characteristics of a lease, the transaction was in fact a sale "with a possibility of reverter" because the state's interest would not come into existence unless additional reserves were recovered.


In two rulings issued simultaneously on April 25, 1994, the IRS reversed its earlier rulings and concluded that the Canadian Petroleum and Gas Revenue Tax (PGRT), imposed on foreign production revenue in accordance with the Canadian Income Tax Act, is not a creditable tax under I.R.C. Section 901 and thus cannot be used to reduce the payor's

49. The IRS agreed to impose its new ruling on a prospective basis.
The IRS reasoned that the PGRT was not an "income tax" for purposes of section 901 because it was not "likely to reach net gain in the normal circumstances in which it applies," i.e., it did not reduce gross receipts "to permit recovery of the . . . significant costs and expenses attributable . . . to such gross receipts." Further, there was no alternative method by which the payor was compensated for such significant costs and expenses (e.g., a tax credit or allowance).