Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Person To Contact:
,
Telephone Number:

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LEGEND:

Authority =

Agreement =

Electric Company =

Manager =

Operator =

Service Area =

Adjustment Factor =

Bonds =

Year 1 =

a =

b =

c =

d =

Dear :

This responds to Authority's request for a ruling that the Agreement described below will not result in private business use of the Bonds under § 141(b) of the Internal Revenue Code (the "Code").

Facts and Representations

You make the following representations. Authority owns all of the stock of Electric Company, a governmental person. Electric Company owns and controls an electric transmission system and an electric distribution system (collectively referred to herein as the "T&D System"), and has the right to provide retail electric service to customers in the Service Area. Proceeds of the Bonds were used to finance the T&D System.

Electric Company and Manager will enter into the Agreement, which requires Manager to operate and maintain the T&D System in accordance with policies established by Authority and Electric Company. Manager will form Operator as a wholly-owned subsidiary to provide substantially all of the management and operations services required under the Agreement as further described below. Without Electric Company's prior approval (and, necessarily, without Authority's concurrence), Operator may not engage in any business or activity other than to provide operation services pursuant to the Agreement.

The Agreement will have a term that does not exceed 10 years, with no provision for extension or renewal of the term of the Agreement. The Agreement may be immediately terminated prior to the end of the term by either party due to specified events of default.

None of the voting power of the governing body of Electric Company in the aggregate is vested in the Manager and its directors, officers, shareholders, and employees. There are no overlapping board members between Manager and either Authority or Electric Company. Authority represents that it is not a related party, as defined in § 1.150-1(b) of the Income Tax Regulations, to either Manager or Operator.

Under the Agreement, Manager will be responsible for operation and maintenance of the T&D System and the management and performance of capital improvements thereto. Manager cannot transmit or distribute electric power and energy using the T&D System other than power and energy obtained by, on behalf of, or with the approval of Electric Company and cannot use the T&D System to serve any person other than Electric Company and its customers in the Service Area.

Manager will be paid the following amounts (collectively referred to herein as the "Services Fee") under the Agreement: (1) the Fixed Direct Fee; (2) the Incentive Compensation Component; and (3) the Reimbursement of Pass-through Expenditures.

1. Fixed Direct Fee. Each contract year, Manager will be paid a stated amount (the "Fixed Direct Fee") in 12 equal monthly installments. The Fixed Direct Fee, expressed in Year 1 dollars, is $a annually. This fixed component amount assumes $b of credit support provided to Electric Company by Manager. At Electric Company's sole option, credit support may be reduced in $c increments, triggering a reduction in the annual Fixed Direct Fee at a stated rate. Also each contract year, the Fixed Direct Fee will be adjusted by the Adjustment Factor, which is based on the Consumer Price Index, except that if the Adjustment Factor is negative, the Fixed Direct Fee will be the same as in the previous contract year.

2. Annual Incentive Compensation Component. In any contract year, Manager also will be eligible to receive a payment referred to as the "Incentive Compensation Component", which will be based on neither gross revenues nor net profits of the T&D System. This amount will be paid from an incentive compensation pool established by Electric Company. The Electric Company tentatively will credit to the compensation pool an incentive compensation, expressed in Year 1 dollars, of $d, an amount which assumes $b of credit support provided to Electric Company by Manager. The Incentive Compensation Component may be earned by Manager based on favorable performance measured against certain performance goals outlined in the Agreement. The Incentive Compensation Component earned by Manager for any year will be adjusted downward if the Manager fails to achieve stated minimums described in the Agreement.

The performance goals consist of, in general, four categories: cost management, customer satisfaction, technical and regulatory performance, and financial performance. The Manager achieves these goals by (1) materially completing the capital and operating work plans within the capital and operating budgets; (2) achieving high levels of end-use customer satisfaction; (3) providing safe, reliable power supply in a way that complies with regulation; and (4) meeting Electric Company's financial needs.

The performance categories are subdivided into actual performance metrics (the "Performance Metrics"). The cost management category contains separate

Performance Metrics for the operating budget and work plan and the capital budget and work plan. If, in any year, Manager does not achieve the expected performance level for both of the cost management Performance Metrics or, alternatively, if it does not achieve the expected performance level for the same cost management Performance Metric for two consecutive years, Manager will not be eligible to receive any incentive compensation for that year or second year, as applicable. If, in any year, Manager achieves the expected performance level for only one of the cost management Performance Metrics, Manager will be eligible for a maximum of 50 percent of the Incentive Compensation Component for that year.

For each contract year (for all performance categories other than the cost management category), Manager's level of performance in each performance category will be measured based on actual results achieved for the year. The performance categories other than the cost management category are weighted according to relative importance. The weighted percentages determine the share of the incentive compensation pool that may be allocated to a performance category.

Adjustments to Incentive Compensation Component. The Incentive Compensation Component earned by Manager for any year will be adjusted downward by 50 percent for any contract year if Manager has failed to achieve a stated minimum performance level for the same Performance Metric for any two years of a consecutive three-year period, and a 100 percent reduction will apply if Manager has failed to achieve the minimum performance level for two or more of the same Performance Metrics for any two years of a consecutive three-year period (unless, in either instance, the minimum performance level for such metric(s) has been satisfied in the then-current year).

Reductions in Service Fee. Poor performance by Manager with respect to certain Performance Metrics relating to customer satisfaction and service interruptions can cause a reduction in the Services Fee. In which case, Manager will be required (a) to forfeit all of its Incentive Compensation Component for the year, and (b) pay to Electric Company a penalty equal to a certain percent of the Fixed Direct Fee for the year.

3. Reimbursement of Pass-through Expenditures. As part of an annual budgeting process, Manager must provide proposed budgets, including the Pass-through Expenditures, for Electric Company's review, revision, and approval. The term "Pass-through Expenditures" generally means those expenditures incurred by Manager (without any mark-up or profit) in the course of providing operations services. Specifically included are wages, salaries, benefits, and other labor costs of the general workforce (*i.e.,* management, professional, and union personnel employed by Operator); costs incurred by Operator for all materials, supplies, vehicles, purchased services, and other costs; subcontractor costs with respect to leases, permits, and similar instruments in performing operations services, including the cost of capital

improvements; costs incurred in connection with a large variety of potential claims; costs related to storm events; various taxes; and costs incurred in transactions with affiliates of Manager. Pass-through Expenditures do not include amounts paid by Manager to or for individuals who are part of senior management and who are employed by Manager.

Manager will be reimbursed by Electric Company for the Pass-through Expenditures at its cost of service without markup, multiplier, or other adjustment. However, the costs to Manager, if any, of transactions with affiliates may include a mark-up of the affiliate's direct expenses in accordance with Federal Energy Regulatory Commission (FERC) sanctioned cost allocation methods, including a FERC-approved return, where applicable.

Law and Analysis

Section 103(a) 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, among other requirements, it is a qualified bond (within the meaning of § 141). Section 141(a) provides that a bond is a private activity bond if the bond satisfies the private business use test and the private security or payment test of § 141(b).

Under §§ 141(b)(1) and 141(b)(6)(A), the private business use test is met if more than 10 percent of the proceeds are used, directly or indirectly, in a trade or business carried on by any person other than a governmental unit. Under § 141(b)(6)(B), any activity carried on by a person other than a natural person is treated as a trade or business.

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 as 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)(4)(i) provides that a management contract with respect to financed property may result in private business use of that property based on all of the facts and circumstances. A management contract with respect to financed property generally results in private business use of that property if the contract provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operation of the facility.

Section 1.141-3(b)(4)(ii) defines a management contract as a management, service, or incentive payment contract between a governmental person and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility. Under § 1.141-3(b)(4)(iii)(C), a contract to provide for the operation of a facility or system of facilities that consists predominantly of public utility property, if the only compensation is the reimbursement of actual and direct expenses of the service provider and reasonable administrative overhead expenses of the service provider, is generally not treated as a management contract that gives rise to private business use. Similarly, § 1.141-3(b)(4)(iii)(D) provides that a contract to provide for services generally does not give rise to private business use if the only compensation is the reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated third parties.

Revenue Procedure 97-13, 1997-1 C.B. 632, as modified by Revenue Procedure 2001-39, 2001-2 C.B. 38 ("Rev. Proc. 97-13"), sets forth operating guidelines for contracts to manage bond-financed facilities which, if satisfied, allow management services to be provided under the contract without causing the facilities to be treated as used in a private business use under § 141(b). Rev. Proc. 97-13 requires that management contracts conform to guidelines relating to (1) compensation arrangements, (2) contract term, and (3) any circumstances substantially limiting the qualified user's ability to exercise its rights. Section 5.02(1) of Rev. Proc. 97-13 provides that reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated third parties is not by itself treated as compensation.

Section 5.02(1) of Rev. Proc. 97-13 also provides in part that the contract must provide for reasonable compensation for services rendered with no compensation based, in whole or in part, on a share of net profits from the operation of the managed facility. For this purpose, § 5.02(3) of Rev. Proc. 97-13 provides that a productivity reward equal to a stated dollar amount based on increases or decreases in gross revenues (or adjusted gross revenues), or reductions in total expenses (but not both increases in gross revenues (or adjusted gross revenues) and reductions in total expenses) in any annual period during the term of the contract generally does not cause the compensation to be based on a share of net profits.

