**Internal Revenue Service**

Department of the Treasury

Washington, DC 20224

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**LEGEND**

City 1 =
City 2 =

State =

Company =

County 1 =
County 2 =

Region =

Date 1 =
Date 2 =

ISO =

PUC =

Bondholder =

Council R =
Council W =

A =
B =
C =

Bonds =

Y
Z

Dear :

This letter is in response to a request submitted by your authorized representatives for a ruling about the effect on the Bonds of certain aspects of the electric industry restructuring within State. Bondholder is the holder of least one of the Bonds. The Bonds were issued for the benefit of Company.

**FACTS**

Generally

City 1 and City 2 (the "Issuers") are both cities and political subdivisions of State. The Issuers are authorized by their charters and by enabling ordinances to issue revenue bonds and lend the proceeds to the Company. The Company is an investor-owned utility ("IOU") engaged in the business of generating, transmitting, and distributing electric energy and natural gas. Under PUC regulation, the Company has the exclusive right to distribute electric energy to retail customers (the "Native Load Customers") within a service area consisting of County 1 and a contiguous portion of County 2 (the "Electric Service Area").

The Company wholly owns and operates (or by long-term power purchase agreement controls) an integrated system of electric generation, transmission, and distribution facilities (the "Local System") that are directly connected to each other and that comprise the majority of the Company's facilities used to provide electric service throughout the Company's Electric Service Area. The Local System operates at voltage levels ranging from A volts to B kilovolts ("kV").

Consistent with national energy policy, the Local System is connected with other transmission systems located within Region.[1] The Company's interconnection and transmission contracts require the Company to operate the transmission components of the Local System within standards imposed by regional authorities such as Council R

[1] See section 202(c) of the Federal Power Act which authorizes the FERC to require electric utilities, including the Company, to interconnect for the emergency transfer of power.

and Council W. Council W's operating procedures specifically created a security coordinator which was authorized to direct load curtailments, interchange curtailments, generation dispatch adjustments, transmission configuration adjustments, and other actions deemed necessary to maintain the integrity of the national transmission grid.

Excess transmission capacity on the Local System is used to wheel electricity for the benefit of other utilities and to make wholesale sales of electricity for consumption outside the Electric Service Area. Wholesale electric supply customers and persons (other than the Native Load Customers) who purchase transmission service that uses the Local System pay or have paid rates established by the Federal Energy Regulatory Commission ("FERC") based in part upon the Company's blended costs of capital, including the cost of interest on tax-exempt bonds.[2]

The Bonds were issued to finance or refinance a portion of the Company's costs of improvements to the Local System. Approximately $ Y of the Bonds financed or refinanced electric transmission facilities which are part of the Local System (the "Local Transmission System"). Substantially all of the remaining proceeds financed or refinanced electric distribution facilities. The Bonds were issued for the benefit of the Company pursuant to letter rulings to the Company that concluded the Local System consists of facilities for the local furnishing of electric energy (herein referred to as a "local furnishing system") within the meaning of § 103(b)(4)(E) of the Internal Revenue Code of 1954 (the "1954 Code") and §§ 142(a)(8) and 142(f)(1) of the Internal Revenue Code of 1986 (the "1986 Code").[3] The Company also received a letter ruling that the Local System would continue to qualify as a local furnishing system despite the use of excess transmission capacity on the Local System for wheeling transactions to benefit customers other than Native Load Customers so long as there is a net inbound flow of electric energy into the Local System on an annual basis. The Company represents that it has met and will in the future continue to meet this requirement.

In connection with these rulings, the Company represented that the Local System was not acquired or constructed sooner, larger, or of a different character than was reasonably considered necessary to provide reliable electric service to the Company's Native Load Customers. Other than as described herein, the Company represents that the Local System continues to operate as a local furnishing system in the manner described in its previous letter rulings.

Electric Industry Restructuring: ISO Control

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[2] See infra p. 4 for additional discussion of FERC established rates.

[3] Assets of a utility that can be financed as part of a local furnishing system under § 142(a)(8) are sometimes referred to herein as "local furnishing assets".

The Company and other major IOUs in State have entered into a Transmission Control Agreement ("TCA") with the ISO that affects transmission facilities owned by the IOUs including the Local Transmission System (the "IOU Transmission Network"). The TCA became effective on Date 1. The relationship between the ISO and the IOUs is also governed by the ISO Tariff and the Transmission Owners Tariff (the "Tariffs"). Under the Tariffs, the ISO is authorized and obligated to perform the following functions:

1. ensure that transmission service is offered over the IOU Transmission Network on a nondiscriminatory basis;
2. ensure reliability of the IOU Transmission Network;
3. ensure compliance with guidelines, standards and policies of Council R and other bodies;
4. participate actively with transmission owners and market participants in transmission planning;
5. schedule transmission service over the IOU Transmission Network;
6. oversee maintenance of the IOU Transmission Network;
7. control the dispatch and maintenance of the transmission network;
8. propose augmentations to the IOU Transmission Network; and
9. develop procedures to monitor the IOU Transmission Network.

