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LEGEND

Authority =

Bonds =

State =

Act =

Supplier =

Occurrence =

Order =

Report =

Department =

Court	=
Coal Complex	=
Mine A	=
Mine B	=
Settlement Agreement	=
Exceptions Resolution Agreement	=
Consulting Firm	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Month 1	=
Month 2	=
Month 3	=
Month 4	=
Month 5	=

Month 6	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
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Dear :

This letter is in response to a request for a ruling submitted on behalf of Authority, that (1) the expenditures for the Excess Costs and Excess Financing Costs (described below and collectively herein referred to as "Excess Charges") to be financed in part with Bonds are extraordinary items within the meaning of § 1.148-6(d)(3)(ii)(B) of the Income Tax Regulations and, therefore, not subject to the proceeds-spent-last method in § 1.148-6(d)(3)(i); and (2) under § 1.148-10(a)(4), the Bonds will not be outstanding longer than is otherwise reasonably necessary to accomplish the governmental purposes of the Bonds.

Facts and Representations

Authority is a public body and body corporate of State created pursuant to the Act. Authority's primary business operation is the production, transmission, and distribution of electrical energy, both at wholesale and retail, to customers located in State. Authority owns and operates coal-fired power plants that produce approximately a percent of the power generated by Authority. Authority has no taxing power. Authority recovers its costs of operation through rates charged to its customers.

In Year 1, Authority became involved in a lawsuit relating to its decision to suspend the construction of a capital project. On Date 1, Authority executed a Settlement Agreement in connection with the lawsuit in which it agreed to: (1) make certain payments for the benefit of the class action members to the lawsuit; (2) implement a freeze on rates Authority charges the majority of Authority's retail electric customers and Authority's largest wholesale customer during a specific time period (the "Rate Freeze Period"); and (3) not to defer any costs and expenses incurred during the Rate Freeze Period to any other years with the exception of certain extraordinary expenses (the "Rate Freeze Exceptions") identified in annual compliance reports required to be filed with the Court pursuant to the Settlement Agreement. Expenses treated as Rate Freeze Exceptions were permitted to be deferred during the Rate Freeze Period and then collected in rates by Authority after the Rate Freeze Period.

In order to obtain a supply of coal for its coal-fired power plants, Authority entered into a coal supply contract (the "Contract") with Supplier in Month 1 for coal from the Coal Complex which includes Mine A and Mine B. Supplier was Authority's largest and lowest-cost coal supplier supplying c percent, a substantial amount, of the total coal that Authority regularly received. The initial term of the Contract with Supplier was scheduled to expire at the end of Year 5.

In Month 2, the Occurrence took place at the Coal Complex. The Occurrence and the resulting Order issued by the Federal government in response to the Occurrence halted coal production at the Coal Complex. Supplier notified Authority in a letter dated Date 2, that the Occurrence and the Order was a force majeure event under the Contract and that Supplier was unable to predict when, and at what levels, mining at the Coal Complex would resume.

From Month 3 through Month 4, Authority received no coal from the Coal Complex. On Date 3, the Order was modified, allowing Supplier to resume the production of coal at Mine A, but Mine B remained closed. On Date 4, Supplier notified Authority that Mine A had restarted production, but that the force majeure event was ongoing. After the reopening of Mine A, Authority began receiving d percent of coal specified in the Contract from the Coal Complex.

The Occurrence and Supplier's inability to provide the coal supply required under the Contract led to the significant reduction of Authority's coal inventory. As a result of the reduction, in Month 5, Authority filed a Report with the Federal government informing the Department of a fuel supply emergency that could impact electric power system adequacy or reliability. Authority represents that the only time it has been required to report a fuel supply emergency is as a result of the Occurrence.

Despite the inability to obtain the coal specified under the Contract from the Coal Complex, Authority was still required to provide power to its customers and had to find replacement sources of fuel and power. During the period following the Occurrence, Authority was unable to replace all of the coal supply under the Contract, and most replacement coal was significantly more expensive than the price under the Contract. In Year 2, Authority purchased approximately e tons of replacement coal; in Year 3, Authority purchased approximately f tons in replacement coal; and in Year 4, Authority purchased approximately g tons in replacement coal. Other sources of power were obtained by increasing natural gas generation through additional purchases of natural gas and purchasing power on the open market. Obtaining fuel and power from these alternative sources was significantly more expensive than what the cost would have been had the coal supply under the Contract been available.

The Occurrence increased Authority's costs from Month 3 through Month 6 by $h, which represents the incremental costs above what would have been incurred in the absence of the Occurrence, netted against any fuel-related revenues received from customers (the "Excess Costs"). The Excess Costs created by the Occurrence were substantial amounts for which Authority would not ordinarily budget to pay out of its revenues. Authority quantified the Excess Costs using a model that compared how its electric power system actually operated during the relevant period with the manner the system would have operated if it had received the contracted coal from the Coal Complex. Authority's calculation of the Excess Costs was evaluated by Consulting Firm, an independent consulting firm with experience in analyzing power supply resource-related options and costs. Authority determined that for financial accounting purposes the Excess Costs are a regulatory asset under the Governmental Accounting Standards Board principles, allowing Authority to defer recognition and recover these costs on its books over a specified time period. Authority identified the Excess Costs as Rate Freeze Exceptions in the annual compliance reports submitted to the Court pursuant to the Settlement Agreement.

The Occurrence took place after the Settlement Agreement that imposed the rate freeze was executed resulting in the inability of Authority to recover the Excess Costs at the time they were incurred. The Excess Costs resulting from the Occurrence incurred during the Rate Freeze Period and, together with other Authority costs, during the Rate Freeze Period caused Authority to rapidly deplete its existing cash on hand. Authority represents that the Excess Costs would have completely depleted and exceeded the amounts in Authority's revenue fund, which are used for daily operating expenses (including fuel expenses), by the end of Year 3. Authority also represents that the

Excess Costs would have completely depleted and exceeded all of Authority's cash on hand by the end of Year 4.

Authority does not maintain reserves specifically intended to deal with the fluctuating nature of the costs of coal, although it has reserves for other operational needs. Authority maintains approximately b days of cash on hand to support its operations and to maintain its credit rating. Approximately half of Authority's cash on hand is designated for specific purposes such as landfill closure expenses and water system funds or is otherwise unavailable to use for Authority's electric system. If the cash designed for specific purposes was depleted, it would need to be replenished to fulfill its intended purpose. The remaining cash on hand is used to support day-to-day operations or is earmarked for capital projects.

Authority's Board of Directors authorized the issuance of obligations to finance the Excess Costs on Date 5. With available cash amounts rapidly depleting, Authority began borrowing on a short-term basis beginning on Date 6, to maintain adequate cash on hand and to pay the Excess Costs. Authority financed the Excess Costs, and certain financing costs described further below, using short-term, non-amortizing taxable notes issued from Month 5 through Month 6 (the "Taxable Notes"). Authority represents that restoring its cash on hand to adequate levels by borrowing was the only solution due to the Occurrence and the rate freeze imposed under the Settlement Agreement which prevented Authority from collecting the Excess Costs from its customers through rate adjustments during the Rate Freeze Period. With the rate freeze in place, Authority had no means to increase its revenue to pay for the Excess Costs. Authority represents that it paid the Excess Costs with borrowed funds in order to continue to supply power to meet the needs of its customers, increase cash on hand to meet its financial obligations, and prevent a potential downgrade to Authority's credit rating.

Authority began refinancing portions of the Taxable Notes with short-term, non-amortizing tax-exempt notes on Date 7 (the "Tax-Exempt Notes"), subject to the rules applicable to the financing of working capital under § 148 . Authority refinanced a portion of the Taxable Notes eligible to be refinanced with the Tax-Exempt Notes. Authority represents that it has complied with the safe harbor for longer term working capital financings contained in § 1.148-1(c)(4)(ii). Authority refinanced $i of the Tax-Exempt Notes with additional taxable notes (the "Additional Taxable Notes") as an interim measure to ensure compliance with the safe harbor for longer-term working capital financing under § 1.148-1(c)(4)(ii).

Authority initially paid from its cash-on-hand the financing costs including interest on the Taxable Notes and the Tax-Exempt Notes issued to finance the Excess Costs (the "Excess Financing Costs"). In Year 6, Authority issued Taxable Notes to reimburse amounts used to pay for the Excess Financing Costs. Authority did not set aside funds or maintain a reserve for payment of the Excess Financing Costs. The Excess Financing Costs were incurred during the Rate Freeze Period and, similar to the Excess

Costs, were identified as Rate Freeze Exceptions, along with certain other expenditures eligible under the Settlement Agreement.