Section 5.03 of Rev. Proc. 97-13 sets forth permissible compensation arrangements. Section 5.03(2) provides an arrangement under which at least 80 percent of the services for each annual period during the term of the contract must be based on a periodic fixed fee. The arrangement provided in § 5.03(2) also contains a term limit under which the term of the contract, including all renewal arrangements, must not exceed the lesser of 80 percent of the reasonably expected useful life of the financed property and 10 years. Section 5.03(3) of Rev. Proc. 97-13 provides that if all of the financed property subject to the contract is a facility consisting of predominantly public utility property (as defined in § 168(i)(10)), then 20 years is substituted for 10 years in applying § 5.03(2).

Section 3.05 of Rev. Proc. 97-13 defines a periodic fixed fee to mean a stated dollar amount for services rendered for a specified period of time. The stated dollar amount may automatically increase according to a specified, objective, external standard that is not linked to the output or efficiency of a facility. For example, the Consumer Price Index and similar external indices that track increases in prices in an area or increases in revenues or costs in an industry are external standards.

Section 5.04(1) of Rev. Proc. 97-13 provides that the service provider must not have any role or relationship with the qualified user that, in effect, substantially limits the qualified user's ability to exercise its rights, including cancellation rights, under the contract, based on all of the facts and circumstances. Section 5.04(2) provides this requirement is satisfied if (a) Not more than 20 percent of the voting power of the governing body of the qualified user in the aggregate is vested in the service provider and its directors, officers, shareholders, and employees; (b) Overlapping board members do not include the chief executive officers of the service providers or its governing body or the qualified user or its governing body; and (c) The qualified user and the service provider under the contract are not related parties, as defined in § 1.150-1(b).

The Agreement must meet all requirements of section 5 of Rev. Proc. 97-13 for that contract to be deemed under that revenue procedure not to result in private business use of the T&D System by Manager. If any requirement is not met, then pursuant to § 1.141-3(b)(4)(i), whether the Agreement results in private business use depends on all of the facts and circumstances. In determining whether the facts and circumstances indicate private business use, the principles set forth in Rev. Proc. 97-13 are useful reference points.

Whether Manager's compensation meets the requirements of Rev. Proc. 97-13 first requires an analysis of the amounts paid to Manager under the Agreement, which are: (1) the Fixed Direct Fee; (2) the Incentive Compensation Component; and (3) Reimbursement of Pass-through Expenditures.

The Fixed Direct Fee does not meet the requirements of section 5.03(2) of Rev. Proc. 97-13, since it is not a periodic fixed fee. It is subject to adjustments based on reduced credit support as well as reductions because of poor performance. These adjustments or reductions are not specified, objective, and external within the meaning of section 3.05 of Rev. Proc. 97-13. Nevertheless, based on all of the facts and circumstances, we conclude that the Fixed Direct Fee does not cause the Agreement to result in private business use of the T&D System for purposes of § 141. Neither an adjustment based on reduced credit support nor a reduction based on poor performance will be based on a change of net profits. In addition, the Fixed Direct Fee, after an adjustment, will remain a stated amount for the particular annual period.

Based on all of the facts and circumstances, we also conclude that the Incentive Compensation Component of the Services Fee does not cause the Agreement to result in private business use of the T&D System. Although the various performance categories that make up the Performance Metrics provide incentives to reduce expenses, none of the performance categories are based on gross revenues or net profits of the T&D System.

Manager also will be reimbursed by Electric Company for the Pass-through Expenditures at its cost of service without markup, multiplier, or other adjustment or profit. The reimbursements for Pass-through Expenditures, with the exception of the charges from its affiliates, are reimbursements for actual and direct expenses. The charges from the affiliates, however, may include a FERC-approved return on its direct expenses, where applicable. Although the charges from the affiliate may include a markup, any such markup will be based on FERC cost allocation methods and will not be based on a share of T&D System's net profits. Hence, we conclude that under the facts and circumstances, the reimbursements for Pass-through Expenditures do not cause the Agreement to result in private business use.

Finally, neither the length of the Agreement nor any relationship between Manager and Authority or Electric Company will result in private business use of the T&D System. The term of the Agreement will not exceed the 20-year term allowable under § 5.03(3) of Rev. Proc. 97-13. Pursuant to § 5.04(2), Manager will have no role or relationship with Authority or Electric Company that will substantially limit Electric Company's ability to exercise its rights under the Agreement.

Conclusion

Based on the facts and circumstances represented, we conclude that the Agreement does not result in private business of the Bonds within the meaning of § 141(b).

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 the authorized representative of Authority.

The ruling contained in this letter is based upon information and representations submitted by Authority 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
(Financial Institutions and Products)

By: _____
Vicky Tsilas
Assistant to the Branch Chief
Branch 5

cc: