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April 02, 2008

LEGEND:

District =

Authority =

State =

Certificates =

Act =

Utility 1 =

Utility 2 =

Corporation X =

a =

b =

c =

d =

Year =

Dear :

This letter is in response to your request on behalf of District for rulings that (1) Authority is a "utility" within the meaning of § 1.148-1(e)(2)(iii)(B) of the Income Tax Regulations, (2) Authority has a "service area" within the meaning of § 1.148-1(e)(2)(iii)(C), and (3) neither Utility 1 nor Utility 2 will be considered to use the proceeds of the Certificates in a private business use within the meaning of § 1.141-3.

Facts and Representations

You make the following factual representations. District is a political subdivision of State formed in part to develop power resources in a region of State spanning portions of several counties. District is the owner/operator of a hydro-electric power plant and is developing a natural gas-fired power plant. Authority is a public joint powers agency in State, comprised of a member cities and b member counties, formed for the purpose of implementing a community choice aggregation program (the "Program") for electric power customers within the boundaries of Authority's members. Because Authority has no operational experience in providing electricity for retail customers, Authority will receive assistance from District, which has been serving as a utility for more than 20 years. District will act on behalf of Authority and will provide all electric power services for Authority. The governing board of Authority, made up of one representative appointed by each member, will set the rates to be charged for the electricity.

State's community choice aggregation law, Act (the "Act"), gives consumers the ability to purchase their electricity supply from a community choice aggregator (a "CCA"), rather than from their existing electric utility. The existing utility would continue to provide electricity delivery services to the consumers purchasing their supply from a CCA. Under the Act, a CCA, which must be a city, county, or a joint powers agency of cities and/or counties, is authorized to serve the electric load of consumers within its boundaries (other than the load served by a local publicly owned electric utility) and must offer the opportunity to purchase electricity from that CCA to all residential customers within its boundaries.

Electricity customers within Authority's boundaries (*i.e.*, the boundaries of the a cities and b counties that comprise its members) are currently customers of Utility 1 or Utility 2, each of which is a for-profit investor owned utility. End-use customers of Utility 1 and Utility 2 may choose whether to enroll in the Program or remain full-requirements customers of Utility 1 or Utility 2, respectively. Authority will provide power for those customers that are enrolled in its Program and must utilize the distribution and transmission system of Utility 1 and Utility 2, as the existing utilities, to transmit and distribute the power to its customers.

The electric bills for Program customers will show separate charges for generation provided by the Program (charges set and to be received by Authority) and for delivery of the electricity and other utility charges (that will continue to be assessed and retained by Utility 1 or Utility 2).

District is currently in the process of developing a nominal c megawatt base-load power plant (the "Plant") within its service territory, with the majority of the Plant's output to be used to supply the Program. District targets commercial operation of the Plant in Year. Once it is operational, the Plant will serve as an integral part of the Program. Power purchased by District will be the exclusive source of supply delivered under the Program until the Plant is operating and will be a supplemental source of supply once the District begins producing electricity at the Plant. To procure electricity during the construction and start-up period for the Plant, District will purchase electricity from Corporation X, using the proceeds of the Certificates to make a prepayment (the "Prepayment"), with the electricity to be delivered over a period of d years.

Law and Analysis

The Prepayment

Section 103(a) of the Internal Revenue Code (the "Code") provides that gross income does not include interest on any state or local bond. Interest on a state or local bond is not excluded from gross income if the bond is an arbitrage bond within the meaning of § 148 or is a private activity bond which is not a qualified bond within the meaning of § 141. § 103(b).

Section 148(a) provides that an arbitrage bond is any bond issued as part of an issue any portion of the proceeds of which are reasonably expected (at the time of issuance of the bond) to be used directly or indirectly to acquire higher yielding investments, or to replace funds which were used directly or indirectly to acquire higher yielding investments. For purposes of this subsection, a bond shall be treated as an arbitrage bond if the issuer intentionally uses any portion of the proceeds of the issue of which such bond is a part in a manner described above.

A "higher yielding investment" is "any investment property which produces a yield over the term of the issue which is materially higher than the yield on the issue." § 148(b)(1). Investment property includes, among other things, investment-type property. § 148(b)(2).

Section 1.148-1(e)(1) provides that investment-type property includes any property (other than property defined in § 148(b)(2)(A), (B), (C), or (E)) that is held principally as a passive vehicle for the production of income. Production of income includes any benefit based on the time value of money.

Section 1.148-1(e)(2)(i)(A) provides that, except as otherwise provided in § 1.148-1(e)(2), a prepayment for property or services also gives rise to investment-type property if a principal purpose for prepaying is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made. A prepayment does not give rise to investment-type property if it is a prepayment for electricity that meets the requirements of § 1.148-1(e)(2)(iii)(B).

Section 1.148-1(e)(2)(iii)(B) provides a prepayment meets the requirements of this paragraph if --

(1) It is made by or for one or more utilities that are owned by a governmental person (each of which is referred to in this paragraph (e)(2)(iii)(B) as the issuing municipal utility) to purchase a supply of electricity; and

(2) At least 90 percent of the prepaid electricity financed by the issue is used for a qualifying use. Electricity is used for a qualifying use if it is to be –

(i) Furnished to retail electric customers of the issuing municipal utility who are located in the electricity service area of the issuing municipal utility, or

(ii) Sold to a utility that is owned by a governmental person and furnished to retail electric customers of the purchaser who are located in the electric service area of the purchaser.

Section 1.148-1(e)(2)(iii)(C) provides, in part, that for purposes of § 1.148-1(e)(2)(iii), the service area of a utility owned by a governmental person consists of –

(*1*) Any area throughout which an electric utility provided electricity distribution at all times during the 5-year period ending on the issue date; and

(*2*) Any area recognized as the service area of the utility under state or Federal law.

Section 141 provides, in part, that a private activity bond means any bond issued as part of an issue which meets the private loan financing test of § 141(c). Section 141(c) provides that an issues meet the private loan financing test if the amount of the proceeds of the issue which are to be used (directly or indirectly) to make or finance loans (other than loans described in § 141(c)(2)) to persons other than governmental units exceeds the lesser of 5 percent of such proceeds, or $5,000,000.

Section 1.141-5(c)(2)(ii) provides that, except as otherwise provided, a prepayment for goods or services is treated as a loan for purposes of the private loan financing test if a principal purpose is to provide a benefit of tax-exempt financing to the seller. A prepayment is not treated as a loan for purposes of the private loan financing test if the prepayment meets the requirements of § 1.148-1(e)(2)(iii)(A) or (B) (relating to certain prepayments to acquire a supply of natural gas or electricity).

The Prepayment is a prepayment for property or services that will give rise to investment-type property and to a private loan, unless the exception in § 1.148-

1(e)(2)(iii)(B) for electricity prepayments applies. District asks for rulings that Authority is a utility and has a service area within the meaning of that exception.

Section 1.148-1(e)(2)(iii) does not define the term "utility". Section 1.141-1 provides that "public utility property" means public utility property as defined in § 168(i)(10). Section 168(i)(10) defines the term "public utility property", in part, to mean property used predominantly in the trade or business of the furnishing or sale of electrical energy if the rates for such furnishing or sale have been established or approved by a state or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof. Section 7701(a)(33) provides, in part, for purposes of Title 26 generally, that a "regulated public utility" means a corporation engaged in the furnishing or sale of electric energy if the rates for such furnishing or sale have been established or approved by a state or political subdivision thereof, by an agency or instrumentality of the United States, by a public service or public utility commission or other similar body of the District of Columbia or of any State or political subdivision thereof, or by a foreign country or an agency or instrumentality or political subdivision thereof.

We conclude that Authority is a utility for purposes of § 1.148-1(e)(2)(iii)(B). Authority, through its agent District, will be engaged in the sale of electricity to its customers. It must offer service to all residential customers within its boundaries. Authority's board, appointed by its member cities and counties, will set the rates to be charged for the electricity.

Section 1.148-1(e)(2)(iii)(C) provides, in part, that the service area of a utility consists of any area recognized as the service area of the utility under state law. Under the Act (a State law), Authority has the right to serve the electric load of consumers within its boundaries. Authority is required to offer the opportunity to purchase electricity from Authority to all residential electric customers located with its boundaries. We thus conclude that Authority has a service area within the meaning of § 1.148-1(e)(2)(iii)(C).

Private Business Use

Section 103(b)(1) provides that § 103(a) does not apply to any private activity bond, unless it is a qualified bond under § 141.

Section 141(a) provides that a private activity bond is any bond issued as part of an issue that meets either (1) the private business use test of § 141(b)(1) and the private security or payment test of §141(b)(2), or (2) the private loan financing test of § 141(c).

Section 141(b)(1) provides that generally a bond issue meets the private business use test if more than 10 percent of the proceeds of the issue are to be used for any private business use. Section 141(b)(6)(A) generally provides that the term "private business use" means use (directly or indirectly) in a trade or business carried on by any person

other than a governmental unit. For purposes of § 141(b)(6)(A), use as a member of the general public shall not be taken into account. Section 141(b)(6)(B) provides that, for purposes of § 141(b)(6)(A), any activity carried on by a person other than a natural person shall be treated as a trade or business.

Section 1.141-3(a)(1) provides that 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. Section 1.141-3(a)(2) provides that in determining whether an issue meets the private business use test, it is necessary to look to both the indirect and direct use of proceeds.

Section 1.141-3(b)(1) generally provides that both actual and beneficial use by a nongovernmental person may be treated as private business use. Section 1.141-3(b)(1) further provides that, in most cases, the private business use test is met only if a nongovernmental person has special legal entitlements to use the financed property under an arrangement with the issuer. Section 1.141-3(b)(1) also provides that, in general, a nongovernmental person is treated as a private business user of proceeds and financed property 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. Arrangements that convey special legal entitlements for beneficial use of bond proceeds or of financed property that are comparable to the arrangements in the prior sentence also result in private business use. Section 1.141-3(b)(7)(i). For example, an arrangement that conveys priority rights to the use or capacity of a facility generally results in private business use.

The issue presented is whether Utility 1 and Utility 2, by transmitting and distributing the electricity purchased with the proceeds of the Certificates, will be private business users of the electricity.

Neither Utility nor Utility 2 is entering into any arrangement to purchase the financed electricity or that otherwise conveys special legal entitlement to actual or beneficial use of the electricity. Utility 1 and Utility 2 will use their facilities to provide transmission and distribution services to Authority and its customers. *Cf.* § 1.141-7(f)(4) (regarding nongovernmental person acting solely as a conduit for the exchange of output). Authority will set and receive the electricity supply charges from its customers, and Utility 1 and Utility 2 will continue to assess and retain the delivery and other utility charges.

Conclusions

We conclude that (1) Authority is a “utility” within the meaning of § 1.148-1(e)(2)(iii)(B), (2) Authority has a “service area” within the meaning of § 1.148-1(e)(2)(iii)(C), and (3)

neither Utility 1 nor Utility 2 will be considered to use the electricity financed with proceeds of the Certificates in a private business use within the meaning of § 1.141-3.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with a Power of Attorney on file with this office, a copy of this letter is being sent to District's authorized representative.

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

Sincerely,

Associate Chief Counsel
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By: _____
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