INTERNAL REVENUE SERVICE

Index Number:

103.02-00

199950036

CC:DOM:FI&P:5-PLR-106088-99

SEPT 10, 1999

Legend

Authority =

Proposed Debt =

State Act =

Project =

Baseload Plant =

Peaking Plant =

State =

Federal Act =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

a =

b =

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c =

d =

e =

f =

Dear :

This responds to your request submitted on behalf of the Authority for a ruling that the proceeds of the Proposed Debt will be treated as financing property used for governmental purposes under §§ 103 and 141.

FACTS

The Authority was created by the State Act as a corporate municipal instrumentality and a political subdivision of the State. The Authority's primary purpose under the State Act is to develop and maintain safe, dependable, and economic electrical power for use in the State. The Authority generates, transmits, and sells electric power, principally at wholesale, as permitted or required by applicable law to fulfill its statutory objectives.

The Project is a hydroelectric generating facility which consists of water intakes, waterways, the Baseload Plant, the Peaking Plant with storage reservoir, and power transformation and transmission facilities. The energy generated by the Project is among the least expensive energy produced anywhere in North America. Based in part on the limited supply of water available to the Project, the Federal Energy Regulatory Commission (FERC) rates the combined capacity of the Project as a kilowatts. The Authority owns the Project.

The Federal Act governs licensing of the Project, and expressly directs the Federal Power Commission, the predecessor to FERC, to issue a license to the Authority to construct and operate the Project. The Federal Power Commission issued the first license to the Authority in Year 1 and that license will expire in Year 2. The Authority is currently preparing to renew its license for the Project. The Authority expects FERC to issue a second license to it * * * * *

The Federal Act also governs the allocation of a portion of the total power provided by the Project. As used in the Federal Act and in this ruling, the term "power" means capacity and associated energy. As material to this ruling, the Federal Act requires the Authority to allocate b percent of the total power produced by the Project (Preference Power) to a group of customers consisting of public bodies (Governmental Preference Customers) and non-profit cooperatives (Cooperative Preference Customers and together with Governmental Preference Customers, the Preference Customers). That portion of Preference Power that is available to Governmental Preference Customers is hereinafter referred to as Governmental Preference Power. The Federal Act further allocates Preference Power between Preference Customers within the State and such customers in neighboring states.[1] When the Authority sells power to Preference Customers in neighboring states, the Federal Act requires the Authority to deal exclusively with bargaining agents when these customers have designated such an agent. The Federal Act authorizes the Authority to sell Preference Power to private utility companies if the Authority makes flexible arrangements to withdraw sufficient Preference Power from the private utility companies to satisfy the reasonably foreseeable needs of the Preference Customers. All provisions of the Federal Act described herein are incorporated into the terms of the license for the Project.
* * * * *

For purposes of this ruling request, all Cooperative Preference Customers are considered nongovernmental persons.

All Governmental Preference Customers are publicly-owned utilities that sell energy directly to retail end-users. All Governmental Preference Customers are governmental entities which have been delegated the right to exercise part of the sovereign power of a state or local governmental unit, are part of a larger governmental entity invested with some or all of such sovereign power, or are the public instrumentality of an entity that has been delegated the right to exercise part of such sovereign power.

Where it is necessary to draw a distinction between Governmental Preference Customers located within the State and those located in neighboring states, we refer to these customers,

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[1] Preference Customers within the State are entitled to receive c percent of the power provided by the Project, and such customers in neighboring states are entitled to receive d percent of the power provided by the Project.

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respectively, as the State Governmental Preference Customers and the Out-of-State Governmental Preference Customers. Unless otherwise noted, the term "Out-of-State Governmental Preference Customers" includes any designated bargaining agent of those customers, whether or not the bargaining agent itself is a public body. Each Out-of-State Governmental Preference Customer has designated such an agent. Those agents act on behalf of the Out-of-State Governmental Preference Customers, and, with two exceptions, solely as conduits for the exchange of output between the Authority and the Out-of-State Governmental Preference Customers.[2]

In satisfaction of the Federal Act and the terms of the Authority's license, the Authority entered into contracts with the Governmental Preference Customers. All contracts specify each Governmental Preference Customer's contract demand, which represents entitlement to Project capacity. Currently, the Governmental Preference Customers' aggregate contractual right to Project capacity is e kilowatts, or f percent of the capacity of the Project (e kilowatts/a kilowatts). Pursuant to their contracts, Governmental Preference Customers pay their proportionate share of the costs incurred by the Authority with respect to the Project.

The State Governmental Preference Customers' contracts expire in Year 2 and the Authority expects that these contracts will be extended to Year 3 upon renewal of the license to operate the Project. The Out-of-State Governmental Preference Customers' contracts expire in Year 4 and contain provisions for month-to-month extensions until Year 5. Following the expiration of these contracts, the Authority does not anticipate any change in the allocation of power that is contractually committed to Governmental Preference Customers. This is due to the allocation requirements of the Federal Act and the Governmental Preference Customers' continued demand for Project power given the economically low cost of purchasing output produced by the Project. Even if particular contracts are not renewed, the rights of the Governmental Preference Customers, as a class, will continue and any surrendered rights will be meted out to other Governmental Preference Customers. Hence, the Authority reasonably expects that, during the term of the Proposed Debt, the Governmental Preference Customers' aggregate rights to, and share in, the power provided by the Project will not be less than f percent of the total power provided by the Project. The Authority does not expect that the implementation of programs generically described as "retail access" will reduce the

[2] Two of the bargaining agents are also Preference Customers.

Authority's allocation of power that is contractually committed, in the aggregate, to the Governmental Preference Customers.

The Governmental Preference Customers currently resell their respective allocations of Governmental Preference Power to various end-users as follows. Governmental Preference Power is resold directly to retail customers within the State Preference Customers' respective service areas, including customers who are natural persons not engaged in a trade or business. No such retail customers purchase Governmental Preference Power under an arrangement that conveys priority rights or other preferential benefits. In particular, Governmental Preference Power is sold to these retail customers according to rates imposed under tariffs of general applicability. Although different rates imposed under such tariffs apply to different classes of users, the differences in rates are customary and reasonable. The Authority reasonably expects that the State Governmental Preference Customers will resell Governmental Preference Power in this manner during the term of the Proposed Debt.

The contracts with the designated bargaining agents for the Out-of-State Governmental Preference Customers require such agents to cause all Governmental Preference Power that is sold to the Out-of-State Governmental Preference Customers to be resold to retail customers of those Out-of-State Governmental Preference Customers, including customers who are natural persons not engaged in a trade or business. With respect to certain Out-of-State Governmental Preference Customers, no such retail customers purchase Governmental Preference Power under an arrangement that conveys priority rights or other preferential benefits. In particular, Governmental Preference Power is sold to these retail customers according to rates imposed under tariffs of general applicability. Although different rates imposed under such tariffs apply to different classes of users, the differences in rates are customary and reasonable. For all other Out-of-State Governmental Preference Customers, payments that are substantially certain to be made in any year by each such Out-of-State Governmental Preference Customer on account of its entire allocation of Project power do not exceed .5 percent of the expected average annual debt service on the Proposed Debt. Nonetheless, the bargaining agents are contractually permitted to enter into arrangements with Out-of-State Governmental Preference Customers that allow those customers to resell Governmental Preference Power at wholesale (non-conforming sale) if the Authority is provided advance written notice and the Authority approves the non-conforming sale. The Authority has neither been notified of nor approved any non-conforming sales prior to the submission of this ruling request. The Authority reasonably expects that all Out-of-State Governmental Preference Customers' resales of Governmental Preference Power will be for the exclusive benefit of the retail customers of the Out-of-State

Governmental Preference Customers and that such sales will continue to be made in the manner described herein during the term of the Proposed Debt.

The Authority proposes to use the proceeds of the Proposed Debt to finance upgrade costs and certain relicensing costs for a portion of the Project, namely the f percent of Project capacity that is allocable to the use of Governmental Preference Customers. The upgrade costs include the capital costs associated with specified Baseload Plant generating units at the Project, such as engineering, procurement, construction, and spare equipment for those generating units. The relicensing costs for the Project include licensing studies, environmental impact studies, license application preparation, legal expenses, costs of expert consultants, and miscellaneous improvements and additions not otherwise included as costs to upgrade the Baseload Plant generating units. No portion of the proceeds of the Proposed Debt will be used to finance the Project's transformation and transmission facilities.

LAW AND ANALYSIS

Section 103(a) generally provides that gross income does not include interest on any state or local bond. Section 103(b)(1) provides that this exclusion does not apply to any private activity bond unless it is a qualified bond (as such terms are defined under § 141). As material to this ruling request, § 141(a) provides that a bond is a private activity bond if the bond satisfies the private business use test of § 141(b)(1) and the private security or payment test of § 141(b)(2).

Under §§ 141(b)(1) and (b)(6)(A), private business use occurs if more than 10 percent of the proceeds of the bonds are used, directly or indirectly, in a trade or business carried on by any person other than a governmental person. Under § 141(b)(6)(B), any activity carried on by a person other than a natural person is treated as a trade or business. Under § 1.141-3(a)(1), the private business use test relates to the use of the proceeds of an issue, and for this purpose, the use of financed property is treated as the direct use of proceeds. Under § 1.141-3(a)(2), in determining whether an issue meets the private business use test, it is necessary to look to both the indirect and direct uses of proceeds. Under § 1.141-3(b)(1), in general, a nongovernmental person is treated as a private business user of proceeds as a result of ownership; actual or beneficial use of property pursuant to a lease, or a management or incentive payment contract; or certain other arrangements such as a take or pay or other output-type contract.

"Government use" under § 141(b)(7) means any use other than private business use. Under § 1.141-1(b), the term "governmental person" means a state or local governmental unit as defined in § 1.103-1 or any instrumentality thereof. As material to this ruling request, § 1.103-1(a) provides that the term "state or local governmental unit" means a state or a political subdivision of a state. Section 1.103-1(b) provides that the term "political subdivision" denotes any division of any state or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit.

Under § 141(b)(6)(A), use as a member of the general public is not taken into account in determining whether the private business tests are satisfied. Under § 1.141-3(c)(1), use of financed property by nongovernmental persons in their trades or businesses is treated as general public use only if the property is intended to be available and in fact is reasonably available for use on the same basis by natural persons not engaged in a trade or business. Under § 1.141-3(c)(2), generally, use under an arrangement that conveys priority rights or other preferential benefits is not use on the same basis as the general public. Under § 1.141-3(c)(2), arrangements providing for use that is available to the general public at no charge or on the basis of rates that are generally applicable and uniformly applied do not convey priority rights or other preferential benefits. Under § 1.141-3(c)(2)(i), for this purpose, rates may be treated as generally applicable and uniformly applied even if different rates apply to different classes of users, such as volume purchasers, if the differences in rates are customary and reasonable.

Under § 141(b)(2), the private security or payment test is met if the payment of the principal of, or the interest on, more than 10 percent of the proceeds of such issue is directly or indirectly (1) secured by any interest in property used or to be used for a private business use, or payments in respect of such property, or (2) to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used for a private business use.

Section 1.141-7T sets forth rules to determine whether arrangements for purchases of output from an output facility cause an issue of bonds to meet the private business tests. Section 1.141-7T(c)(1) provides that the private business use test and the private security or payments test are met when a nongovernmental person purchases the available output of an output facility (output contract) that is financed with the proceeds of an issue if the purchase has the effect of transferring substantial benefits of owning the facility and substantial burdens of paying the debt service on the bonds used

(directly or indirectly) to finance the facility (the benefits and burdens test). Under § 1.141-7T(c)(2)(i), an output contract transfers substantial benefits of owing a facility if the contract gives the purchaser (directly or indirectly) rights to capacity on a basis that is preferential to the rights of the general public. Under § 1.141-7T(c)(2)(ii), an output contract transfers substantial burdens of paying debt service on an issue to the extent that the issuer reasonably expects that it is substantially certain that payments will be made under the terms of the contract (disregarding default, insolvency, or other similar circumstances).

For purposes of § 1.141-7T output contracts, available output for generating facilities is determined under § 1.141-7T(b)(1) by reference to nameplate capacity or the equivalent (or lacking either, its maximum capacity), which is not reduced for reserves or other unutilized capacity. However, under § 1.141-7T(b)(1)(iv), where a limited source of supply constrains the output of an output facility, the number of units produced or to be produced by the facility must be determined by reasonably taking into account those constraints. For example, the available output of a hydroelectric unit must be determined by reference to the reasonably expected annual flow of water through the unit.

Under § 1.141-7T(f)(1), an output contract is not taken into account under the private business tests if the purchaser is not required under the contract to make a payment that is substantially certain to be made under § 1.141-7T(c)(2)(ii) in any year in an amount greater than .5 percent of the average annual debt service on an issue that finances the output facility.

Under § 1.141-7T(f)(6), a nongovernmental person acting solely as a conduit for the exchange of output among governmentally owned and operated utilities is disregarded in determining whether the private business tests are met with respect to financed facilities owned by a governmental person.

Example 1 of § 1.141-7T(h) involves a City and a privately-owned utility that agree to jointly construct an electric generating facility of a size sufficient to take advantage of the economies of scale. The facility will be one-third bond-financed and two-thirds financed by the privately-owned utility, and will be owned by the City and the private utility jointly as tenants in common. The City and the private utility will share in the ownership, output, and operating expenses of the facility in proportion to each entity's respective contribution to the cost of the facility, that is, one-third by the City and two-thirds by the privately-owned utility. The City will need only 50 percent of its share of the annual output of the facility during the

first 20 years of operations. Accordingly, the City agrees to sell 10 percent of its one-third output share to the private utility under a 20-year take contract. The City will also sell 40 percent of its share of the annual output of the facility during the first 20 years of operations to numerous other private utilities under contracts of 90 days or less entered into under a prevailing rate schedule, including demand charges. The example concludes that the bonds are not private activity bonds because the City's one-third interest in the facility is not treated as used by the other owner of the facility and not more than 10 percent of the available output of the City's portion of the facility will be used in the trade or business of a nongovernmental person.

The Conference Report (the "Conference Report") to the Tax Reform Act of 1986, H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-690 (1986), 1986-3 (Vol. 4) C.B. 690, contains a similar example which is substantially incorporated into § 1.141-8T(c). In the Conference Report example, a single issue of tax-exempt bonds is contemplated to finance the acquisition of a $500 million electric generating facility. Ten percent of the output of the facility will be sold to an investor-owned utility under an output contract. The Conference Report example concludes that $465 million of tax-exempt bonds may be used to acquire the facility, $450 million for the 90 percent of the facility that is governmentally used, plus $15 million for the allowable private use portion under § 141(b)(4).

The issue presented here is whether the Authority may treat a portion of the Project allocable to the use by the Governmental Preference Customers (based on their entitlement to f percent of the Project's capacity) as a separate facility and thereby treat the Proposed Debt as financing such separate facility for purposes of applying the private business tests to the Proposed Debt.

Special rules apply to governmentally owned output facilities for purposes of applying the private business tests to bonds issued to finance those facilities. Example 1 of § 1.141-7T(h) illustrates the principle that, under certain circumstances, an undivided ownership interest in an output facility may be treated as a separate facility. This undivided ownership interest may be financed on a tax-exempt basis if it is governmentally used (including any permitted amount of private business use), even if the remainder of the facility is owned and used by a nongovernmental person. The Conference Report example, which is substantially incorporated into the Example at § 1.141-8T(c), acknowledges and affirms this principle in a slightly different context. In that example, the governmentally owned and used portion of the facility (including any permitted amount of private business use) was treated as a separate

facility from the remaining portion of the facility that, although governmentally owned, was used by an investor-owned utility under an output contract.

It is fundamental to the principle illustrated by these examples that a portion of an output facility that is both governmentally and privately used may be financed on a tax-exempt basis where the governmental entity has an identifiable interest in the facility (*e.g.*, by ownership, contract, or statute) and the use of the governmental entity's share of the available output of the facility does not cause the bonds to satisfy the private business tests. Hence, the Authority must first establish that the Governmental Preference Customers have an identifiable interest in the Project and, second, that the use of the Governmental Preference Customers' share of the available output of the Project will not cause the Proposed Debt to satisfy the private business tests.

First, we consider the nature of the Governmental Preference Customers' rights to Project capacity to determine whether those rights constitute an identifiable interest in the Project. The Federal Act is the source of those rights. The Federal Act establishes that b percent of the power provided by the Project is set aside as Preference Power for all Preference Customers. The Federal Act permits the Authority to sell that portion of the Preference Power to private utility companies which exceeds the reasonably foreseeable needs of the Preference Customers. As a result, the Federal Act guarantees that no customers other than Preference Customers, a group which includes the Governmental Preference Customers, may have rights to up to b percent of Project capacity. This result is assured by the fact that all provisions of the Federal Act are incorporated into the terms of the license to operate the Project. Although the current license will expire during the term of the Proposed Debt, the Authority reasonably expects that it will be re-licensed to operate the Project when the current license expires * * * * *

The Authority's contracts with the Governmental Preference Customers implement the Federal Act allocation provisions. Project capacity is a kilowatts, which takes into account the limited source of water supply available to the Project. Total capacity reserved under contracts with the Governmental Preference Customers is e kilowatts, which is f percent of Project capacity (e kilowatts/a kilowatts). Although all Governmental Preference Customers' contracts will expire during the term of the Proposed Debt, the source of the Governmental

Preference Customers' rights, as a class, is and will remain the Federal Act. Those rights cannot be subverted by the Authority. In effect, the Authority's ownership and enjoyment of the Project are conditioned on, and subordinated to, the rights of the Governmental Preference Customers. Moreover, even if the Authority's contracts with the Governmental Preference Customers are not renewed, the Federal Act guarantees that the rights of those customers, as a class, will continue. Any rights surrendered by one Governmental Preference Customer will be meted out to other Governmental Preference Customers. Due to the allocation requirements of the Federal Act and the expected demand of the Governmental Preference Customers for Project power given the economically low cost of purchasing power produced by the Project, the Authority reasonably expects that not less than f percent of the Project capacity will continue to be allocated to the Governmental Preference Customers over the term of the Proposed Debt.

We conclude that the portion of the Project (f percent, based on the Governmental Preference Customers' entitlement to Project capacity) allocable to the Governmental Preference Customers represents an identifiable interest in the Project.

Second, assuming the Proposed Debt finances an identifiable interest in the Project allocable to the Governmental Preference Customers, we consider all users of Governmental Preference Power in the determination of whether the Proposed Debt satisfies the private business tests. This is because Governmental Preference Power flows not only to the Governmental Preference Customers, but also to bargaining agents, and, finally, to the Governmental Preference Power consumers.

All Governmental Preference Customers are governmental persons within the meaning of §§ 1.141-1(b) and 1.103-1 because they are governmental entities that have been delegated to right to exercise part of the sovereign power of a state or local governmental unit; are part of a larger governmental entity invested with some or all of such sovereign power of the state; or are a public instrumentality of an entity that has been delegated the right to exercise part of such sovereign power.

The State Governmental Preference Customers resell their respective allocations of Governmental Preference Power directly to retail customers within the State Governmental Preference Customers' respective service areas, including customers who are natural persons not engaged in a trade or business. No such retail customers purchase Governmental Preference Power under an arrangement that conveys priority rights or other preferential benefits. In particular, Governmental Preference Power is sold to retail customers according to rates imposed under tariffs of general applicability. Although different rates imposed under

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such tariffs apply to different classes of users, the differences in rates are customary and reasonable. The Authority reasonably expects that all State Governmental Preference Customer sales will continue to be for the exclusive benefit of the retail customers of each such State Governmental Preference Customer and that such sales will continue to be made in the manner described herein while the Proposed Debt remains outstanding. As a result, State Governmental Preference Customers' resales of Governmental Preference Power will satisfy the § 1.141-3(c) exception to the private business use test.

The contracts with the designated bargaining agents for the Out-of-State Governmental Preference Customers require such agents to cause all Governmental Preference Power that is sold to the Out-of-State Governmental Preference Customers to be resold to retail customers of those Out-of-State Governmental Preference Customers, including customers who are natural persons not engaged in a trade or business. With respect to certain Out-of-State Governmental Preference Customers, no such retail customers purchase Governmental Preference Power under an arrangement that conveys priority rights or other preferential benefits. In particular, Governmental Preference Power is sold to retail customers according to rates imposed under tariffs of general applicability. Where different rates imposed under such tariffs apply to different classes of users, the differences in rates are customary and reasonable. For all other Out-of-State Governmental Preference Customers, payments that are substantially certain to be made by each such Out-of-State Governmental Preference Customer on account of its entire allocation of Project capacity do not exceed .5 percent of the expected average annual debt service on the Proposed Debt. Although bargaining agents are contractually permitted to enter into arrangements with Out-of-State Governmental Preference Customers that allow those customers to resell Governmental Preference Power at wholesale, the Authority has not been notified of any resale of Governmental Preference Power at wholesale and has not approved any such resale prior to the time that this ruling request was submitted. The Authority reasonably expects that all Out-of-State Governmental Preference Customers' resales of Governmental Preference Power will be for the exclusive benefit of the retail customers of the Out-of-State Governmental Preference Customers and that such sales will continue to be made in the manner described herein during the term of the Proposed Debt.

Hence, all resales of Governmental Preference Power by Out-of-State Governmental Preference Customers will satisfy either the § 1.141-7T(f)(1) exception for small purchases of output or will satisfy the § 1.141-3(c) exception to the private business use test.

Although bargaining agents for Governmental Preference Customers in neighboring states have been included within the term "Out-of-State Governmental Preference Customers", we separately consider use by the bargaining agents for purposes of determining whether the Proposed Debt satisfies the private business use tests. Each Out-of-State Governmental Preference Customer has designated a bargaining agent. In their role as bargaining agent, these agents act on behalf of the Out-of-State Governmental Preference Customers, and solely as conduits for the exchange of output between governmentally owned and operated utilities, *i.e.*, between the Authority and such Out-of-State Governmental Preference Customers. That two bargaining agents are also Preference Customers does not alter this result. Hence, the bargaining agents are disregarded under § 1.141-7T(f)(6) in determining whether the private business tests are met with respect to the Project.

CONCLUSION

We conclude that the use of the portion of the Project allocable to the Governmental Preference Customers will not cause the Proposed Debt to satisfy the private business tests. The provisions of the Federal Act, the terms of the Authority's license, and the Authority's contracts create an identifiable interest in f percent of the Project for the Governmental Preference Customers. All use of Governmental Preference Power is either use by a governmental entity or the general public, or use that falls within the exception for small output purchases. Consequently, we conclude that the Authority may treat the portion of the Project allocable to the use by the Governmental Preference Customers (based on their entitlement to f percent of the Project's capacity) as a separate facility for purposes of applying the private business tests to the Proposed Debt. Accordingly, the use of the proceeds of the Proposed Debt to finance f percent of the costs to upgrade the Baseload Plant and to relicense the Project will not cause the Proposed Debt to satisfy the private business tests contained in § 141(b).

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item that is not discussed or referenced in this letter. We have not been requested to rule on and, therefore, express no opinion as to any aspect of the relicensing costs

associated with the rehabilitation of existing Project-related recreational facilities and the development of new environmental or recreational facilities.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that 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 the taxpayer.

Sincerely,

Assistant Chief Counsel
(Financial Institutions & Products)

By: _____
Bruce M. Serchuk
Senior Technician Reviewer
Branch 5

Enclosure:
Copy for § 6110 purposes

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