Disputes arose among the parties to the Settlement Agreement regarding the Rate Freeze Exceptions. The parties to the Settlement Agreement resolved the disputes by entering into another settlement agreement (the "Exceptions Resolution Agreement"). The Exceptions Resolution Agreement was approved in an order of the Court on Date 8 (the "Exceptions Order").

The Exceptions Resolution Agreement sets forth the nature and amounts of the Rate Freeze Exceptions recoverable through future rates to be charged to its customers by Authority (in total, the "Recovery Amount"). The Recovery Amount includes the Excess Charges along with certain other costs incurred during the Rate Freeze Period and certain future costs of issuance of debt to finance the amount that is to be recovered after the Rate Freeze Period. The Excess Charges are the only portion of the Recovery Amount that Authority seeks to finance with the Bonds. Pursuant to the Exceptions Order, the Recovery Amount is to be recovered from Authority's customers through a charge imposed over a j-year period (the "Recovery Charge").

Authority intends to issue the Bonds together with taxable bonds (the "Taxable Bonds") to finance the uncollected Recovery Amount over the j-year period during which the Recovery Charge will be collected. The Recovery Charge collected before the issuance of the Taxable Bonds and the Bonds will be used to pay down the Taxable Notes and the Tax-Exempt Notes on a pro rata basis. Upon receipt of a favorable private letter ruling from the Internal Revenue Service, Authority intends to issue the Bonds in an amount sufficient to: (1) refund the outstanding Tax-Exempt Notes and the Additional Taxable Notes; (2) refund a portion of the outstanding Taxable Notes issued to finance the Excess Financing Costs; and (3) pay the costs of issuance of the Bonds. Authority will issue the Taxable Bonds to refund any remaining Taxable Notes. The Bonds and the Taxable Bonds will each be structured to be amortized pro rata over a period of j years, aligning with the imposition and collection of the Recovery Charge. Authority does not intend to apply the safe harbor for longer term working capital financings contained in § 1.148-1(c)(4)(ii).

Authority represents that issuing the Bonds with a maximum term of j years and a weighted average maturity of not more than k years provides Authority with a reasonable debt service expense over the term of the issue which considers the economic impact of the Occurrence and the Excess Charges without causing downgrades to its credit rating while preserving customer affordability. The Exceptions Order provides that issuing the Bonds with a maximum term of j years, and weighted average maturity not expected to exceed k years will limit the total amount collected from the class protected by the Settlement Agreement and will not greatly increase the typical residential customer bill.

Law and Analysis

Section 103(a) of the Internal Revenue Code provides that, except as provided in § 103(b), gross income does not include interest on any state or local bond. Section 103(b) provides, in part, that § 103(a) shall not apply to any arbitrage bond (within the meaning of § 148) or any private activity bond which is not a qualified bond (within the meaning of § 141).

Section 148(a) defines an arbitrage bond as 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 (1) to acquire higher yielding investments, or (2) to replace funds which were used directly or indirectly to acquire higher yielding investments. Section 148(a) further provides that a bond is 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 in (1) or (2).

Section 1.148-1(b) defines proceeds, in part, to mean any sale proceeds, investment proceeds, and transferred proceeds of an issue. Transferred proceeds are defined in § 1.148-9. Section 1.148-9(b) provides, in part, that when proceeds of the refunding issue discharge any of the outstanding principal amount of the prior issue, proceeds of the prior issue become transferred proceeds of the refunding issue and cease to be proceeds of the prior issue.

Section 1.148-6(d)(3)(i) provides that, except as otherwise provided in § 1.148-6(d)(3) or (d)(4), proceeds of an issue may only be allocated to working capital expenditures as of any date to the extent that those working capital expenditures exceed available amounts (as defined in § 1.148-6(d)(3)(iii)) as of that date (i.e., a "proceeds-spent-last" method). For this purpose, proceeds include replacement proceeds described in § 1.148-1(c)(4).

Section 1.148-6(d)(3)(ii)(B) provides that § 1.148-6(d)(3)(i) does not apply to expenditures for extraordinary, nonrecurring items that are not customarily payable from current revenues, such as casualty losses or extraordinary legal judgments in amounts in excess of reasonable insurance coverage. If, however, an issuer or a related party maintains a reserve for such items (e.g., a self-insurance fund) or has set aside other available amounts for such expenses, gross proceeds within that reserve must be allocated to expenditures only after all other available amounts in that reserve are expended.

Section 1.148-6(d)(3)(ii)(C) provides that § 1.148-6(d)(3)(i) does not apply to expenditures for payment of principal, interest, or redemption prices on a prior issue and, for a crossover refunding issue, interest on that issue. Section 1.148-6(d)(3)(iii)(A) defines available amount, in general, as any amount that is available to an issuer for working capital expenditure purposes of the type financed by an issue. Except as otherwise provided, available amount excludes proceeds of any issue but includes cash, investments, and other amounts held in accounts or otherwise by the issuer or a related party if those amounts may be used by the issuer for working capital expenditures of the type being financed by an issue without legislative or judicial action and without a legislative, judicial, or contractual requirement that those amounts be reimbursed.

Section 1.148-1(c)(4)(i)(A) provides that replacement proceeds arise to the extent that the issuer reasonably expects as of the issue date that: (1) the term of an issue will be longer than is reasonably necessary for the governmental purposes of the issue; and (2) there will be available amounts during the period that the issue remains outstanding longer than necessary. Whether an issue is outstanding longer than necessary is determined under § 1.148-10. Replacement proceeds are created under § 1.148-1(c)(4)(i)(A) at the beginning of each fiscal year during which an issue remains outstanding longer than necessary in an amount equal to available amounts of the issuer as of that date.

Section 1.148-1(c)(4)(i)(B)(1) provides, as a safe harbor, that replacement proceeds do not arise under § 1.148-1(c)(4)(i)(A) for the portion of an issue that is to be used to finance restricted working capital expenditures, if that portion is not outstanding longer than the temporary period under § 1.148-2(e)(3). For the portion of an issue that is a refunding issue, § 1.148-1(c)(4)(i)(B)(3) provides that replacement proceeds do not arise if that portion has a weighted average maturity that does not exceed the remaining weighted average maturity of the prior issue, and the issue of which the prior issue is a part satisfies § 1.148-1(c)(4)(i)(B)(1) or (2).

For the portion of an issue (including a refunding issue) that is to be used to finance working capital expenditures, § 1.148-1(c)(4)(i)(B)(4) provides that replacement proceeds do not arise if that portion satisfies § 1.148-1(c)(4)(ii) of this section. Section 1.148-1(c)(4)(ii) provides a safe harbor against the creation of replacement proceeds for longer-term working capital financings. This safe harbor requires annual testing for available amounts and application of the available amounts to reduce the burden on the tax-exempt bond market.

Section 1.148-10(a)(4) provides that an action overburdens the tax-exempt bond if it results in issuing more bonds, issuing bonds earlier, or allowing bonds to remain outstanding longer than is otherwise reasonably necessary to accomplish the governmental purposes of the bonds, based on all the facts and circumstances. Whether an action is reasonably necessary to accomplish the governmental purposes of the bonds depends on whether the primary purpose of the transaction is a bona fide governmental purpose (e.g., an issue of refunding bonds to achieve a debt service restructuring that would be issued independent of any arbitrage benefit). An important factor bearing on this determination is whether the action would reasonably be taken to accomplish the governmental purpose of the issue if the interest on the issue were not excludable from gross income under § 103(a) (assuming that the hypothetical taxable interest rate would be the same as the actual tax-exempt interest rate). Factors evidencing an overissuance include the issuance of an issue the proceeds of which are reasonably expected to exceed by more than a minor portion the amount necessary to accomplish the governmental purposes of the issue, or an issue the proceeds of which are, in fact, substantially in excess of the amount of sale proceeds allocated to expenditures for the governmental purposes of the issue. One factor evidencing an early issuance is the issuance of bonds that do not qualify for a temporary period under § 1.148-2(e)(2), (e)(3), or (e)(4). One factor evidencing that bonds may remain outstanding longer than necessary is a term that exceeds the safe harbors against the creation of replacement proceeds under § 1.148-1(c)(4)(i)(B). These factors may be outweighed by other factors, however, such as bona fide cost underruns, an issuer's bona fide need to finance extraordinary working capital items, or an issuer's long-term financial distress. Section 1.148-10(b) imposes limitations on an issue that overburdens the tax-exempt market, including the mandatory application of the proceeds-spent-last rule under § 1.148-6(d)(3)(i).

The Bonds are refunding bonds. Under § 1.148-6(d)(3)(ii)(C), the proceeds-spent-last method does not apply to expenditures for payment of principal, interest, or redemption price on a prior issue. However, proceeds of the Bonds will include any transferred proceeds from the Additional Taxable Notes, Taxable Notes issued to finance Excess Financing Costs, and Tax-Exempt Notes to be refunded with the Bonds. The answer to the question of whether the Excess Charges are subject to the proceeds-spent-last method will determine the amount of the proceeds of the refunded bonds, or of any transferred proceeds of the Bonds, that Authority can allocate to the Excess Charges.

The Occurrence caused Authority to lose access to its coal supply under the Contract and Authority could not obtain replacement coal from other suppliers on the Contract terms. The Occurrence resulted in unprecedented increases in Authority’s costs ultimately amounting to the Excess Charges. Authority could not reasonably have expected or planned to pay out of current revenues the Excess Charges. Concurrently, the terms of the Settlement Agreement, particularly the rate freeze, prevented Authority from increasing the rates to its customers and recovering any part of the Excess Charges during the Rate Freeze Period. Consequently, it was necessary for Authority to borrow in order to pay for the Excess Charges. Authority is financing with the Bonds a portion of the Excess Charges. The Excess Charges include only amounts beyond amounts Authority would have ordinarily incurred if the coal supply under the Contract were available. The calculations of the Excess Charges have been reviewed by independent experts and approved by Authority. The Excess Charges have been reported to the Court in annual filings in accordance with the Settlement Agreement. Authority’s customers and the Court, through the Exceptions Resolution Agreement and the Exceptions Order, have approved the recovery of the Excess Charges as a Rate Freeze Exception. We conclude that the Excess Charges being refinanced with the proceeds of the Bonds are extraordinary, nonrecurring expenses that are not customarily payable from current revenues and that the exception to the proceeds-spent -last requirement in § 1.148-6(d)(3)(ii)(B) applies to the Excess Charges.

Authority had not maintained and does not maintain specific reserves for expenses such as the Excess Charges. Accordingly, Authority need not allocate amounts prior to allocating proceeds of the Additional Taxable Notes, Taxable Notes, Tax-Exempt Notes, or the Bonds to the Excess Charges.

Whether the Bonds will remain outstanding longer than is otherwise reasonably necessary to accomplish the governmental purposes of the Bonds is determined based on all the facts and circumstances. In determining whether the term of an issue used to finance extraordinary working capital items is reasonable, considerations include the nature of the event giving rise to the expenditures, the size of the expenditures relative to the size of a borrower's budget, and the impact of the expenditure on a borrower's operating budget over the term of the issue that will finance the expenditures.

First, we conclude Authority has a bona fide need to finance the Excess Charges as an extraordinary working capital item. Authority did not plan or reserve for the Excess Charges and the amount of the Excess Charges is substantial. Authority was subject to a rate freeze when the Excess Charges were incurred and could not collect the Excess Charges in rates from its customers. In addition, Authority financed (and refinanced) the Excess Charges with the Taxable Notes and Tax-Exempt Notes after substantially depleting its coal inventory and any cash on hand that it was able to use to pay for the Excess Charges.

Further, Authority has represented that issuing the Bonds with a term up to j years and a weighted average maturity not expected to exceed k years provides Authority with a reasonable debt service expense over the term of the issue which considers the economic impact of the Occurrence and the Excess Charges without causing downgrades in its credit rating. The term of j years for the Bonds was determined at arm's length by and among Authority, counsel, and Authority's largest customer with input from the Court in the context of the ongoing Court case and Settlement Agreement. The Court determined j years was the appropriate recovery period that will best serve Authority's customers by limiting the total amount collected over time from Authority's customers without greatly increasing the typical residential customer bill. Authority's costs, including its debt, can only be paid with revenues from its ratepaying customers. By providing a debt service payment that is expected to be manageable, the term and weighted average maturity of the Bonds will also assist Authority in meeting its budgetary requirements. Accordingly, we conclude under § 1.148-10(a)(4), the Bonds will not be outstanding longer than reasonably necessary to accomplish the governmental purpose of the Bonds.

Conclusion

Based solely on the information submitted and representations made, we conclude that (1) the expenditures for the Excess Charges are extraordinary items pursuant to § 1.148-6(d)(3)(ii)(B) and, therefore, not subject to the proceeds-spent-last method in § 1.148-6(d)(3)(i); and (2) pursuant to § 1.148-10(a)(4), the Bonds will not be outstanding longer than is otherwise reasonably necessary to accomplish the governmental purposes of the Bonds.

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, including whether the interest on the Bonds is excludable from gross income under § 103(a).

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.

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

Sincerely,

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Associate Chief Counsel
(Financial Institutions & Products)
Zoran Stojanovic
Branch Chief
Branch 5

cc: