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Year 2 =

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Dear :

This is in response to the request submitted on behalf of Issuer for a ruling that the City's proposed contracts described below will not result in private business use of the proceeds of the Bonds under § 141 of the Internal Revenue Code (Code).

#### FACTS AND REPRESENTATIONS

Issuer was created pursuant to State 1 law for the purpose of permitting political subdivisions of State 1 that own and operate retail electric utility systems to secure by joint action an adequate, reliable, and economical supply of electric power. Issuer has the authority to develop, finance, construct, acquire and operate generation, transmission and distribution facilities to meet the electricity requirements of its members. Issuer is authorized to issue bonds for this purpose. Issuer allows certain rural electric cooperatives and municipalities located outside of State 1 to participate in Issuer's power supply programs and projects as non-voting members.

City is a municipality in State 2. City owns and operates an electric distribution system through which it delivers electricity to its customers within City.

Power Plant is an electric generating station located in City. Issuer has an undivided ownership interest in Power Plant and financed or refinanced substantially all of the acquisition and construction costs of its interest in Power Plant with the Bonds. The Bonds are revenue bonds payable from the revenues of Power Plant, including payments received under power purchase agreements with municipalities located in States 1 and 2, including City. City's power purchase agreement (the PPA) entitles City to a specified percentage share of the capacity of, and energy generated by, Issuer's interest in Power Plant and requires that City pay to Issuer that same percentage share of Issuer's costs of acquisition and construction, including the debt service on the Bonds, (fixed costs) and operation (variable costs) of Power Plant on a take or pay basis.

ISO is a regional transmission organization that was recognized as such by the Federal Energy Regulatory Commission in Year 1. In Year 2, ISO's geographical region expanded to include the area in which Power Plant is located. ISO also operates as an energy market (the ISO Market) by buying energy from participating generators and

selling that energy to the load serving entities (LSEs) that sell energy to wholesale and retail customers.

ISO, along with regulators from states participating in ISO, has the responsibility to ensure that sufficient electric generating capacity exists within the ISO system (or elsewhere from which electricity can be delivered into the ISO system) to cover the anticipated peak demand, plus an appropriate reserve margin, for each LSE within ISO's region. The amount of capacity required for an LSE is referred to as its resource adequacy requirement. The market mechanism that ISO uses to ensure an LSE meets its resource adequacy requirement is zonal resource credits (ZRCs). All of the generating capacity within ISO's region is assigned an amount of ZRCs, with 1 ZRC equal to 1 megawatt-day of capacity. The number of ZRCs for any generating facility is determined once per year based upon a variety of factors, including the type of facility and historical generation at the facility.

An LSE can meet its resource adequacy requirement by (1) owning a generation asset available to produce power within the ISO system (to which ZRCs will be assigned); (2) having contractual rights equivalent to ownership of such a generation asset, such as, for example, a "take or pay" contract for the purchase of power; (3) entering into bilateral contracts to purchase ZRCs; or (4) purchasing ZRCs at the yearly ISO ZRC auction. If a LSE fails to meet its resource adequacy requirement (that is, has an insufficient amount of ZRCs for its load), it pays a penalty to ISO.

If an ISO market participant has ZRCs in excess of its resource adequacy requirement, it must make such ZRCs (above an ISO-determined threshold) available in the yearly ISO auction to allow the LSEs with inadequate ZRCs to purchase the needed amount of ZRCs. The market value of ZRCs is largely dependent on the ratio between the capacity and the load that the ISO serves and the availability of transmission services for the load served. Under the ISO regulations, the owner of a generating facility that has sold assigned ZRCs must offer the electric energy produced by that facility in the ISO Market. A purchase of a ZRC provides no legal entitlement to the energy corresponding to the ZRC purchased.

City proposes to enter into three agreements. City plans to enter into a long-term electric service contract with Cooperative, an entity exempt from Federal income tax under § 501(c)(12) of the Code (the Electric Supply Agreement). Under the Electric Supply Agreement, Cooperative will supply all of City's electricity requirements.

As a result of the Electric Supply Agreement, City will no longer need the electricity that it receives from Power Plant under the PPA. City plans to sell that electricity through short-term contracts and spot sales in the ISO market. To hedge the difference between the revenue City collects from selling its PPA power in the ISO market and the price City must pay to Issuer under the PPA, City will enter into a a-year financial swap agreement with Corporation (the Swap). Specifically, City will pay Corporation the

excess of the price for which City sells its electricity under the PPA in the ISO market over the variable costs it incurs in producing its electricity at Power Plant, and Corporation will pay City the excess of the variable costs City incurs in such production over the price at which City sells its PPA electricity in the ISO market. The fixed costs payable to Issuer under the PPA, including the debt service on the Bonds, are not factored into the Swap payments.

Corporation is an electric generation and transmission cooperative corporation located and operating in State 2. It serves its member cooperatives through long-term all requirements contracts. Cooperative is a member of Corporation, but not a related party to Corporation under § 1.150-1(b) of the Income Tax Regulations.

As a result of the Electric Supply Agreement and Cooperative's requirements contract with Corporation, City's resource adequacy requirement will be transferred to Corporation as Cooperative's supplier. Consequently, the ZRCs assigned to City's share of the capacity of Power Plant will be available for City to sell. City will enter into a a-year contract to sell its ZRCs to Corporation (the ZRC Sales Agreement). Corporation will use these ZRCs to satisfy its resource adequacy requirement or may resell them to other LSEs. The ZRC Sales Agreement does not entitle Corporation to any energy, capacity, or control over the operations of Power Plant.

## LAW AND ANALYSIS

Section 103(a) of the Code provides that gross income does not include interest on any state or local bond. Section 103(b)(1) provides that § 103(a) does not apply to any private activity bond which is not a qualified bond within the meaning of § 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) 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. 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) of the Income Tax Regulations 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(b)(1) provides that both actual and beneficial use by a nongovernmental person may be treated as private business use. 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. 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.

Section 1.141-3(b)(7)(i) provides that any other arrangement that conveys special legal entitlements for beneficial use of bond proceeds or of financed property that are comparable to special legal entitlements such as ownership, leases, or output contracts (or other arrangements not relevant for this purpose) results in private business use. For example, an arrangement that conveys priority rights to the use or capacity of a facility generally results in private business use.

Section 1.141-7 provides special rules to determine whether arrangements for the purchase of output from an output facility cause an issue of bonds to meet the private business tests. Section 1.141-3 applies to determine whether other types of arrangements for use of an output facility cause an issue to meet the private business tests. Section 1.141-1(b) provides that an “output facility” means electric and gas generation, transmission, distribution, and related facilities, and water collection, storage, and distribution facilities.

Section 1.141-7(b)(1) provides that the available output of a facility financed by an issue is determined by multiplying the number of units produced or to be produced by the facility in one year by the number of years in the measurement period of that facility for that issue. Section 1.141-7(b)(1)(i) provides that the number of units produced or to be produced by a generating facility in one year is determined by reference to its nameplate capacity or the equivalent (or where there is no nameplate capacity or the equivalent, its maximum capacity), which is not reduced for reserves, maintenance or other unutilized capacity. Section 1.141-7(c)(1) provides that the purchase pursuant to a contract by a nongovernmental person of available output of an output facility (output contract) financed with proceeds of an issue is taken into account under the private business test if the purchase has the effect of transferring the benefits of owning the facility and the burdens of paying the debt service on the bonds used (directly or indirectly) to finance the facility (the burdens and benefits test).

Issuer is requesting a ruling that the three agreements described above, specifically, the Electric Supply Agreement, the Swap, and the ZRCs Sale Agreement (collectively, the Agreements) will not result in private business use under § 141 of the Code.

Proceeds of the Bonds were spent on the costs of acquiring, constructing, and refinancing Issuer’s interest in Power Plant, an output facility as defined in § 1.141-1(b).

Although ZRCs are assigned to Power Plant based on its capacity, ZRCs do not increase or otherwise impact the nameplate capacity of Power Plant, and the sale of ZRCs does not affect the units of electricity that may be sold nor entitle Corporation, the ZRC purchaser, to any energy or capacity of Power Plant. We thus conclude that ZRCs are not output for purposes of § 141 and the rules in § 1.141-7 do not apply to the ZRC Sales Agreement.

The rules under § 1.141-3 must also be examined to determine whether there is private business use. Under the Agreements, Corporation, the purchaser of City's ZRCs, will receive no legal entitlements to the energy or capacity of Power Plant. The ZRCs are a market mechanism to meet the LSE resource adequacy requirements and do not themselves constitute capacity or use of Power Plant. Under the ZRC Sales Agreement, City will have no obligation to Corporation to produce any electricity, and Corporation will have no control over Power Plant and its operations. Thus, Corporation has no direct or indirect control of the operation of, or any other special legal entitlement with respect to, Power Plant under § 1.141-3.

Similarly, the Swap is not an output contract and does not grant any special legal entitlements to Corporation, the Swap counterparty, regarding the energy, capacity, or control over the operations of Power Plant. Finally, the Electricity Supply Agreement is not an agreement with respect to the output of Power Plant, nor does it grant Cooperative any special legal entitlements relating to the energy, capacity, or control over the operations of Power Plant.

## CONCLUSION

Based on the foregoing, we conclude that the Agreements will not result in private business use of the Bonds.

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

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.

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.

Sincerely,

Associate Chief Counsel  
(Financial Institutions & Products)

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By: \_\_\_\_\_  
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