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September 14, 1979

Mr. Larry Vandenberg
NRC/TMI Special Inquiry Group
U. S. Nuclear Regulatory Commission
Washington, D. C. 20555

Dear Mr. Vandenberg:

In response to the inquiries of Mr. Rogovin's letter to me dated August 13, 1979, I enclose copies of the letter dated August 27, 1979 of Shaw, Pittman, Potts & Trowbridge and the letter dated September 5, 1979 of Guggenheimer & Untermyer, together with copies of the documents referred to in the Guggenheimer & Untermyer letter.

Although I believe that the matters covered by Item 1 of the Guggenheimer & Untermyer letter are not relevant to the inquiry in Mr. Rogovin's letter, it may be useful to you to have the following information:

As that letter indicates, there was concern that the PaPUC rate order might deprive Penelec of the right to utilize liberalized depreciation on the ground that the rate base deduction made by the PaPUC for deferred taxes for depreciation exceeded that permitted by the IRS regulations. Consequently, Penelec filed a petition with the PaPUC on February 13, 1979 seeking the modification of that portion of the PaPUC order if the IRS should hold, in response to a request for a ruling which Penelec stated it intended to file with the IRS, that the rate base deduction made by the PaPUC exceeded that permitted by the Internal Revnue Code. The draft of application for such IRS ruling was furnished to the PaPUC staff. However, the PaPUC denied Penelec's petition for modification of the rate order and the basis for filing the request for the IRS ruling was thereby removed. Penelec then appealed the rate order on this point, in an effort to protect its right to utilize liberalized depreciation. The issue subsequently became moot when the PaPUC subsequently reduced Penelec's rates to eliminate therefrom the capital and operating costs associated with Penelec's interest in TMI-2 and the appeal was withdrawn following the PaPUC rate order of June 15, 1979.

At your meeting with Mr. Holcombe and me, you requested a copy of Mr. Holcombe's letter to the FERC staff relating to the appropriate beginning date for the test period under Instruction 9D of the Uniform System of Accounts. A copy of that letter, dated August 18, 1978, is enclosed.

You also requested data for the last seven months of 1978 on a month-by-month basis, of the sources and cost of energy and I enclose pages 13 and 14 from the GPU monthly reports supplying that information, both on an individual month and a months-to-date basis.

Very truly yours,

James B. Liberman

James B. Liberman

JBL:RD
ENC.

cc: Messrs. E. J. Holcombe
R. H. Sims
E. L. Blake

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JOHN H. SHARON
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COUNSEL

August 27, 1979

James B. Liberman, Esq.
Berlack, Israels & Liberman
26 Broadway
New York, New York 10004

Dear Jim:

Please refer to your memo of August 21 enclosing letter from Mitchell Rogovin to you, dated August 13, 1979, concerning tax documents associated with commercial operation of TMI-2. This is to confirm that our office has no copies of any of the documents listed in Mr. Rogovin's August 13 letter other than copies of the materials already made available by you to the Special Inquiry Group.

Sincerely,

George F. Trowbridge

GUGGENHEIMER & UNTERMYER
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September 5, 1979

Mr. James B. Liberman
Berlack, Israels & Liberman
26 Broadway
New York, New York 10004

Re: NRC/TMI Special Inquiry

Dear Jim:

We are writing to reply to the request for documents contained in Mitchell Rogovin's letter to you dated August 13, 1979. In reviewing our files, we have found the following documents which may be responsive to Mr. Rogovin's requests:

1. A draft of a proposed application to the IRS by Pennsylvania Electric Company for a ruling under Section 167(l) of the Code on the method required to be used to determine first year TMI-2 depreciation in rate proceedings in order to preserve for Penelec the right to continue to deduct liberalized depreciation. This was prepared by our firm as a result of a PaPUC rate order dated January 26, 1979, in which the PaPUC's calculation of the adjustment to the reserve for deferred taxes for depreciation on TMI-2 was believed to be contrary to the "normalization" requirements of the Regs. § 1.167(l)-1(h)(6)(ii). This ruling request apparently was never filed with the IRS, but we believe the issue was pursued by the Company in an appeal of the PaPUC's order which was taken in the Pennsylvania courts.

2. A letter from Jerome J. Cohen of our firm to Samuel Russell, dated May 21, 1979, outlining an approach to support the validity of the normalization requirements contained in Regs. § 1.167(l)-1(h)(6)(ii), in connection with Mr. Russell's handling of the appeal of the PaPUC's rate order referred to in 1. above.

3. A file copy of the first page of Rev. Rul. 79-98 which deals with the issue of when a nuclear generating unit is

deemed to be placed in service for purposes of depreciation. This was put in our GPU files not in response to any specific inquiry from the GPU System Companies, but merely as part of our routine practice of making a record in our files of published IRS rulings and other current developments involving tax issues potentially germane to our client's business activities.

These were the only documents we found in our files which might fall within the scope of the specific requests in Mr. Rogovin's letter.

Let me add, moreover, that we have no record of any communications from any of the GPU companies to us, or from us to them, relating to the question of when TMI-2 would be treated as in service for purposes of depreciation deductions and investment credits allowable under the Internal Revenue Code.

Sincerely,

George Minkin

George Minkin

GM:ls

Enclosures

HC

Copy submitted to PaPUC Staff at 2/28/79 meeting

PENNSYLVANIA ELECTRIC COMPANY
1001 BROAD STREET
JOHNSTOWN, PENNSYLVANIA 15907

March , 1979

Commissioner of Internal Revenue
Washington, D. C. 20024

Attention: T:PS:T

Re: Request for Ruling Under Section 167(l)

Dear Sir:

Application is hereby made by Pennsylvania Electric Company ("Penelec") for a determination as to the effect of an order of the Pennsylvania Public Utility Commission entered on January 26, 1979 (the "PaPUC's Order") on Penelec's eligibility for accelerated depreciation under Section 167(l) of the Internal Revenue Code, and for depreciation based on the Class Lives Asset Depreciation Range ("CLADR") system.

Penelec is a public utility engaged in furnishing electrical energy to customers in Pennsylvania. Its rates are regulated by the PaPUC. Penelec's principal office is at the address shown above, and its EIN is 25-0718085.

Penelec is a member of an affiliated group, the parent of which is General Public Utilities Corporation ("GPU") whose principal office is at 260 Cherry Hill Road, Parsippany, New Jersey 07054 and whose EIN is

13-5516939. The consolidated Federal income tax returns for the GPU Group are filed with the IRS Service Center in Holtsville, New York.

Pursuant to an election duly made by Penelec under Section 167(1)(4)(A) of the Code, Penelec has been using the SYD method to compute depreciation on its post-1969 public utility property for tax purposes; and in connection therewith, it has been using a normalization method of accounting for regulatory and rate making purposes. In addition, for each tax year beginning with the year 1971, Penelec has duly made an election to use the CLADR system in computing depreciation for its post-1970 public utility property and, pursuant to Section 1.167(a)-11(b)(6)(ii) of the Regulations, it has been normalizing the tax deferrals resulting from such elections. It is Penelec's intention to make similar elections, in the consolidated return to be filed for the GPU Group for 1979, to use the SYD method of depreciation and the CLADR system with respect to all eligible public utility property placed in service by it during 1979.

On April 28, 1978, Penelec filed an application with PaPUC for an increases in its electric rates. The PaPUC's Order granted Penelec an increase, and authorized Penelec to put the new rates into effect beginning on _____, 1979. The test period used in setting these rates was the calendar year 1978. Penelec's cost of

service and its rate base for the test period was determined on the basis of budgeted data submitted by Penelec as to its operations for the year 1978, annualized and otherwise adjusted to approximate the year end level of operations. Data as to actual operations for the test year were submitted through September, 1978, and compared with the budgeted data for the same period. However, no data as to actual operations were presented for the last three calendar months of the test year.

The rate base determined for the test year took into account all property projected to be in service at December 31, 1978, including Penelec's interest (as a tenant in common with two other GPU subsidiaries) in a nuclear generating station known as Three-Mile Island Unit No. 2 (TMI #2) which was placed in service on December 30, 1978. At that date, Penelec's accumulated book cost for its interest in TMI #2 was $175,841,000 and its estimated unadjusted tax basis for the property was $127,007,000.

In computing Penelec's depreciation expense and tax expense for purposes of determining its cost of service for the test period, a full year's depreciation was projected for TMI #2. The depreciation expense was computed using the straight-line method and a 35-year useful life, resulting in an allowance of a depreciation expense for TMI #2 of $_____. The same amount was reflected in the reserve for depreciation which was deducted from

the test year rate base. In computing Penelec's tax expense, the allowance for depreciation for TMI #2 was determined using the straight-line method and the 20 year life specified in Rev. Proc. 77-10 as the asset guideline period applicable to these assets.

Penelec also claimed, and was allowed by the PaPUC, $4,286,000 as a provision for deferred taxes attributable to TMI #2 for the test year. This represented the amount of the tax deferral (Federal and State) resulting from the difference between (a) an allowance of a full year's depreciation for TMI #2, computed under the SYD method and using the 16-year useful life specified in Rev. Proc. 77-10 as the lower limit of the asset depreciation range for Asset Guidline Class 49.12, and (b) an allowance of a full year's depreciation for the property, computed under the straight-line method and using the 20-year life. The method by which the deferred tax provision was so calculated is set out in greater detail in Schedule A attached hereto.

However, in the proceedings before the PaPUC, a question arose as to the proper amount to be excluded from the rate base on account of the provision for deferred taxes attributable to TMI #2 for the test year. Because of concern that the 1978 test year might be treated by the IRS as a "future period" for purposes of Section 1.167(l)-1(h)(6)(ii) of the Regulations, Penelec took the position that the rate base should not be reduced by the $4,286,000 representing the full year's provision. Instead, Penelec

claimed that the rate base should be reduced only by a prorated portion of that amount, determined in accordance with the method specified in the last sentence of Regs. §1.167(l)-1(h)(6)(ii) and in Example 2 of Regs. §1.167(l)-1(h)(6)(iv). Accordingly, Penelec calculated the maximum rate base reduction at $2,056,000, as set forth in the attached Schedule B.

In the PaPUC's Order, the PaPUC determined that the full $4,286,000 was the proper amount by which to reduce the rate base for the increase in the reserve for deferred taxes attributable to TMI #2. As it explained at pages 5 and 6 of its Order, the PaPUC was of the view

> "that a full year's credit to the accumulated deferred income tax account is appropriate since respondent is taking a full year's income deduction. Although respondent interpreted the IRS Code as a limitation on its credit to accumulated deferred income taxes, we are of another opinion. We feel the basic principles of regulation dictate the matching of a full year's credit with the full year's expense for deferred income taxes claimed by respondent. We, therefore, agree with the Staff calculation and increase the accumulated federal deferred income taxes deducted from rate base by $2,230,000 to $4,286,000."

Because of uncertainty as to whether this determination by the PaPUC would be treated by the IRS as being in compliance with the applicable requirements of the Code and Regulations, Penelec filed a petition with PaPUC, on February 13, 1979, stating its intention to seek a ruling from the IRS with respect to this issue, and requesting that the PaPUC reconsider and modify this portion of its Order,

should modification be necessary in light of the ruling which the IRS issues herein. Accordingly, Penelec hereby respectfully requests a determination as to the following:

(1) If Penelec's rate base is reduced by $4,286,000 for deferred taxes attributable to TMI #2 for the test year, as provided in the PaPUC's Order, would such reduction:

(a) exceed the maximum amount that may be excluded from the rate base, with respect to deferred taxes for TMI #2, under the provisions of Section 1.167(l)-1(h)(6) of the Regulations;

(b) cause Penelec to be treated as not using a normalization method of accounting within the meaning of Section 167(l)(3)(G) of the Code and Sections 1.167(l)-1(h)(1)(i) and 1.167(a)-11(b)(6)(ii) of the Regulations; or

(c) result in Penelec being denied the right to use (i) an accelerated method of depreciation or (ii) the CLADR system, in determining its deductions for depreciation for Federal income tax purposes with respect to any public utility property.

(2) If the determination of the amount of the rate base reduction contained in the PaPUC's Order would result in a denial of Penelec's right to use either an accelerated method of depreciation or the CLADR system, would such denial be avoided if the PaPUC were to modify

its Order so as to provide for a rate base reduction, in respect of the tax deferrals attributable to TMI #2 for the test year, not in excess of $2,056,000, as calculated in Schedule A attached hereto.

To the best of our knowledge, the issues presented herein are not presently being considered by any field office of the IRS in connection with an active examination or audit of Penelec's tax returns, nor are they being considered by any branch office of the Appellate Division.

In connection with this application, we are submitting herewith a copy of the PaPUC's Order, a copy of Penelec's Petition to the PaPUC for Reconsideration and Modification, and a Power of Attorney (Form 2848) authorizing Jerome R. Hellerstein, George Minkin, or Jerome J. Cohen, to act in this matter on Penelec's behalf. Should you have any questions concerning this matter, or if you require any additional information, please contact one of the aforementioned representatives.

If any question should arise as to the issuance of the determinations requested herein, we request an opportunity for a conference.

Respectfully submitted,

PENNSYLVANIA ELECTRIC COMPANY

By: _____

DECLARATION

Under penalties of perjury, the undersigned declares that he has examined this request, including accompanying documents, and to the best of his knowledge and belief, the facts presented in connection with this request are true, correct, and complete.

_____

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TELEX-126278

May 21, 1979

Samuel B. Russell, Esq.
Ryan Russell & McConaghy
530 Penn Square Center
P. O. Box 699
Reading, Pennsylvania 19603

Re: Appeal of Pa.PUC Order in Penelec Rate Case

Dear Sam:

As you requested, we have looked into the question of whether there is anything in the legislative history of Section 167(l) of the Code that might be cited to support the validity of the provisions of Regs. § 1.167(l)-(a)(h)(6)(ii) which require a "proration" of the amount of deferred taxes that can be taken into account as a rate base reduction.

As I mentioned in our telephone conversation on May 10, the Committee Reports for Section 167(l), as enacted by the Tax Reform Act of 1969, contain only one brief reference to the rate reduction problem. Both the House and Senate Committee Reports contain a statement to the effect that Section 167(l) was not intended to change the power of state regulatory agencies to exclude the normalized tax reduction from the rate base. I am enclosing copies of the relevant portion of the Committee Reports, as they appear in 1969-3 CB 200, et seq.

Obviously, these statements are not helpful to the Company's position. Indeed, the Pa.PUC might try to use these statements to support an argument to the effect that Congress specifically contemplated that under Section 167(l), utility commissions would be allowed to do exactly what the Pa.PUC did in Penelec's case, namely to reduce the rate base by the full amount of the charge for deferred taxes taken into account in determining tax expense. This argument might appear even more persuasive, at least superficially, if it could be shown that prior to 1969 it had been the common practice, amongst utility commissions which allowed normalization and which made rate base reductions for the resulting deferred taxes, to reduce the rate base by the full amount of the normalizing charge to tax expense.

However, I think an effective response to such a contention can be made, if it can be shown that although utility

commissions may have been making full, rather than prorated, rate base reductions in 1969 and prior years, the commissions were also setting rates during those years on the basis of historical, rather than future, test periods. Even under Regs. § 1.167(a)-1(h)(6)(ii) a rate base reduction for the full amount of deferred taxes is permitted where a historical test period is used. These Regulations require proration only in connection with the use of a future test period. Accordingly, if it can be established that the utility commissions did not begin to use future test periods until some time shortly before 1974 when these Regulations were adopted, I think it can be successfully argued that the comments in the Committee Reports were intended only to authorize, in a general way, a rate base reduction when normalization was allowed; but were not intended to deal with the question of the amount of the reduction that could properly be made.

We were unable to find anything else in the Committee Reports or in the hearings held by the House and Senate Committees having a bearing on the rate base reduction problem.

On the judicial front, the only litigation we are aware of in this area are the California cases involving Pacific Telephone and Telegraph Co. and General Telephone Co. Based on two private IRS rulings which we believe were issued to these companies (copies of the rulings are enclosed) the "proration" aspects of § 1.167(1)-1(h)(6)(ii) were not at issue. However, these cases apparently did involve the general questions of (1) whether the California PUC's calculation of the rate base reduction for the tax deferrals for liberalized depreciation was in compliance with Regs. § 1.167(1)-1(h)(6)(i), and (2) if not, as the IRS ruled, whether the taxpayers were thereby disqualified from the use of liberalized depreciation for tax purposes. Accordingly, there may be some useful material in the briefs submitted in connection with the petitions for certiorari that were filed with the U. S. Supreme Court by these companies. However, we do not presently have access to any of these briefs.

Nevertheless, as I indicated in our telephone conversation, there is some judicial authority, dealing with the force and effect of Treasury regulations generally, that may be helpful in supporting the validity of the Regulations here in question.

Under Section 7805 of the Code, Congress has given the Secretary of the Treasury a broad mandate to issue regulations to implement the statute. Section 7805(a) provides:

> ". . . the Secretary shall prescribe all needful rules and regulations for the enforcement of this title . . . ."

As a result of this Congressional grant of power to the Treasury, the Courts have consistently held that the regulations are to

be given great weight in resolving controversies as to the proper interpretation or application of the provisions of the Code; and they have recognized only a very limited scope for judicial review of the regulations. In its opinion in Commissioner v. South Texas Lumber Co., 333 U.S. 496 (1948), the United States Supreme Court articulated the standard for the courts to follow in determining the validity of Treasury regulations. The Supreme Court's opinion states:

> "This Court has many times declared that Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes and that they constitute contemporaneous constructions by those charged with administration of these statutes which should not be overruled except for weighty reasons." (333 U.S., p. 501)

To the same effect, see Bingler v. Johnson, 394 U.S. 741, 750 (1969); Thor Power Tool Co. v. Commissioner, 99 S.Ct. 773, 781, footnote 11 (1979).

The reasons for this limited scope of judicial review of the rules and regulations promulgated by the IRS and the Treasury are explained in the Supreme Court's opinion in United States v. Correll, 389 U.S. 299 (1967). In that case, the taxpayer challenged the validity of an IRS rule that in order for a taxpayer to obtain a deduction under Section 162 of the Code for the cost of meals incurred on a business trip while "away from home," the trip must require the taxpayer to stop over night for sleep or rest. The Court of Appeals for the 6th Circuit held that the IRS's sleep or rest rule was not a valid regulation under the statute. In reversing the Court of Appeals, the Supreme Court stated:

> "Alternatives to the Commissioner's sleep or rest rule are of course available. Improvements might be imagined. But we do not sit as a committee of revision to perfect the administration of the tax laws. Congress had delegated to the Commissioner, not to the courts, the task of prescribing 'all needful rules and regulations for the enforcement' of the Internal Revenue Code. 26 U.S.C. § 7805(a). In this area of limitless factual variations, 'it is the province of Congress and the Commissioner, not the courts, to make the appropriate adjustments.' Commissioner v. Stidger, 386 U.S. 287, 296. The role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner. Because the rule

> challenged here has not been shown deficient on that score, the Court of Appeals should have sustained its validity. The judgment is therefore Reversed." (389 U.S., at p. 307)

The Regulations in question in Penelec's case may be entitled to even greater weight, because they were not merely promulgated under the general rule-making power granted by Congress under Section 7805, but were issued under a more specific grant of power contained in Section 167 itself. Section 167(1)(5) provides

> "If . . . the application of any provisions of this subsection to any public utility property does not carry out the purposes of this subsection, the Secretary shall provide by regulations for the application of such provisions in a manner consistent with the purposes of this subsection."

Similarly, in connection with the tax deferrals attributable to the use of the CLADR system under Section 167(m) of the Code, Section 167(m)(3) states that a taxpayer's election to use the CLADR system "shall be made . . . subject to such conditions as may be prescribed by the Secretary by regulations." The Regulations issued under Section 167(m) not only require normalization as a condition for the use of the CLADR system but also expressly provide that a determination as to whether a taxpayer is normalizing for this purpose shall be made under the same principles as are applicable under Section 167(1) and Regs. § 1.167(1)-1(h) for determining whether the taxpayer is normalizing tax deferrals resulting from the use of an accelerated method of depreciation. Regs. § 1.167(a)-11(b)(6)(i) states:

> "A determination whether the taxpayer is considered to normalize under this subdivision the tax deferral resulting from the election to apply this section shall be made in a manner consistent with the principles for determining whether a taxpayer is using the 'normalization' method of accounting (within the meaning of section 167(1)(3)(G)). See § 167(1)-1(h)."

The courts have held that regulations such as these, issued pursuant to an express authorization under a specific statutory section, are not merely interpretive; they are "legislative in character and, as such, as binding upon a court as a statute if they are (a) within the granted power, (b) issued pursuant to a proper procedure, and (c) reasonable." Kramertown Co. v. Commissioner, 488 F.2d 728, 730 (5th Cir. 1974).

The additional weight to be given to "legislative" regulations was recognized by the U. S. Supreme Court in

Commissioner v. South Texas Lumber Co., supra. The issue in that case was the validity of regulations promulgated under a predecessor to present Section 453 of the Code which permitted taxpayers to use the installment method of reporting income from the sale of property. The Supreme Court's opinion states:

> "That the Commissioner was particularly intended by Congress to have broad rule-making power under the regulation was manifested by the first words in the new installment basis section which only permitted taxpayers to take advantage of it 'Under regulations prescribed by the Commissioner with the approval of the Secretary * * *.' The clause is still contained in § 44 of the Code. This gives added reasons why interpretations of the Act and regulations under it should not be overruled by the courts unless clearly contrary to the will of Congress." (333 U.S. at p. 503)

See also, Union Electric Company of Missouri v. United States, 305 F.2d 850, 854 (Ct. Cl. 1962); Allstate Insurance Company v. United States, 329 F.2d 346, 349 (7th Cir. 1964); Regal, Inc. v. Commissioner, 53 T.C. 261, 264 (1969), aff'd per curiam, 435 F.2d 922 (2d Cir. 1970), all recognizing that regulations issued not only under the general rule-making power granted under Section 7805 but also under the specific provisions of a particular Code section are legislative in character and have the force and effect of law.

These authorities may not be dispositive of the issue as to the validity of the "proration" requirement under Regs. § 1.167(1)-1(h)(6)(ii). It would still be open to the Pa.PUC to argue that this requirement is "unreasonable." Perhaps it might also argue that this requirement is "clearly contrary to the will of Congress," in view of the statements in the Committee Reports dealing with rate base reductions. Nevertheless, these cases should be helpful in persuading the Pennsylvania court that a difficult burden must be met in order to sustain a challenge to the validity of Treasury regulations; and that it is the Pa.PUC, which must assert the invalidity of the regulations to sustain its calculation of the rate base reduction in this case, that should have the burden on this issue. In addition, if it can be established that future test periods come into general use only after 1969, it can be argued that the proration rule of the Regulations represents merely an attempt to apply the normalization rules of Section 167(1) to a new factual circumstance not present when the legislation was passed and not otherwise dealt with by the specific provisions of the statute. Arguably, this is exactly the kind of situation that Congress intended to be dealt with by an exercise

of the administrative rule-making powers granted by it under both Section 7805 and 167(l).

I hope the foregoing will be useful to you. If you have any questions about it or if there is anything else that I can do, please let me know.

Sincerely,

Jerry

Jerome J. Cohen

JJC:ls