All of these functions are performed by the ISO's employees and other personnel. All other functions, including the physical operation of the IOU Transmission Network, continue to be performed by the Company and by other owners of the IOU Transmission Network, subject to directions of the ISO.

The Tariffs incorporate specific "Encumbrances" and "Operating Procedures" that limit the ISO's ability to take actions in connection with the Local Transmission System. The Encumbrances specifically limit the ISO's authority take any action that (i) would cause the Company to become a net annual exporter of electricity, or (ii) would abridge priority service rights on the Local Transmission System previously enjoyed by the Native Load Customers, or (iii) otherwise might jeopardize the tax-exempt status of the Bonds. The TCA itself limits the ISO's authority to require the Company to construct additions or improvements to the Local Transmission System except under an order of the FERC that would meet the requirements of § 142(f)(2)(A). The Operating Procedures implemented by the Company specify acts that must be taken to ensure implementation of the Encumbrances.

Electric Industry Restructuring: Rate Making

The rates the Company charges its customers for electric service are subject to both state and federal regulation. FERC establishes rates and tariffs for transmission service and for wholesale electric supply service provided by the Company and by other IOUs in interstate commerce. The Commission establishes rates and tariffs for

distribution service and retail sales of electricity provided by the Company and by other IOUs within State.

Historically, the FERC and the Commission have established IOU rates through cost of service based rate regulation. The FERC has established electric transmission rates, and the Commission has established retail electric rates based on a revenue requirement that takes into account the Company's overall blended cost of capital. Because the Company is the beneficiary of tax-exempt bonds, a portion of the Company's capital structure consists of debt obligations bearing interest at lower rates than would apply if interest on the bonds were taxable. The lower rate of interest attributable to tax-exempt bonds results in a lower overall blended cost of capital than otherwise would be the case. This lower blended cost of capital produces a lower revenue requirement, and hence lower rates for the Company's FERC-approved cost-of-service-based transmission rates and for the Company's Commission-approved cost-of-service-based distribution rates.

The FERC recently authorized the ISO to implement a new rate making approach. Effective on Date 2, the IOU Transmission Network and transmission systems of other participating utilities within State (the "State Transmission Network") will be segregated for rate making purposes into high voltage transmission ("HVT") facilities, which operate at C kV or greater, and low voltage transmission facilities, which operate below C kV. The revenue requirements of all HVT facilities of the State Transmission Network will be aggregated, and each user receiving HVT service will pay uniform rates for the service that reflect an allocated portion of the aggregate HVT facility revenue requirement. As a result, consumers of electricity in State other than Native Load Customers, who will have an HVT service component as part of their electric service bills, will pay rates for HVT service that reflect up to approximately Z percent of the Company's tax-exempt financing of the Local System.

**LAW AND ANALYSIS**

Generally

The fundamental question presented by this case is whether implementation of electric industry restructuring in State will cause the Local System to no longer be a local furnishing system for purposes of §§ 142(8) and 142(f)(1). Two aspects of restructuring are at issue: (1) The ISO control of the Local Transmission System, which includes the Company's HVT facilities, and (2) statewide pricing of HVT service, which will cause an increased portion of Company's tax-exempt financings to be shared with consumers of electricity in State other than Native Load Customers.

Geographic limitation under § 142(f)(1)

Section 142(a)(8) of the Code provides that "exempt facility bond" means any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide facilities for the local furnishing of electric energy or gas. For purposes of § 142(a)(8), § 142(f)(1) of the Code provides that the local furnishing of electric energy or gas shall only consist of furnishing solely within an area consisting of a city and one contiguous county, or two contiguous counties.

Revenue Ruling 83-56, 1983-1 C.B. 22[4], provides guidance for determining whether the geographic limitation of § 142(f) on local furnishing assets has been exceeded. In the Revenue Ruling, a regulated electric utility was required by the state public utility commission to provide electric service to retail customers in an electric service area that included several counties. The utility satisfied that obligation with an integrated system consisting of electric generation, transmission, and distribution facilities that served all of the customers in its service area. The utility proposed to finance a hydroelectric generating plant, all the electric energy from which would be consumed within a single county within its multi-county electric service area, as a facility for the local furnishing of electricity within the meaning of § 103(b)(4)(E) of the 1954 Code (the predecessor to § 142(a)(8)). Electricity was currently supplied to customers in the county by other generating plants owned by utility. These plants would continue to supplement the electric needs of the single county's population after completion of the proposed facility. The public utility commission established utility's retail electric rates, which were uniform throughout the multi-county electric service area. As a consequence, the rates, in part, would be based on the tax-exempt financing for the proposed plant.

The Revenue Ruling concluded that the proposed plant would serve more than two contiguous counties (or more than a city and one contiguous county) and therefore, would not be a facility for the local furnishing of electric energy. Three factors significantly contributed to the conclusion in the Revenue Ruling: (1) because electric rates were based on the utility's blended cost of capital, all of the utility's customers in the multi-county area, rather than only its customers in the single county, would benefit from the tax-exempt financing of the proposed; (2) the proposed hydroelectric plant would enhance the utility's capacity to serve customers in the entire electric service area rather than only its customers in the single county; and (3) the electric energy produced at the proposed hydroelectric plant would simply replace electric energy previously supplied by the utility's other regional generating plants.

Certain factors in this case are analogous to those in Rev. Rul. 83-56. The FERC, like the public utility commission in Rev. Proc. 83-56, will establish uniform, statewide

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[4] Rev. Rul. 83-56 was issued under § 103(b)(4)(E) of the Internal Revenue Code of 1954, the predecessor to § 142(a)(8). To the extent not amended, Congress intended that principles of law under the 1954 Code continue apply under the 1986 Code. H. Conf. Rept. 99-841 (Vol. II), at II-686.

pricing for HVT transmission transactions on the HVT portion of the State Transmission System, which includes the HVT portion of the Local Transmission System. These prices will be based on the blended cost of capital of the HVT portion of the State Transmission System and will cause an increased portion of the benefits of the Company's tax-exempt financings to be shared throughout State. Also, some of the ISO's management responsibilities with respect to the IOU Transmission System, which includes the Local Transmission System, are similar to those of the regional utility in Rev. Rul. 83-56 toward its regional transmission system: scheduling transmission service, maintenance oversight, and assurance of transmission reliability These responsibilities are designed to insure the Local Transmission System, like the proposed hydroelectric plant, operates efficiently and reliably as part of a larger, regional system, the State Transmission Network.

Other factors in this case, however, indicate that electric industry restructuring has not fundamentally altered the character of the Local System: First, unlike the proposed hydroelectric plant in Rev. Rul. 83-56, which replaced (and could be replaced by) other generating units in the multi-county area for purposes of supplying electricity to the utility's customers, the Local Transmission System, after the ISO control, continues under PUC regulation to be the sole system devoted on a priority basis to the conveyance of electric energy to the Native Load Customers. Second, the Encumbrances and Operating Procedures effectively prevent the ISO from using anything other than excess capacity on the Local Transmission System to transmit electric energy for other utilities. In addition, the TCA limits the ISO's authority, except under an order from the FERC, to require the Company to augment the Local Transmission System beyond that required to serve the Native Load Customers. Third, the ISO itself is not like the utility in Rev. Rul. 83-56 that proposed building the hydroelectric the plant to generate electric energy for retail customers in its service area. It does not own or operate substations or transmission lines. It also has no service area or retail electric customers. Instead, its function is to ensure the reliability and efficiency of the IOU Transmission System for the general benefit of retail customers of utility systems in State, including the Local System. Specific relationships with retail customers like the Native Load Customers continue to be the responsibility of the owners of the IOU Transmission System including the Company.

There is an additional reason why the analogous sharing of the benefits of tax-exempt financing in this case is not given significant weight in our determination that there has not been a change of use of the Local System. Prior to the ISO control, the Company used excess capacity on the Local Transmission System to wheel power for other utilities based on regulated rates. These rates, which in part were based on the Company's tax-exempt financings, caused some sharing of the benefits tax-exempt bonds with customers other than-Native Load Customers. Nevertheless, the Congress has acknowledged that wheeling transactions, like those undertaken by Company, will not cause properly issued local furnishing bonds to lose their tax-exempt status. When § 142(f)(2) was enacted as part of the Energy Policy Act of 1992, the Congress, describing "Present law," indicated that transmission for the benefit of other parties (wheeling) did not violate local furnishing requirements as long as the system of which

the local transmission assets were a part was not designed differently, sized larger, built sooner, or constructed in a more costly fashion than is required to serve the customers in the electric service area. H.R. Rept. 474, 102d Cong. 2d Sess., page 24 (1992).

**CONCLUSION**

Consequently, based solely on the facts supplied and representations of the Company, we conclude that on balance the Company's execution of and compliance with the TCA, together with the specified changes in rate making for HVT service, has not and will not adversely affect the continued qualification of the Local System as a system for the "local furnishing of electric energy" within the meaning of §§ 142(a)(8) and 142(f)(1) of the Code and corresponding provisions of prior law. We express no opinion whether augmentations of the Local Transmission System can be financed with tax-exempt bonds under §§ 142(a)(8) and 142(f).

Sincerely,
Timothy L. Jones
Acting Branch Chief
Tax Exempt Bonds

cc: