COMMENTS ON REGULATIONS UNDER SECTION 141
OF THE CODE AS THEY RELATE TO OUTPUT FACILITIES

The following comments and recommendations express the individual views of
the members of the Section of Taxation who prepared them and do not represent the position of
the American Bar Association or the Section of Taxation.

These comments and recommendations were prepared by members of the
Committee on Tax-Exempt Financing. Primary responsibility was taken by Richard H. Nicholls
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Although many of the members of the Section of Taxation who participated in
preparing these comments and recommendations have clients who would be affected by the
federal tax principles addressed, or have advised clients on the application of such principles, no
such member (or the firm or organization to which such member belongs) has been engaged by a
client to make a governmental submission with respect to, or otherwise influence the
development or outcome of, the specific subject matter of these comments except that other
attorneys at the firm where Mr. Nicholls is employed who did not participate in the preparation
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EXECUTIVE SUMMARY

Congress, in enacting the industrial revenue bond provisions of the Internal Revenue Code of 1954 (the “1954 Code”), did not explicitly suggest that use of the output of a bond financed facility is tantamount to use of the facility and of the proceeds of the bonds that financed the facility. The Internal Revenue Service, after proposing regulations regarding output facilities that were somewhat vague, issued final regulations under the 1954 Code that equated use of output with use of the facility only in situations where there is a clear transfer of the benefits of ownership (or rights similar to a leasehold interest) and the burdens of paying debt service. In areas other than tax-exempt financing, the IRS and Congress also generally have followed that same approach in analyzing use of the output or services provided by a facility.

While the legislative history of the Internal Revenue Code of 1986 (the “1986 Code”) is somewhat conflicting, Congress expressly stated that, except as “amended,” the prior law was to continue as before. The temporary regulations under the 1986 Code regarding output facilities (the “Temporary Regulations”), however, substantially depart from the prior regulations under the 1954 Code in ways not suggested by the statutory amendments enacted in 1986. The departures are both technical and qualitative. The temporary regulations create a regime that treats use of the output of a facility as use of the facility in ways that would be considered totally unwarranted in other areas of the tax law, and contain rules that are more difficult to apply and interpret. Thus, while appreciative of the effort that clearly went into the Temporary Regulations, the drafters of this report have substantial comments on the Temporary Regulations, including the following:

• The concept that preferential rights give rise to private use is vague and unworkable.

• The concept of substantially certain payments is difficult to apply in the context of applying the burdens of debt service test. The Regulations should clarify that a user of the output of a facility should be considered to have the burden of debt service only in the case of a take or take or pay contract, except where the underlying circumstances make clear that there is such certainty that payments will be made that the contract is in effect a take or take or pay contract.

• The provisions treating contract termination payments as substantially certain payments should be limited to payments that relate to the facility that was financed.
• The provisions regarding wholesale requirements contracts will be very difficult to administer and are contrary to the prior interpretation of the IRS under both the 1954 and the 1986 Code. If a new approach is to be adopted, the Temporary Regulations should take into account other relevant factors beyond those set forth in the Temporary Regulations. In addition, the transition rule for existing contracts should recognize that changes to such contracts that do not change the scope of the requirements covered or the term of the contract should not be considered new contracts.

• The provision regarding retail requirements contracts is appropriate.

• The provision regarding swapping and pooling is generally appropriate, although minor changes could improve it further.

• The concept of measuring use through reserved capacity may be appropriate as an anti-abuse measure for facilities such as peaking facilities but, as a universal rule, it is an unwarranted departure from prior regulations.

• The return to nameplate as a general measure of available output is appropriate in a field that requires a bright line test, but is undermined by the reserved capacity rule as presently written and by the limited source of supply rule.

• All of the new rules that require subjective determinations raise the further question as to when the determination should be made. We believe the appropriate time is at the time of the initial financing. This determination should govern subsequent financings and refundings.
• We generally agree with the provisions of section 1.141-8 relating to the $15,000,000 limitation, although we suggest certain modifications.

Regarding transmission facilities, our comments are:

• Addressing the private use of facilities that provide ancillary services will involve difficulties that far outweigh the benefit to the fisc. Thus, in the case of both existing bond financed facilities and future facilities, the use of such facilities to provide ancillary services should not be considered use by the entity controlling transmission, rather than as use by the municipal utility, unless a principal purpose of the construction of the facility is to provide such services.

• The report discusses at some length likely future transmission arrangements and concludes that in many cases there will not be private use.

• Use of transmission facilities by an independent system operator (an “ISO”) should not, if the ISO is nonprofit and governmentally controlled, be considered private use. The management by the ISO should be analyzed based on the unique circumstances involved. If, instead, the IRS concludes that ISOs are to be evaluated under management contract rules, the IRS should reconsider Example 5 of section 1.141-7T(h), where an arrangement that appears to meet the management contract rules nonetheless gives rise to private use. If the IRS believes the arrangement described in the example violates the management contract rules, it should specify the reasons, and those reasons should only be reasons that are generally applicable to management contracts.
The grandfathering rules relating to open access to transmission are appropriate and valid regulations, although certain technical changes would be useful. The open access rules regarding stranded generating costs are less useful. The inapplicability of the rules to advance refundings after July 8, 1996 and current refundings of obligations issued after that date is unwarranted, however, as is the rule that, for current refundings issued after the effective date of the Temporary Regulations, the new regulations must be elected in whole in order to be subject to the grandfathering rules.

The following comments apply to bonds issued to finance both generation and distribution facilities:

- The provision regarding specific performance rights should be dropped or replaced with a rule similar to that contained in section 7701(e) of the Code relating to service contracts treated as leases.

- There should be a significant safe harbor for short term contracts that do not in any real sense pass meaningful benefits of ownership or burdens of debt service.

- The de minimis contract provision is inappropriate. The IRS instead should adopt the approach of the Proposed Regulations issued in 1994, which used a 1 percent test, but the rule should be limited to guaranteed payments and should be applied after first applying the generally applicable rules for determining which payments are allocable to which bonds.
• The general rules relating to measurement periods require some modification as applied to output facilities.

• It is essential that the regulations allow private use to be allocated to the equity financed portion of a facility. Otherwise the $15,000,000 limitation will not work as described in the legislative history. It is also important that a municipally owned utility (“MOU”) be able to allocate system sales to the equity-financed portion of its system.

• Purely financial contracts of the type described in this report should not affect bond financed facilities.

• Options should be analyzed in accordance with their nature.

The following comments have broader application than simply to output facilities:

• The $15,000,000 per issue limitation of section 141(b)(5), generally applicable to bonds issued under the 1986 Code, and applicable to grandfathered advance refundings of bonds for output facilities pursuant to section 1313(b)(5), should be subject to a multi-project rule as was the case under Notice 87-69.

• Rules regarding refundings should allow measurement of use over the term of the refunding bonds, the original term of the refunded bonds, or the combined term, as long as the analysis of the refunding bonds is not inconsistent with the tax-exempt status of the refunded bonds.

• The regulations should recognize that there may be anticipatory remedial action.
• The “cliff” approach to remedial action leads to arbitrary and capricious results and should be abandoned.

The following additional comments relate to transition rules:
• The change in use rules should not apply to bonds that are subject to the 1954 Code.
• Where it is necessary to apply section 141(b)(4) to a refunding of bonds issued before the effective date of the regulations, the regulations should not be used to determine the non-qualified amount with respect to the prior issue unless the issuer elects to do so.
• The requirement for an election in whole should not apply to election of the open access rules, to actions taken before the effective date of the regulations, or to bonds issued under the 1954 Code.

INTRODUCTION

The Committee has organized its comments by focusing on the particular functions of output facilities rather than dealing with these subjects together the way they are handled in the Temporary Regulations. Thus, after discussing the law prior to the 1986 Act and the effects of that Act on output facilities, we deal first with the impact of the Temporary Regulations on electric generation facilities, next on the treatment of transmission and distribution facilities, and finally on provisions that deal with both types of facilities. We recognize that this approach may result in some duplication and overlap, but we believe it is useful to evaluate separately how the Temporary Regulations deal with these different types of facilities.
Because the Temporary Regulations for the first time apply the general provisions of the 1997 Final Regulations to output facilities, we also discuss the application of the 1997 Final Regulations.

**BASIC CONCEPT OF USE AND EFFECT OF 1986 LEGISLATION**

Under the regulations applicable under the 1954 Code (“the Subparagraph 5 Regulations” or “Subparagraph 5”), the standard for judging sales of output was whether the use of the output had the effect of “transferring to non-exempt persons the benefits of ownership of such facilities and the burdens of paying the debt service on governmental obligations used directly or indirectly to finance such facilities, so as to constitute the indirect use by them of a major portion of such proceeds.” Reg. §1.103-7(b)(5). The legislative history of the 1986 Act is inconclusive, but we believe the better reading is that Congress did not intend to change this test except to the limited extent specified in that legislation. The Temporary Regulations, however, substantially change the meaning of the benefits and burdens test in a restrictive way that has no parallel in other similar areas of tax law. Because we believe this question of the interpretation of the effect of the 1986 Act on prior law is so fundamental, we discuss it at some length.

**1954 Code**

The industrial development bond provisions had their genesis in proposed regulations that were published in the Federal Register March 23, 1968.\(^1\) These regulations predated the enactment of statutory provisions regarding industrial development bonds. All of the examples of transactions contained in those proposed regulations involved actual use of a facility through ownership or lease. Similarly, when statutory industrial development bond provisions were

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\(^1\) Prop. Reg. §1.103-7.
enacted by Congress later that year, the subject of concern was financing facilities to be leased to, or owned by, private business. In the legislative history of those provisions, there was no suggestion that use of the output of a facility constituted use of the facility or the bond proceeds. Regulations proposed on January 13, 1969, similarly discussed only transactions involving ownership or lease and did not address the use of output of facilities.

During 1970, the IRS received two ruling requests involving electric facilities. In one, half the output of a nuclear plant was to be sold by a municipal utility at cost to an investor-owned utility pursuant to a take or pay contract for most of the life of the facility. PLR 7011120430A (Nov. 12, 1970). In the other, a very significant portion of the output of a generating facility owned by a municipal utility was to be sold to a rural electric cooperative for an extended period of time until the municipal utility needed the capacity, under a contract providing very favorable terms to the cooperative and giving the cooperative management and substantial control of the facility. PLR 7101260590A (Jan. 26, 1971). The IRS then published proposed regulations on June 5, 1971 that, for the first time, provided that sales of output could result in use of an output facility and the proceeds of the bonds issued to finance the facility. Under these proposed regulations, take and take-or-pay contracts were described merely as examples of the type of contracts that could pass the benefits and burdens to a purchaser. A copy of these proposed regulations is attached as Appendix A. On July 15, 1971, a ruling was requested on whether a requirements contract for sale of output from a municipal utility to a cooperative that was its biggest customer, providing about 28 percent of its revenues, gave rise to

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2 The bonds were completion bonds. The ruling concluded the bonds would be exempt without specifying a particular reason. The regulations later grandfathered similar transactions. Reg. § 1.103-12(f).

3 The ruling concluded the bonds would be IDBs but would be tax-exempt under the local furnishing rule.
impermissible use. The contract was for a term of 16 years, with a further period of 18 years during which a fixed amount of energy was to be purchased. A favorable ruling was issued. PLR 7108270510A (Aug. 27, 1971). The final Subparagraph 5 Regulations were issued the following year. Those final regulations did not refer to take and take-or-pay contracts as examples, but rather as the type of contracts that did pass the benefits and burdens.

This background underscores the significance of the fact that in the final Subparagraph 5 Regulations the IRS limited private use to take and take or pay contracts (and certain underlying arrangements). The combination of the issuance of a favorable ruling on a requirements contract in PLR 71082270510A and the change from the June 5 proposed regulations (which contemplated that various types of contracts could pass the benefits and burdens) to the August final Subparagraph 5 Regulations, which were limited to only take and take or pay contracts, makes clear that the IRS intended to cover only contracts similar to ownership or lease.

Moreover, it should not be surprising that the Subparagraph 5 Regulations contain no exceptions for short-term contracts or for arrangements entered into subsequent to the issuance of bonds. Nobody thought they were relevant. As discussed above, each of the ruling requests that had come before the IRS involved contracts in existence at the time bonds were to be issued, each involved sales for a term at least approximating the life of the bonds, each involved substantial obligations on the part of the purchaser and each, except perhaps the requirements contract situation, involved substantial attributes of ownership. The IRS had concluded long-term contracts were the problem and believed tax-exemption was determined on the date of issuance. The IRS’s alteration of its position on change in use was more than 20 years away.

4 In the T.D. 7199 file, a memorandum dated April 7, 1971, cited in GCM 36555 (Jan. 15, 1976), stated:
During the period leading to the 1986 Act, there were significant developments in the concept of “use” in connection with other provisions of the tax law. For example, property “used by” a tax-exempt or governmental entity was not eligible for the investment credit. IRC §48(a)(4)-(5) (prior to repeal by section 211 of the 1986 Act). “Used by” had been limited by regulation to property “leased by,” Reg. §1.48-1(j)-(k), and some extremely liberal rulings had been issued under those regulations. Similarly, property used in the trade or business of a public utility was public utility property subject to limited investment credit and potentially restricted depreciation. IRC §46(c)(3)(B), 46(f) (prior to repeal by Section 211 by the 1985 Act), IRC §168(i)(10). These rules on tax-exempt use and use by public utilities stemmed from the same type of policy considerations involved in section 103, namely that when the nexus between property eligible for tax benefits and a person not entitled to those tax benefits becomes sufficiently close, the benefits should not be available.

Section 103(c) does not cover a bond issue used to construct a state owned and operated shoe factory if the state in substance owns and operates the factory, merely because the shoes produced are work shoes and are sold entirely to business customers. This assumes, however, that there are not special selling arrangements, such as long-term output contracts.

This latter qualification is necessary because a long-term purchase contract to purchase the output of a facility can have the same economic effect as ownership of the facility itself. The facility can effectively be transferred to the purchaser of the output by such device. Accordingly, the draft regulations have special provisions to deal with this type of take, or take or pay, contract situation in which the taxable person does not ostensibly own or operate the facility but agrees to take more than 25 percent of the output for a long period of time. [emphasis added]

5 See G.C.M. 37158 (June 13, 1977), approving Rev. Rul. 77-416, which allowed the sale of bond financed electric facilities. (“As a general matter, the long standing Service position has been against altering a bond’s Code Section 103(a)(1) status due to subsequent sale of securing property.”) and (“We believe that the facts in the instant case clearly indicate that the transaction herein is a legitimate, non-prearranged sale, lacking any indication of being a “sham” or “gimmick” to obtain low cost financing.”)

These concerns led to the enactment of section 7701(e) in 1984 to provide criteria to
determine when a transaction styled as a service contract or other arrangement is sufficiently
similar to a lease that certain tax benefits should be denied. Section 7701(e) applies for all
purposes of the Code and provides a list of facts and circumstances that should be analyzed in
determining whether the tax benefits should be denied. These factors include physical
possession, control of the property, significant economic or possessory interest (itself a multi-
factor test, taking into account whether the property is dedicated to the service recipient for a
substantial portion of the useful life of the property, whether the service recipient shares the risk
if the property declines in value or benefits if it appreciates or shares in operating economies or
bears the risk of loss of the property), concurrent use to serve multiple parties, the relationship of
the price for services to the rental value, and the risk to the service provider of failure to provide
the service. While this provision does not control for purposes of section 103, it provides
guidance as to what Congress considered relevant in cases involving remarkably similar
considerations, and the 1986 Act should not be considered to depart radically from this type of
standard without a very clear statement of intent to do so.

The 1986 Act and the Legislative History

The Conference Report to the 1986 Act stated with respect to the bond provisions:

As part of this reorganization, the present-law rules contained in Code
sections 103 and 103A are divided, by topic, into 11 Code sections (secs.
103 and 141-150). The conferees intend that, to the extent not amended,
all principles of present law continue to apply under the reorganized

See, e.g., Rev. Rul. 68-109, 1968 C.B. 10, in which telephone equipment placed at the location of an
exempt entity and operated by its employees was not “used” by the exempt entity.
Aside from changing the quantitative limits on private use, the only relevant amendments that were made to the private use provisions were (1) to provide that use by all persons other than governmental entities (as opposed to persons other than exempt persons) and other than as members of the general public is to be taken into account (section 141(b)(6)) and (2) to direct the Treasury to amend its regulations to eliminate the requirement of a 3 percent guaranteed minimum payment (section 7703(i) of the 1986 Act.)

These very limited statutory changes do not provide any basis for a sweeping change in the basic concept of the benefits and burdens test. Clarification that use by the general public is not private use should not be construed as a very restrictive provision, but rather simply as clarification of a safe harbor. This conclusion is reinforced by the statutory structure: the statute provides that general public use is not private use, not that all use other than general public use is private use.\(^8\) The IRS adopted this analysis in the 1997 Final Regulations, which provide not only that use by the general public is never private use, but also that there are activities other than use by the general public that are not private business use.

Similarly, the direction that the 3 percent rule be repealed should not be read as meaning that all but the smallest or shortest contracts should be ignored. The 3 percent rule excluded persons each of which paid “annually” a guaranteed minimum payment not exceeding 3 percent of the average annual debt service. Thus, what was contemplated by the Subparagraph 5 Regulations was that people would be counted who acting together each paid “annually” over an extended period of time, the contract term, more than 3 percent of debt service. The rule was

\(^8\) Compare the next provision: “The term “governmental use” means all use other than a private business use.” Section 141(b)(7).
considered to be the equivalent of excluding persons who took 3 percent of the nameplate capacity for the contract term. In fact, footnote 12 of the Conference Report states that:

The conference agreement directs the Treasury Department to modify its present regulations (Treas. Reg. sec. 1.103-7(b)(5)) for determining the portion of an output facility that is privately used to reflect the reduced limits on such use. Specifically, the Treasury is directed to delete the special exception under which users of three percent or less of the output of a facility are disregarded in calculating whether the issue satisfies the trade or business use and security interest test. [emphasis added] Conference Report at II-689.

It is not surprising that, in an environment where private use of a facility is limited to 10 percent or $15 million of proceeds, persons taking 3 percent of the output for the contract term under guaranteed payment contracts should not be ignored, but the enactment of this directive should not be read as requiring anything more than a correlative reduction in the limitation for exclusion of guaranteed purchasers.

Nonetheless, the legislative history of the 1986 Act contains conflicting and confusing statements regarding narrow categories of transactions that fall into the general public use category, namely pooling transactions and 30 day spot sales. We believe these examples should be regarded as safe harbors rather than exclusive examples. The IRS appears to agree because both in the Temporary Regulations and in the 1997 Final Regulations, as noted, the IRS recognizes that there is use other than use as a member of the general public that is not private use. The leadership of Congress apparently also agreed, as evidenced by its approval of a non-conforming pooling arrangement for WPPS. Blue Book, n. 63 at 1164. This conclusion is supported by other legislative history indicating that prior law concepts involving actual or beneficial use are to be continued. Thus, the House Report states:

The general concept of use applicable under present law is retained under the bill. Thus, as under present law, a person may be treated as a user of bond proceeds or
bond-financed property as a result of (1) ownership, or (2) actual or beneficial use
of the property pursuant to a lease, a management or incentive payment contract,
or an arrangement such as a take-or-pay or other type of output contract. House
Report at 521.

The same general approach is stated in a slightly different form in both the Senate Report

We think this general background is relevant to our specific comments below because it
demonstrates that, in the 1986 Act, Congress intended only limited changes to the definition of
private use.

**SPECIFIC COMMENTS ON PROVISIONS REGARDING USE OF GENERATION FACILITIES**

**Benefits of Ownership**

**General Comments.** The benefits of ownership test provides that the benefits of
ownership exist where “the contract gives the purchaser (directly or indirectly) rights to capacity
of a facility on a basis that is preferential to the rights of the general public.”\(^9\) The reference in
the definition to “rights to capacity” is useful in that it indicates that sales of energy do not pass
the benefits of ownership. “Energy” sales have traditionally been non-firm transactions
involving the sale of energy if available, with only limited payment for the energy beyond direct
costs of production (fuel and other operating costs). Beyond the exclusion of energy sales,
however, the definition lacks clarity. The only discussion of what constitutes preferential rights
and thus the benefits of ownership is in Example 2 of section 1.141-7T(h) of the Temporary
Regulations, which states that a requirements contract must be taken into account because it
provides the purchaser with “substantial benefits of ownership (rights to capacity).” The regular

\(^9\) Reg. §1.141-7T(c)(2)(i).
general public customers of the city in the example almost certainly have “rights to capacity” that are no more interruptible than that of the investor-owned purchaser. What then are the preferential rights of the purchaser that are a benefit of ownership? There are no facts suggesting that price was the factor. “Preferential rights” may be relevant in cases involving physical possession, but we do not think “preferential rights” is an adequate concept for determining whether substantial benefits of ownership are passed through a service contract. Rights at least somewhat akin to those of a lessee should be required, and, as discussed elsewhere, we think the factors enumerated in section 7701(e) of the Code, if not controlling, are relevant in this regard.

**Application to Joint Action Agencies.** Section 1.141-7T(c)(2) of the Temporary Regulations provides that an output contract transfers substantial benefits of owning a facility if the contract “gives the purchaser (directly or indirectly) rights to capacity of the facility on a basis that is preferential to the rights of the general public.” Many joint action agencies and other similar governmental entities with municipal members sell only at wholesale. Often this limitation on their scope of operation is imposed by state law. Under the Temporary Regulations, because these entities do not sell to the general public, every contract entered into by such an entity, no matter how subordinate to other obligations, would be preferential to the rights of the general public and would meet the benefits and burdens test, whereas a comparable contract entered into by a retail utility might not. If the “preferential rights” concept is retained, it is suggested that this matter be clarified by adding the following language to the end of section 1.141-7T(c)(2):

> For the purposes of this section, a contract of a governmental wholesale supplier of electricity gives the purchaser rights to capacity of the facility on a basis that is preferential to the rights of the general public if the right is preferential to the rights of the general public served by governmental purchasers of the governmental wholesale supplier.
Burdens of Paying Debt Service

General Comments. The burdens of paying debt service test is met under the Temporary Regulations to the extent that the issuer reasonably expects that it is “substantially certain that payments will be made under the terms of the contract.” While the test refers only to the “terms of the output contract,” it appears from the rules regarding requirements contracts that the surrounding circumstances must be evaluated as well.

As presented, the “burdens” test is reasonably consistent, in keeping with Congressional intent, with prior law. The application of such test under other portions of the Temporary Regulations, however, appears to depart significantly from interpretations under the Subparagraph 5 Regulations. For example, under the Temporary Regulations, payment obligations on a 1-year contract for one percent of the output of a facility may apparently be considered “substantial” burdens of ownership even though such payments represent considerably less than 1% of total debt service on bonds having, for example, a 30-year term. (See discussion below under “Short-Term Contract Safe Harbor”.)

Many members of the Committee commented on the need for clarification of the rule that payments be substantially certain. Given that the basic concept is “burden” of debt service, we think that generally the obligation to pay should rise to the level of a take or take or pay contract or guaranteed payment, as under prior law. Lesser levels of obligations should be taken into account only in the rare or exceptional case, such as where the transaction is so clearly beneficial to the purchaser at the time it is made that there is no question that the payments will be made. The basic test should remain whether the burdens of debt service are passed, and the substantial-

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10 Reg. §1.141-7T(c)(2)(ii).
certainty-of-payment concept should operate more along the lines of the underlying arrangement rule of the prior regulations.

We note in addition that this provision is a part of the IRS reversal of its position on requirements contracts that is discussed in the following section.

Payments on Contract Termination. The Temporary Regulations provide that the burdens of paying debt service are met “for example…if payments must be made upon contract termination.” Reg. §1.141-7T(c)(2)(ii). Similarly, the provision regarding retail requirements contracts refers to “payments that are not contingent on the output requirements of the purchaser.” Reg. §1.141-7T(c)(4)(iii).

Many contracts for the sale of output involve construction of minor facilities such as substations for the purpose of facilitating the delivery of output. It is not unusual for the purchaser of the output to agree to make payments based on the cost of these improvements if service is terminated before the cost is amortized. In such a case, the benefits and burdens test should be treated as met with respect to the improvement, but that does not mean that the benefits and burdens test is met with respect to the generating facility that supplies the output. Accordingly, we believe the reference to payments in the two above-cited regulatory provisions should be followed by the phrase “properly allocable to the output facility.”

In a competitive environment, it seems likely that many retail contracts will contain minimum terms and termination fees for early termination, as is the case with similar services such as cellular phone service. Those types of fees should not be treated as causing the burdens of paying debt service test to be met.
The comments in the preceding two paragraphs are also applicable to retail requirements contracts.

**Wholesale Requirements Contracts**

**General Comments.** A wholesale requirements contract is taken into account “only to the extent that, based on all the facts and circumstances, the contract meets the benefits and burdens test.”\(^{11}\) The Temporary Regulations specify “[s]ignificant factors that tend to establish that the benefits and burdens test is met” under the rule.\(^{12}\) The factors specified – the significant indicators of stability of the customer base, that the contract covers historical requirements, and that the contract contains an agreement not to acquire other resources – do appear to be factors that provide some indication that the benefits and burdens test is met. However, these factors in and of themselves do not necessarily mean that the purchaser has taken on the burden of ownership and debt service or received a benefit of ownership. Further, the regulation is a substantial shift from prior law, as reflected in the Subparagraph 5 Regulations, which followed PLR 7108270510A, supra, and in PLR 8240049 (July 6, 1982) and PLR 9125007 (Mar. 15, 1991), which have been relied upon by a number of very substantial issuers, particularly with respect to contracts with rural electric cooperatives. There is no suggestion in the legislative history (not even the gratuitous phrase concerning requirements contracts with investor-owned utilities in the Joint Committee Report)\(^{13}\) indicating Congress intended to upset these longstanding, very substantial arrangements.

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\(^{11}\) Reg. §1.141-7T(c)(4)(i).

\(^{12}\) Reg. §1.141-7T(c)(4)(ii).

\(^{13}\) The phrase “Although sales of power to investor-owned utilities pursuant to output or requirements contracts are intended to be counted for purposes of the private business use tests,” was tacked onto the beginning text from the Conference Report on pooling and spot sales. Conference Report at II-690.
The status of requirements contracts is a difficult policy issue. We are not prepared to say that every requirements contract between municipal and investor-owned utilities must be permitted. We are concerned, however, that the Temporary Regulation tests are not administrable, and that their application will change with the passage of time because of gradually changing facts. In addition, at least one significant factor, the term of the contract, is not specified as a factor.

If the factors are retained in their present form, they will be difficult to apply other than adversely. For example, with respect to the test of whether a contract covers historical or projected requirements, requirements contracts typically cover either all requirements or all requirements above those served from a specific source. The contract thus will normally cover historical requirements. It will also cover projected requirements in that it will cover requirements arising in the future. Accordingly, although the parties may be relying heavily on the projected requirements, this factor would appear to be met in the typical case.

The factor relating to whether the customer base has significant indications of stability “such as large size, diverse composition and a substantial residential base” raises the question “compared to what?” These considerations will be very difficult to apply, either by bond counsel or by the IRS in private rulings or on audit, in the absence of some reference points. Moreover, the size, diversity and residential component may become largely irrelevant in the context of open competition, when such objective factors as efficiency and subjective factors like advertising prowess may be more relevant.

Finally, the factor relating to an agreement not to construct or acquire other resources elsewhere would, in its present form, always point to private use. All requirements contracts by
their very nature contain some limitation on the ability of the purchaser to go elsewhere for power. Thus, if retained, this factor needs to be refined. For example, a requirement that the purchaser give reasonable notice, such as five years, before obtaining another source of its requirements is far less significant than a provision that precludes him from doing so for the life of a long term contract.

Similarly, the term of a contract ought to be a material factor in determining whether a contract provides real benefits and burden, as recognized in the T.D.7199 file memorandum cited in note 3. A requirements contract of short term duration, even three or five years, provides no real transfer of benefits and burdens because such short term arrangements provide no protection against market shifts in the context of 30-40 year financings of 40-50 year assets.

Finally, two of the factors specified in the Temporary Regulations, whether the contract covers existing or projected requirements and the stability of the customer base, will likely change over time.

Thus, like many of the other new tests in the Temporary Regulations, these provisions raise issues as to when the tests are to be applied. For the reasons set forth in detail under “Time for Applying Tests – Effect of Involuntary Changes,” we believe that, if these tests are retained, the determination as to the status of any contract in existence at the time of a new money financing should be made either at the time the contract is entered into or at the time of issuance of new money bonds to finance a facility, and that subsequent changes in the nature of the customer base or other factor being tested should not adversely affect that determination with respect to any subsequent refinancings of that facility.
Transition Rule Regarding Wholesale Requirements Contracts. An extension of the term of a requirements contract should only be considered a new contract starting with the first day of the additional term, not from the date the extension is agreed to. This principle is important since contracts are often extended significantly ahead of the time they expire because of the need for forward planning.

The Temporary Regulations provide that a contract will be treated as a new contract if “other material terms” to the contract besides a change in parties or term are modified. This rule is too broad. A change to a material term of the contract which does not change the concept of the amount of electricity covered, e.g. the purchasers’ requirements, or the length of the contract, should not be considered a new contract. In this era of change in the electric industry, there will likely be many modifications required to material terms of existing contracts which, while significant, do not change the scope of the requirements covered or the term of the agreement. Such modifications should not be treated as creating new agreements. In addition, a change in parties that arises by reason of a merger or acquisition should not give rise to a new contract for this purpose.

Relationship Of Requirements Contract Rules To Other Rules. It appears that the requirements contract rules are intended as exclusive rules, but the Temporary Regulations do not make this clear. For example, a requirements contract that is grandfathered under the rule of section 1.141-15T(f)(2), protecting contracts entered into before February 23, 1998, literally could run afoul of the rule of section 1.141-7T(c)(2)(iii), relating to pledged contracts.

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14 Reg.§1.141-15T(f)(2).
Accordingly, the regulations should be amended to make clear that the requirements contract rule is an exclusive rule, or to specify those rules, if any, that might override it.

**Retail Requirements Contracts**

Section 1.141-7T(c)(4)(iii) of the Temporary Regulations provides that a retail requirements contract generally will not be treated as meeting the benefits and burdens test of section 1.141-7T(c)(1). Such a contract may, however, be treated as meeting the benefits and burdens test to the extent that the contract “contains contractual terms that obligate the purchaser to make payments that are not contingent on the output requirements of the purchaser (such as significant termination payments)….”\(^{15}\) The Temporary Regulations state that retail requirements contracts do not meet the benefits and burdens test “because the obligation to make payments on the contract is contingent on the output requirements of a single user.”\(^{16}\) Thus, the requisite certainty of payment is missing, even if the business of the retail customer is economically healthy and the customer has no present plans to change or terminate operations.

The Temporary Regulations in their current form should be interpreted as permitting retail requirements contracts to contain reasonable damages provisions or reasonable termination provisions without causing treatment as a “bad” output contract, provided such damages or termination provisions are payable only in circumstances of default or termination while the purchaser continues to have requirements within the meaning of the contract. We believe this is the correct approach.

\(^{15}\) Reg. §1.141-7T(c)(4)(iii).

\(^{16}\) Id.
The essence of a requirements contract is that the purchaser must purchase its requirements from the supplier, if it has any. It seems self-evident that such a contract can provide for damages in the event of a breach. Silence on this point in the contract would imply damages at law in any event. An explicit prohibition on damages for breach would imply that the contract must be unenforceable, in which case the rule would serve no purpose. Moreover, if the theory of the rule is that payments under the contract are not sufficiently certain to meet the private payment test—presumably because a single retail purchaser can fail to have requirements for a variety of reasons—that logic is as applicable to the defaulting purchaser as to the nondefaulting one. In addition, a reasonable liquidated damages provision should also be permitted; parties should not be forced to litigate their damages. Finally, contracts of this type should be permitted to have termination clauses with reasonable buy-out payments, which analytically are no different from liquidated damages provisions without the “default.” We emphasize again that this would only be in the context of default or termination by a retail purchaser that otherwise has requirements that would be covered by the contract were no default or termination to occur.

The Temporary Regulations generally do not require amendment to reach this result. A contract provision that obligates the purchaser to make payments when its requirements are reduced or eliminated would “obligate the purchaser to make payments that are not contingent on the output requirements of the purchaser…or that obligates the purchaser to have output requirements.” A contract provision that obligates the purchaser to make payments when it defaults or terminates the contract only when it still has requirements does not.

If the Temporary Regulations are modified to clarify this point, however, we recommend against trying to write specific damages or termination provisions that would be permitted.
There are many formulations of such contract provisions. It should be sufficient for the Treasury’s purposes that the damages or termination provision be reasonably related to the purchaser’s obligation that is being discharged.

Our comments on termination payments on page 19 are also applicable to retail requirements contracts.

**Exception for Swapping and Pooling**

This provision provides generally that agreements for pooling and swapping do not result in private business use to the extent amounts exchanged are approximately equal and the purpose is to satisfy different peaks, create diversity, or enhance reliability; this is a substantial improvement over the more restrictive provision of the 1994 Proposed Regulations.\(^\text{17}\) Three additional points should be considered, however.

First, there may be purposes other than the purposes specified which would cause a municipal utility to enter into a swapping arrangement. Consideration should be given to eliminating the purpose requirements or adding the phrase “or other bona fide governmental purpose” to the list. To the extent the value of the amounts exchanged are equal, there is no net private use, regardless of the purpose of the exchange.

Second, the Temporary Regulation is not entirely clear whether the exception is limited to transactions involving payments in kind through the return of power. There appears to be no reason to treat seasonal exchanges (in which the party buying during the first part of the year pays cash and receives cash in the second half) less favorably than those where the party simply

\(^{17}\) Reg. §1.141-7T(f)(2).
returns the power in the second half of the year. In addition, we understand that annual cash settlement on long term swaps is common. We assume that exchanges with annual cash settlements would only involve private use to the extent the municipal utility is a net payee and the arrangement otherwise meets the benefits and burdens tests.

Third, three-cornered and multiple-party transactions should also be able to qualify where the effect on the municipality is similar to that of a two-party swap.

**Three Year Stranded Cost Rules**

Stranded cost recovery may arise because state law allows a utility to charge its customers or transmission customers higher rates to recover excessive costs of its facilities as part of a transition to deregulation or because FERC regulations allow the utility to negotiate with a customer who is ceasing to be a customer to attempt to recover costs incurred with respect to the customer’s load that will then be “stranded.” Thus, the focus of the provision on “the purchase of output” and “all of the output sold” may be inappropriate.

It is not clear why the term of the transactions should be limited to three years in view of the distressed nature of these transactions and the fact that they must either be imposed by state law or negotiated at arm’s length, and the fact that the issuer is required to take remedial action with amounts recovered. In addition, it is unclear why a four year contract would be all bad while a three year contract is all good.

The requirement that the issuer not finance expenditures to increase generating capacity with tax-exempt bonds should, at a minimum, not apply to bonds issued prior to the effective date of the Temporary Regulations. More importantly, this requirement seems to assume that any increase in capacity at a time of stranded costs is a dubious enterprise. We are not so sure
that is a correct assumption. The new facility might be more economical and reliable than outmoded existing facilities. We recommend eliminating this requirement.

Section 1.141-7T(f)(4)(iv) requires that all of the output sold be attributable to excess capacity from open access. Again we think it should be sufficient that the issuer was able to negotiate such an arrangement or that it was imposed by law or regulation or entered into in anticipation of law or regulation.

Finally, section 1.141-7T(f)(4)(v) requires that “any stranded costs recovered” be applied as promptly as possible in a manner consistent with the remedial action requirements. We assume that the reference to “any stranded costs recovered” means that remedial action is required only to the extent of the amounts recovered.

Not all amounts recovered, however, will be available to retire bonds. Some amounts will simply cover ongoing costs, including current debt service. The regulations should clarify that only net amounts recovered must be used to retire debt.

**MEASUREMENT OF PRIVATE USE OF GENERATION**

**Nameplate**

We applaud the return to the bright line test of nameplate capacity, because a test which can be applied with certainty is essential where the limitations on private use are as restrictive as they are in the case of output facilities. We believe, however, that the provisions of the Temporary Regulations relating to facilities with a limited source of supply and measuring use with respect to reserved capacity are inconsistent with this approach, as well as unwise and unnecessary, as discussed below.
Facilities Acquired or Constructed Primarily for Use by Private Business Users

We think the return to the 30 percent standard is appropriate for purposes of determining when a basis other than nameplate should be used to measure the output of a facility.18

This provision specifies that reasonable expectations on the “issue date” control the determination. The issue date refers to “the issue date of the bonds that finance the unit.” Thus, where subsequent experience differs from expectations, issue date expectations can be relied on, and a deviation from expectations would not affect the test because it would not be a deliberate act. The Temporary Regulations are ambiguous, however, as to whether the expectations must be retested in the event of a second issue for the same project, a refunding, or a subsequent financing of improvements. If, as seems likely, “bonds that finance the unit” includes second issues and refunding or improvement bonds, it appears that a retest would be required. We do not believe such a retest should be necessary. See “Time for Applying Tests – Effect of Involuntary Changes.”

The title of this provision, “Facilities Acquired or Constructed Primarily for Use by Business Users”, is largely unrelated to the substance of the provision.

Facilities with a Limited Source of Supply.

This provision appears to cover the same subject covered by the 30 percent rule discussed immediately above, except that there is no limitation to the application of the rule. Theoretically the rule would apply if an operator of a gas fired turbine knew that its output would occasionally be briefly constrained by limits on the supply of gas in periods of peak demand. We think the rule should be limited to cases where it is obvious that the output will be constrained and see no

18 Reg. §1.141-7T(b)(1)(iii).
reason to use a different approach than that applied in the 30 percent rule. Thus, we would eliminate this rule as redundant.\textsuperscript{19}

This rule also raises questions as to when it should be applied. It provides that, if a limited source of supply constrains the output of a facility, the number of units to be produced must be determined by “reasonably taking into account” those constraints, but the rule does not specify when. For example, the output of a hydro-electric facility “must be determined by reference to the reasonably expected” flow of water through the facility. Presumably the pertinent expectations are those at the time of the financing, although the reference could be to the time any contract for sale is entered into. That would add undesirable complexity since expectations would likely change year to year, so that contracts entered into in different years could have different available output.

If a contract is entered into and subsequently the supply of water is less than reasonably anticipated, the contract could turn out to have exceeded the permissible amount of actual capacity. Presumably, however, that would not be by reason of an intentional act of the issuer. Nonetheless, in the event of a refunding, it could be apparent that, on the basis of actual events, the contract was going to involve too large a sale. We suggest the expectation at the date of issue as to the amount of output should not have to be retested. See “Time for Applying Tests – Effect of Involuntary Changes.”

\textbf{Reserved Capacity Rule.}

\textsuperscript{19} Transmission constraints, maintenance requirements, fuel (coal), environmental limits e.g. NOX limits, etc. all should be subsumed in the 30 percent test.
The Temporary Regulations provide that, if an output contract results in private business use under this section, “the amount of private business use generally is the capacity that must be reserved for the non-governmental person under prudent reliability standards.” The rule appears to be a “back door” repeal of the relevance of nameplate. The rule can apply in various different types of situations. The first is illustrated by the example of a peaking unit where 100 percent of the capacity must be reserved to provide 10 percent of the available output based on nameplate. In this context, the rule appears to serve the same function as the 30 percent rule.

This aspect of the rule would also apparently reverse the result of PLR 8327090 (Apr. 8, 1983). There, the private purchaser was to take 37 1/2 percent of actual output but not more than 25 percent of nameplate. The ruling confirmed that power actually taken divided by nameplate, rather than 37 1/2 percent of actual output, was the standard for purposes of the Subparagraph 5 Regulations. Under the Temporary Regulations, it appears an issuer would be required to determine the amount of capacity that would have to be reserved to deliver 25 percent of nameplate, which would be some number other than either 25 or 37 1/2. There is no guidance other than prudent utility practice (on which opinions may differ) for determining how this should be done. It is not a standard which provides the requisite precision for measuring private use under a law that imposes very strict and precise restrictions on such use.

A second application of the rule arises where an MOU sells a specified amount of capacity and energy and is required by regulatory authorities or an entity such as a power pool to maintain reserves in a multiple of that amount. For example, an MOU selling 10 megawatts ("MW") would be required in some states to maintain reserves equal to one hundred fifteen percent of the amount sold, or 11.5 MW. (On the other hand, an MOU selling 10 MW from a specific facility if produced would only have to reserve the 10 MW.)
The additional 1.5 MW reserve requirement above has nothing to do with the output of a particular facility. It need not even be from any facility owned by the MOU if the MOU has contractual rights to such capacity. Moreover, the reserve requirement would be subject to change over time. If the Temporary Regulations are intended to apply to this situation, the regulations would have to address when the requirement is to be determined: when original bonds are issued, when a particular contract is signed, or when bonds are refunded. Further, there may be additional complexities because the same reserve may serve different purchasers at different times where the purchasers have different daily or seasonal peak loads. See “Time for Applying Tests – Effect of Involuntary Changes.”

The rule may also apply in another and different way. Increasingly, utilities are engaging in sales of energy or capacity that are “financially firm.” These transactions are desirable for utilities in part because they do not require that any capacity be reserved. If the touchstone of private use is reserved capacity, these “financially firm” transactions should not be treated as private use. The Temporary Regulations are currently unclear on this point because they provide only that reserved capacity “generally” is the measure of private use. If reserved capacity is indeed the touchstone of private use, the term “generally” should be removed.

Additionally, we think the requirement that reserved capacity be put into the numerator but not the denominator will often result in an overstatement of private use.

On balance, there is a tremendous amount of mischief and complexity in the Temporary Regulations approach to measurement of private use of generation. Whether or not it is

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20 “Financially firm” frequently refers to a contract under which the seller is to provide energy if available, and if the energy is not available, the seller is to pay the buyer’s cost of obtaining substitute energy.
conceptually better than the prior regulations, it will add problems entirely out of proportion to the benefit. The regulations should return to prior law.

In any event, this provision should be excluded from any requirement that the Temporary Regulations be elected in whole.

**Time for Applying Tests – Effect of Involuntary Changes**

A number of provisions in the Temporary Regulations raise questions as to when a particular test is to be applied and whether there are subsequent events that necessitate reapplication of the test. These include the facts and circumstances approach to requirements contracts, the determination of the actual output of a facility, the determination as to the effect of constraints in supply, and the determination of the amount of reserves that must be allocated to a contract. Generally, we have been critical of these rules in part because of uncertainty in their application generally. If the rules are retained, however, a determination needs to be made as to the occasion(s) on which they are to be applied.

Obviously these rules should be applied at the time of the initial financing of a project. If the issuer is required to reapply the tests to subsequent financings or refinancings with respect to the project, the only new facts taken into account should be those that arise from deliberate acts of the issuer; changes in facts over which the issuer has no control, such as an increase in the stability of a requirements purchaser customer base, a change in energy available to a plant, or a deviation from the reasonably determined actual output should be ignored. We have considered whether involuntary revisions to original facts should be taken into account as to any refundings

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21 Initial financing would encompass not only a single new money financing for a facility but also any first substantial financing of a series of new money financings for a project, a common method of financing large projects.
that extend maturity or increase the amount of the borrowing (advance refundings), but think that the 120 percent limit on maturity, together with the fact that output facility bonds are generally revenue bonds and must be repaid during the economic life of the project, are sufficient limitations on maturities, and that the Congressional limitations on the number of tax-exempt advance refundings are a sufficient restraint on such refundings.

COMMENTS REGARDING $15,000,000 LIMITATION

Nonqualified Amount

The Temporary Regulations base the application of the $15,000,000 limitation on the “nonqualified amount” but do not define “nonqualified amount.” The 1994 Proposed Regulations provided that the nonqualified amount is to be determined by reference to “sale proceeds,” thus making clear that investment earnings need not be taken into account. The Temporary Regulations refer to “sale proceeds” for purposes of the payment test but simply to “proceeds” for purposes of the use test. Under section 1.141-1, the term “proceeds” includes investment earnings during the project period. It is inappropriate to use a different base for the two tests. As a practical matter, it would be impossible to apply the rule to include investment earnings on old issues at this stage. We believe the references should be consistent and to “sale proceeds.”

Definition of “Project”

Multiple Units. The Temporary Regulations provide that, where multiple generating units are constructed at the same site, such units are not part of the same project only if one unit is reasonably expected, on the date of each issue that finances the project, to be placed in service.

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22 Reg. §1.141-8T(a)(1).
more than three years before the other unit.\textsuperscript{23} We believe it should be sufficient if the units are placed in service more than a year apart.

The Temporary Regulations provide that, where a multiple unit station is under construction, all costs of common facilities that are incurred before the earlier of the issue date of bonds that finance the second unit and the commencement of construction of the second unit are allocated to the first unit. This provision may be circular, since when the bonds are issued or construction commences may depend on which costs are allocated to the second unit. Moreover, the Temporary Regulations require a precision that is not necessary. A requirement that an allocation be reasonable should be sufficient. The regulations could clarify that an allocation of costs to the second unit generally is not reasonable if the decision has not been made to construct the second unit.

The Temporary Regulations provide that a peaking unit and a baseload unit generally are not part of the same project. The regulations should be clarified to state that this is the case even though the two units are located in the same place and placed in service less than three years (or one year if our prior suggestion is adopted) apart.

**Improvements.** The Temporary Regulations provide that an improvement that is not part of the original design is not part of the same project if commenced more than three years after the original project was placed in service and if the bonds issued to finance\textsuperscript{24} that improvement are issued more than three years after the original project was placed in service. The regulations should clarify whether there is any substantive requirement intended by the use of the term

\textsuperscript{23} Reg. §1.141-8T(b)(3)(ii).

\textsuperscript{24} We have previously noted the ambiguity in the reference to bonds issued “to finance” a facility. Here it seems clear that current or advance refunding bonds ought not be taken into account.
“improvement,” (as opposed to a term such as “addition”) and if so what it is. We suggest it is enough that the item was not a part of the original design. We also believe the requirement that the issuance of the bonds as well as the commencement of the project be 3 years after the in service date of the facility is unnecessarily redundant.

**Replacements.** With respect to replacement property, the Temporary Regulations require that the bonds issued to finance the replaced property have a weighted average maturity that is not greater than 120 percent of the reasonably expected economic life of the property being financed. It is highly unusual to allocate bonds that finance a large generating unit to specific assets. Because level debt service financings have low principal amortization in the early years, it may be difficult to allocate specific bonds to specific replaced items. We think the requirements for repairs that relate to the unexpected nature of the repairs serve the same purpose, and that the requirement with respect to the weighted average maturity of the bonds should relate to the facility as a whole.

**COMMENTS REGARDING ALLOCATION OF OUTPUT TO FACILITIES AND PORTIONS THEREOF**

While Temporary Regulation section 1.141-7T(g) contain rules for determining whether output sold under an output contract is allocated to a particular facility or to the entire system of the seller of that output, additional clarification is needed in several respects.

**System Allocations**

**Allocation to Particular Units.** Under the section 1.141-7T(g) rules, certain sales of output may be allocated to the system of the seller. It is not clear whether such sales must be allocated pro-rata to all units within the system or may still be allocated to particular units. Thus,
where a seller has multiple units within its entire system, some of which are bond financed and some of which are not, the regulations should be clarified to permit the seller to allocate the sales to particular non-bond financed facilities within its system. This would be consistent with longstanding practice as well as with the example in Temporary Regulation section 1.141-8T(c). The possible implication in section 1.141-7T(g) that a “system allocation” requires a pro-rata allocation to all units within the system should be eliminated. Allocations to particular units should be permitted so long as the particular “nexus” rules contained in the Temporary Regulations (e.g., physical or operational factors) would not otherwise preclude an allocation to a particular equity-financed facility.

**Example 3 of Section 1.141-7T(h) Should Be Clarified.** In this example, contracts entered into in 1999 with four investor-owned utilities (“IOUs”) under which the IOUs purchase all of the output of existing facilities are allocated to the municipal utility’s entire generating system, including a new facility funded with bonds in 2004 and to be constructed thereafter. As part of the financing plan for the new bonds, a fifth IOU agrees to take or pay for 15% of the output of the facility but to pay amounts equal to less than 10% of debt service. The balance of the output of the new facility will be available for sale as required, but initially it is not anticipated that there will be any need for that power. The example states that the balance of the debt service will be paid initially from revenues derived from the contracts with the four systems for sale of power produced by the old facilities. The example concludes that the output contracts with all the private utilities are allocated to the MOU’s entire generating system, citing section 1.141-7T(g)(1) and (2), but without specifying a reason.

Apparently the reason for the conclusion was that the contracts entered into in 1999 were a part of the common plan of financing for the new facility. This is unclear from the example,
however, since the contracts were only for the output for the existing facilities, and there is no indication that they were entered into in contemplation of the financing five years in the future. Because the example does not connect the contracts to the financing, it has been read as standing for some kind of vague proposition that sales can never be safely allocated to specific facilities (such as equity financed facilities). The example should be clarified to indicate that the basis for the conclusion that the contracts should be allocated to the entire facilities is their connection to the future financing; if that is not the basis, the basis should be explained.

**COMMENTS REGARDING TRANSMISSION FACILITIES**

**Transmission Facilities**

Section 1.141-7T(b)(6) of the Temporary Regulations defines transmission facilities as follows:

Transmission facilities are facilities for the transmission or distribution of output. Transmission facilities include facilities necessary to provide ancillary services required to be offered as part of an open access transmission tariff under rules promulgated by FERC under Section 205 and 206 of the Federal Power Act. Thus, if a facility also serves another function (for example, the facility provides for operating reserves for transmission and also provides generation), an allocable portion of the facility is treated as a transmission facility.

Thus, transmission is defined to include distribution, as well as facilities used to provide ancillary services, such as generation facilities used to provide voltage control and spinning reserves.

It should be noted that the inclusion of distribution facilities in the definition of “Transmission Facilities” does not mean they are used the same way or have the same private use as true transmission facilities. With some exceptions, the industry distinguishes between transmission and distribution: distribution involving lines generally carrying electricity at 69 kw
or less. The lines are functionally different in that, once power enters the distribution system, it generally is not stepped back up to a higher voltage and used elsewhere.

The inclusion of facilities for ancillary services in the definition of transmission facilities is helpful, but only in so far as it sweeps into the grandfathering rules for open access all of the facilities providing ancillary services that might be used in open access, thereby eliminating a lot of questions that might otherwise bedevil facilities financed with existing bonds. Outside of the grandfathering context, however, the treatment of facilities providing ancillary services as transmission facilities creates so many questions that we doubt it is worthwhile.

Under the Federal Power Act, ancillary services include:

1. Scheduling power, which includes general control centers and computer systems needed to control the flow of electricity through the wires.

2. Voltage control, which is provided by generating facilities to maintain the voltage on certain lines to permit usable power to flow on such lines.

3. Non-spinning and spinning reserves, both of which are provided by generation facilities to assure that if outages occur on scheduled power facilities that alternative sources of power are quickly available to avoid user outages.

4. Black start reserves, which are generating reserves which do not require electric energy to provide power to restart in the case of widespread power outages.

In a vertically integrated industry, ancillary services are part of the services needed to deliver power. Very little separate attention is paid to their cost because it becomes a calculated
component of a charge for transmission only when transmission services are sold separately. In an open access environment, such as under an open transmission tariff under FERC Order 888 or where an independent system operator controls transmission, ancillary services are sold to the “grid” and the cost of such services becomes a component of the overall cost for transmission within a particular area.

As will be discussed below, the Temporary Regulations provide limited provisions for measuring the private use of transmission facilities. “Available Output” is defined as being determined on a reasonable basis, but there is no guidance as to how much of the available capacity is being used (unless it is to be found somewhere in the reserved capacity rule). Finally, there is little guidance as to how the private use, whatever it is, is to be allocated to particular facilities. As to the use of facilities which provide the ancillary services, there is no guidance at all beyond the definition of transmission which provides that transmission includes the “allocable portion” of facilities which provide ancillary services. How the “allocable portion” referred to in the Temporary Regulations is to be determined is far from apparent. If a private user is using some of the transmission facility pursuant to a transmission contract, it can be imagined that some part of the control center(s) (for scheduling services) is used, but how one allocates that use is not clear, other than perhaps as a percentage based on the total capacity of the entire T&D system. If the intent of the Temporary Regulations is that the use of the control center(s) is to be measured based on the private use of the entire T&D system, possibly on the basis of total megawatt hours, language or an example would be useful.

Measuring the private use of a generating facility that provides ancillary services is difficult. The nameplate rating on a generating facility indicates its total capacity and such capacity is the denominator in normal private use analysis. However, how the issuer adds the
use created by a user of the transmission facility, because, for example, that generating facility also supplies spinning reserves or black start services is not at all clear. For example, many of the generating facilities in California will, in all likelihood, not be used for the delivery of power except during peak hours. However, the municipal utility may be paid by an ISO as a result of holding the facility as available to provide ancillary services. We think the simplest measure of use for these services may be to ignore nameplate concepts and focus on compensation for use. Often the payment for facilities held in reserve is equal only to the net operating cost of such facilities and does not include a capital component. In such case, presumably, private use should be considered to be zero and the regulations should so indicate. If the issuer receives a payment reflecting a portion of the capital cost of such facilities, perhaps the portion of the capital cost represented by the payment would be an appropriate measure. The problem with applying the traditional analysis is trying to compare apples and oranges, where a generating facility can both provide power based on its nameplate rating and also provide ancillary services.

In addition, the rule of section 1.141-3(g)(4)(iii) of the 1997 Final Regulations that simultaneous use of a facility causes the entire facility to be privately used cannot be applied. For example, if 100 percent of the ancillary services supplied by a generating facility are sold to an ISO (and such “use” is private use, see the discussion below), but produced power is sold to the MOU’s residential customers, the generating facility is clearly not 100 percent privately used. Even if a capital component is included in the charge for ancillary services, only a portion of the facility should be treated as privately used. The use of an allocation approach is essential. Although the Temporary Regulations imply such a result, the inclusion of an example seems appropriate. Because dollars generally are the only common denominator for measurement, the
private use allocation should be based on the amount paid for capital as part of the ancillary service charge divided by the total capital charge for electricity.

Finally, the effect of excluding ancillary services provided by a generating capacity from the generation function needs to be reviewed. If treating a portion of generating capacity as involving a transmission function means that the available output of all generating properties used for that purpose must be recalculated for purposes of determining permissible sales of output other than for ancillary services going forward, substantial additional complexity would result not only from the recalculation process but from the unknowns involved in evaluating the amount of available output that is, in fact, devoted to ancillary services.

For the above reasons, we believe that while it is desirable to treat generating facilities providing ancillary services as part of transmission for purposes of the open access transition rules, such generating facilities should not be treated in whole or part as transmission facilities for any other purpose.

**Transmission Contracts–Relationship of Firm Contracts to Requirement Contract Rules**

Section 1.141-7T(c)(3)(ii) provides that firm transmission contracts are generally treated as take or take or pay contracts, so that such contracts generally give rise to private use. Because the Temporary Regulations provided that such contracts are take or take or pay contracts, they would seem to be excluded from the requirement contract rules. We believe the concepts involved regarding requirements contracts are as applicable to transmission as they are to generation, and that the same rules should apply to firm contracts for transmission of requirements as apply to generation of requirements. Otherwise a utility that could provide requirements service with its generating facilities might have no way to deliver the electricity.
DISCUSSION OF TRANSMISSION AND OPEN ACCESS

Standard Operation of Transmission and Distribution Facilities

Before discussing the application of the Temporary Regulations to the various aspects of transmission and distribution ("T&D") facilities, it is necessary to review the operation of T&D facilities and the various contracts that are generally entered into with respect to them in the industry. Once this review of the industry has been made, it will be easier to determine how the regulations can be applied to T&D facilities and what questions remain unanswered.

The contracts which directly relate to transmission have generally been in the form of firm transmission capacity contracts which involve the right to reserve a certain portion of a transmission line or system for delivery of power from one specified point to another. Alternatively, the contract may be for network transmission which allows for transmission of power from various points to one or various points. A single contract can include both forms of transmission. A typical contract involves the owner of generation contracting with an MOU that owns transmission to deliver power to a particular point outside the MOU territory or to certain customers within or beyond that MOU’s grid.

In an open access regime, there may or may not be any transmission contracts because the T&D system is intended to be an open highway where rates are charged for the use of the highway (much like a toll road). In some areas, these charges are expected to be on a “postage stamp” basis; that is, only the transmission system where the power is delivered is paid. In other areas, an attempt is made to relate the charge more closely to the service provided. Either procedure is intended to avoid “pancaking,” which involves charges for transmission by every system over which the electricity might pass.
In order to regulate the power grid in California and other places, ultimately perhaps throughout the country, ISOs have been or will be created to ensure open access to the power grid. The ISO may be a governmental entity, a Section 501(c) organization, another form of nonprofit or, conceivably, a private company, but in any case, the ISO performs the function of regulating the transmission grid regionally or statewide, which is at least to some extent a quasi-governmental regulatory function. The ISO will determine the charges for transmission, usually based on cost of service, and pass the charges on to users through tariffs, thereby compensating the owners of transmission facilities on a regulated (cost of service) basis.

Where the transmission network is operated by an ISO under a state imposed regime, no contracts may be necessary except in the case of congestion. In fact, even in the case of congestion, it is expected that transmitting power through a congestion point will result in a bid market congestion charge being added to a bill. An electric company may be able to purchase congestion rights at certain points for certain times to avoid being subject to the market rate congestion charge and to collect such charges from other users.

In other areas, where open access is being established without a state or other imposed regime, the operation of the network may be established by contract as well as tariff. However, these types of general contracts establishing a network framework should not be considered specific transmission contracts for purposes of the discussion that follows.

Although there may be limited contracts with respect to a T&D system in an open access regime, there will be numerous contracts for the sale of power. The basic power sales contracts will involve sale of power from IOUs to MOUs as have existed historically. Sales of power by MOUs to IOUs have been less frequent due to private use constraints. Under open access, there
may be sales by IOUs to customers within an MOU’s territory, and sales by MOUs of power to customers in an IOU’s territory. The primary issue, which is not addressed in the Temporary Regulations, is whether, under any of the power sales contracts, the transmission or distribution system is used and, if so, by whom. In the above examples, if an IOU sells power to an MOU, the delivery point of the power is at some connection point (“bus”) within the MOU system. Historically, it has been clear that the IOU would not be treated as using any of the MOU’s transmission or distribution facilities as a result of that power sales contract. Rev. Rul. 76-149, 1976-1 C.B. 57 (Bonds issued by city to finance distribution facilities were not IDBs where city purchased electricity from IOU). Similarly, if an MOU contracts to deliver power to an IOU, with the MOU using part of its transmission system to deliver the sold power, the IOU usually has not been viewed as using the MOU’s transmission facility, at least in the absence of special contractual provisions regarding transmission. The MOU is using its own facility to deliver its own power so that only the generation facility is used by the IOU. Third, if an IOU has a power sales contract with a customer within an MOU’s territory, the MOU is required to provide T&D services and is separately paid for such services. The IOU may be seen as using the MOU’s facilities, but it is using them on the same basis as the MOU is using them, the very essence of open access. The same charge is imposed on the retail customer by the MOU, whether the power to be delivered is generated by the MOU or by the IOU. The IOU should not be treated as using the MOU’s T&D facility unless a contract with respect to the transmission is entered into. Even if the contract between the IOU and its customer is a firm power contract, there need not be a separate transmission or distribution contract. Finally, the MOU may, of course, sell power into the IOU’s territory and the private customer in the IOU’s territory should not be seen as using the MOU’s transmission facility. The retail customer will pay the T&D charge, just as any
other customer. In fact, under a typical postage stamp regime, no T&D payment would be made to the MOU, because the power was delivered in the IOU’s territory.

This discussion leads to the conclusion that an MOU’s T&D grid is not used by a private party unless there is a specific contract with respect to the use of it. That is, a contract to purchase power from either an IOU or an MOU should not itself be treated as, in part, a contract to use the transmission or distribution facilities of whoever owns such facilities, particularly under an open access regime. This analysis is similar to the analysis of a road system in which even if a contract is entered into for the firm delivery of goods from one party to the other party, and there is only one road directly connecting the two parties, neither party is the user of the road for the purpose of private activity bond analysis.

One situation which could be found troubling is a generating facility for which there is only one transmission line leading to the general transmission grid. Transmission along such line, will necessarily only occur as a result of generation at the facility at the end of such line. Similarly, if a distribution line is built from the transmission grid to a particular customer so as to serve such customer, a concern could be raised that the line would be used in the trade or business of such customer. Nonetheless, as with the road system, the difficulty of drawing distinctions between the various lines in the T&D grid should result in private use of such grid solely as the result of power contracts. Of course, an abuse could arise if a take-or-pay contract is entered into with respect to a particular facility, a transmission line is built to the facility, and the cost of such line is specifically included in the charges under such take-or-pay contract (rather than the charges being made on a general rate scale basis). In such circumstances, the arrangement could be analyzed as a private use or loan. Nonetheless, absent such extraordinary circumstances, even lines which appear otherwise dedicated to particular customers or generators
should not be considered privately used without a specific contract with respect to use of such lines.

The Temporary Regulations appear to reach the above results, because, absent a contract for the use of a facility, no private use appears to arise under the Temporary Regulations. Nonetheless, an example to such effect would provide significant comfort.

**Independent System Operator and Open Access**

**Use by the ISO.** When an MOU cedes control of its transmission facilities to an ISO, a number of questions are raised under the Temporary Regulations, including (i) whether the ISO is a user of the transmission grid, (ii) if so, the portion of the grid that the ISO is considered to use, and (iii) how to apply the grandfathering provisions. First, it should be noted that only transmission facilities are transferred to an ISO and distribution facilities should be unaffected by the transfer of the transmission facility to the ISO.

Second, to require the ISO to be a governmental entity or a 501(c)(3) organization (and that all future transmission facilities be financed with 501(c)(3) bonds) does not seem to further any particular federal policy. Most ISOs will clearly be not-for-profit organizations performing a quasi-governmental function. An ISO’s function with respect to transmission facilities under its mandate is entirely regulatory, so that it should not be treated as the user of the transmission grid. The ISO’s “use” of transmission facilities is analogous to the air traffic controllers’ “use” of airports. Air traffic controllers are federal employees (the federal government is not an exempt

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25 Section 1.141-7T(c)(1) contains the phrase “the purchase by a nongovernmental person of the available output of an output facility (output contract)…” We assume this is not intended to mean that every purchase of electricity, for example by a homeowner pursuant to a tariff, is an output contract. We note also that there are almost no agreements for the purchase of “the” available output, an indication that this phrase was not intended as a universal definition.
person), who regulate the use of airports and airways, controlling all traffic on them. There is no “contract” between the air traffic controllers and the airports that are qualified management contracts; the air traffic controllers’ use is statutorily mandated control. They control the use of the runways, but are not treated as users of them any more than the ISO should be treated as a user of the transmission grid.26

Contracts between the ISO and the municipal user are state mandated arrangements pursuant to which the ISO controls the delivery of power across the transmission facilities, but the responsibilities of construction and maintenance are the MOU’s. Therefore, whether the “management contracts” between the ISO and the transmission owners meet the criteria established for determining whether a private party is a user of a hospital or manufacturing facility does not seem an appropriate standard. Arrangements with the ISO should not be treated as private use whether the ISO happens to be a governmental entity, a 501(c)(3) organization or simply a non-profit organization.27 The ISO will own and operate its own computer systems and is a user of them, so that its access to tax-exempt financing for its facilities depends on its status. However, applying the management contract rules to conclude that the ISO is a user of the transmission wires, even though it has no economic interest in them, is no more appropriate (the consumer pays for the ISO’s services based on the energy used) than concluding that air traffic controllers use airport runways.

26 Though currently air traffic controllers are paid from the general federal budget, proposals are being made to impose a use charge on airport users. One hopes that the manner of payment for the services will not determine “use.

27 The analysis might well be different if the ISO were organized as a profit making enterprise.
Example 5 of section 1.141-7T(h). In Example 5 of section 1.141-7T(h), it is determined that the management contract with the ISO did not meet the management contract rules. It is not clear in the example what fact(s) caused the arrangement to fail to meet the management contract rules. The example states that “the functions of the ISO include control of transmission access and pricing, scheduling transmission, control of operations in settlements and billing. In addition, under certain circumstances it may order the transmission owners to construct additional transmission facilities.” The conclusion was that the “operation of the financed facilities by the ISO does not meet the exception from management contracts that do not give rise to private business use . . . because it is not a contract solely for the operation of the facility under the exception.” It is not clear why the contract was not solely for the operation of the facility. Mandated construction of additional transmission likely could only occur if the ISO were a governmental entity or acting on a governmental entity’s behalf. In fact, the ISO may be able to have transmission facilities built on its own behalf, but it normally cannot mandate a transmission owner to build more facilities without the ISO paying for them. In addition, an ISO would not normally control pricing. The pricing is calculated on a regulated basis based on a statutory scheme. The ISO described in the example could only fail to be a manager if it were instead a governmental entity or acting as agent for a governmental entity. Its pricing control was not intended to generate either a profit for itself or the transmission owner or a subsidy for the consumer. Again, attempting to apply the management contract rules to a situation for which they were not intended seems in error. The management contract rules were not designed to answer questions concerning this type of arrangement and should not be applied to do so.

At a minimum, if a state wishes to create an ISO to meet a “management contract” limit, it would not know how to do so under the Temporary Regulations. If a “management contract”
limitation is to be applied, it should be no more restrictive than the management contract limitation for other facilities, and the regulations should explicitly state what, if any, problem is posed by the contract in Example 5.

**Retail Access**

The treatment under the Temporary Regulations of actions taken to implement the offering of open access tariffs is essentially targeted at transmission arrangements governed directly or indirectly (as a matter of reciprocal treatment) by FERC or by a state regulatory authority. Such treatment does not really address “retail access” or “retail choice”, which is likely to be governed by neither FERC nor a state regulatory authority. Instead, the MOU, acting alone, will establish programs and procedures whereby its historic retail customers can engage the services of third-party suppliers of electric services, often referred to as “energy marketers” or “power marketers,” and under which such MOU is likely to continue as the “provider of last resort”.

In a typical case, either the MOU (acting on behalf of its “contract” customers) or the contract customer will take title to deliveries of third-party suppliers at the border of such MOU’s service area. The MOU will transport such supplies over its T&D facilities to each contract customer for the account and cost of such customers. The third-party suppliers will have no contractual (or other) right to use the T&D facilities or to profit from the transportation services provided by the MOU. Meters, which will continue to belong to the MOU, will be read by the MOU at regular intervals, and bills for transportation services (according to normal rates) and for capacity and energy charges (according to contract information and calculations provided by third-party suppliers) will be submitted by the MOU to contract customers. Upon receipt of a
customer’s payment, the MOU will cause the appropriate portion to be paid over to the third-party supplier.

In the case described, it is difficult to imagine how a third-party supplier could be considered to use the T&D facilities in its trade or business of purchasing and selling electric services. A rule or example to this effect should be included in final output regulations.

**Grandfathering Provisions Regarding Open Access to Transmission**

**Section 1.141-7T(f)(5) – Special Exceptions For Transmission Facilities.** The Temporary Regulations provide that entering into a contract for the use of transmission facilities\(^{28}\) does not constitute a deliberate action if it is in response to (or in anticipation of) an order of the United States under Section 211 of the Federal Power Act or a state regulatory authority under provisions of state law provided certain conditions are met. This provision is intended to protect outstanding tax-exempt bonds (as well as current refundings that do not extend average life).

**The Open Access Provisions Are Valid Regulations.** On June 25, 1998, the chief of staff of the Joint Committee on Taxation, Lindy L. Paull, wrote to The Honorable Bill Archer, Chairman of the Committee on Ways and Means of the House of Representatives, concluding that “the Code and legislative history accompanying the 1986 Act contains no provisions to support the special exceptions contained in the Regulations allowing public power to enter into arrangements that would be treated as private business use for other issuers of tax-exempt bonds.”

\(^{28}\) We assume that no inference should be drawn from the reference to contract that a general open access agreement where no specific transmission contracts are entered into or required would result in private use.
The letter states:

“Both before and after 1986, the Treasury Department administratively has provided alternative sanctions to retroactive loss of tax-exemption for post-issuance changes in use in certain cases when the change was not reasonably expected at the time the bonds were issued. These alternative sanctions require immediate surrender of the benefits of tax-exempt financing by redemption of outstanding bonds, or if immediate redemption is precluded by pre-existing bond terms, by immediate defeasance of the bonds through establishment of an escrow account funded with taxable debt accompanied by redemption on the first possible date.”

If, as the context suggests, this statement was intended to refer to governmental bonds, it is flatly incorrect as to the situation in 1986. Moreover, there is nothing in the legislative history of the 1986 Act requiring the rule stated in the letter as to governmental bonds.

Prior to 1986, in certain cases involving bonds for private housing and small issue IDBs, and in the case of violations of information reporting and arbitrage rebate requirements, Congress had specifically provided that bonds would become taxable if action was not taken. In addition, in cases where 90% of proceeds of IDBs were to be spent on prescribed types of costs and were not, the IRS indicated that it would not challenge the exemption on the bonds if certain requirements, including early redemption, were met, e.g., Rev. Proc 79-5, 1979-1 C.B. 485. Finally, the IRS had ruled that certain deliberate acts to create arbitrage caused retroactive taxability, as to which no defeasance or redemption solution existed. The alleged rules described in the Joint Committee letter, however, were never generally applicable to public power bonds or other municipal governmental or exempt facility bonds prior to a change in Treasury policy in 1993.

The seminal authority on the effect of changes in use of output facilities on governmental bonds that finance the facilities is Revenue Ruling 77-416, which remained in effect until 1993. In that ruling, an MOU, which had expected to use its municipal utility system indefinitely at the
time bonds were issued, decided to sell the system because of unforeseen changes in circumstances. The ruling concluded that this sale would have no adverse effect on the exclusion from income of interest on the bonds, notwithstanding that the bonds were defeased and would remain outstanding until maturity. Contrary to the statement in the Joint Committee letter, no requirement was imposed that the bonds be called at their earliest call date or otherwise prematurely removed from the market.

The rationale for this ruling is stated in GCM 37158 (June 13, 1977). In approving the conclusion proposed for Rev. Rule 77-416, the General Counsel of the IRS stated:

As a general matter the long standing Service position has been against altering a bond’s Code §103(a)(1) tax status due to subsequent sale of securing property. Of course, subsequent to the 1968 amendments that restricted the circumstances in which exemption of interest under Code §103(a)(1) is allowed, efforts to circumvent these restrictions are more likely.

* * *

Code §103(b)(2)(A) and Treas. Reg. §1.103-7(b) define an industrial development bond as an obligation, “which is issued as part of an issue call, or a major portion of the proceeds of which are to be used directly or indirectly in any trade or business carried on by any person who is not an exempt person. There is, then, on the face of the statute, a strong implication that bonds are characterized as industrial development bonds (or not) at the time of issue.

* * *

Ultimately, an examination of legislative history provides a more convincing answer. Sen. Ribicoff, the sponsor of the industrial development bond provisions in the Senate, referred to industrial development bonds as “…corporate bonds [in which] the local government’s involvement is often little more than a sham,” and as a “device or gimmick for allowing industrial corporations to claim the benefit of the lower interest rate…” Sen. Ribicoff went on to state:

The tax-exemption of State and local government bonds was originally intended to help our State and local governments meet these [government facility] needs at the lowest possible cost. The federal tax-exemption was not intended to permit U.S. Steel, Armco Steel and other major corporations to gain tax advantages at
the expense of other taxpayers. It was not intended to permit such private corporations to drain investment funds away from schools, hospitals, roads and other public facilities. In short, it was not intended as a method of permitting corporations to finance corporate facilities on a tax-exempt basis. [Debates, H.R. 156414, Revenue and Expenditure Control Act of 1968, 90th Cong., 2nd Sess., March 28, 1968, P.S. 3547]

We believe that the facts in the instant case clearly indicate that the transaction herein is a legitimate, non-prearranged sale, lacking any indication of being a “sham” or “gimmick” to obtain low cost financing. The City has owned and operated its system for some years, with the original intent to do so indefinitely; the obligations have been issued at various times since 19553 and the recent dramatic increases in fuel costs present an unforeseen intervening situation which would reasonably cause the City to alter its original intent to continue operating the plant. [footnotes omitted]

No one would suggest that compliance with national policy of open access to transmission and electric facilities constitutes a “sham” or a “gimmick”.


Most of these rulings contained language along more or less the same lines:
In Rev. Rul. 77-416, 1977-2 C.B. 14, the Service considered a transaction in which a city proposed the sale of a facility financed by bonds, the interest on which was exempt from taxation under section 103(a) of the Code. At the time of the proposed sale the city had operated the facility for many years. However, unforeseen changes in economic conditions had rendered the city’s continued operation of the facility unfeasible. The terms of the sale dictated that it was an arms length transaction. The facts surrounding the sale did not indicate that the transaction was a mechanism to transfer the benefits of tax-exempt financing to the purchaser.

In this case, continued deterioration of the Hospital’s financial condition has necessitated another change in the operation of the facility. The circumstances surrounding this change do not indicate that it is a mechanism to pass on the benefits of tax-exempt financing to a nonexempt person. Therefore, we conclude that the Hospital’s engagement of the Partnership through the management agreement and the consummation of the transactions contemplated in the agreement will not adversely affect the tax-exempt status of interest on the Bonds.

Thus, at the time of the 1986 Act there was clearly no general rule that bonds had to be called following a change in use, although the Code did contain certain provisions that provided for bonds becoming taxable (failure to meet certain requirements for single or multifamily housing bonds, violation of the capital expenditure limitation for small issue bonds, violation of the test period beneficiary rule for small issue bonds) and the IRS had ruled that bonds could become taxable arbitrage bonds because of intentional acts that were in substance actions taken in bad faith. The Conference Report to the 1986 Act recognized this:

Tax-exempt bonds generally are not required to be redeemed if the use of bond-financed property changes from a use qualifying interest on the bonds for tax-exemption to a nonqualified use. In certain cases, however, interest on the bonds becomes taxable. [emphasis added] Conference Report at II-733.

The only change made to this regime was to codify the rule that intentional arbitrage would cause bonds to become taxable. Code section 148(a)(1). A close reading of all the statements in the legislative history regarding bonds becoming taxable indicates that they all refer to the above-described provisions, provisions that were not enacted, special situations being addressed for the first time by Congress, or the arbitrage provision. Set forth in Appendix B are
all the references in the legislative history of the 1986 Act to bonds that were originally tax-exempt later becoming taxable. Thus, the legislative history of the 1986 Act does not support a rule that requires the issuer of governmental bonds for output facilities to call bonds when there is an unanticipated change in use as a result of bona fide reasons such as a change in national energy policy. In fact, the legislative history of the $15,000,000 volume cap requirement for output facilities supports the conclusion that bona fide, unexpected changes after bonds are issued are disregarded by stating that changes in expectations that arise before bonds are issued must be taken into account. Conference Report at II-739. See also Blue Book at 1195 and discussion below under “The Change In Use Rules Should Not Apply to Bonds Subject to the 1954 Code” at p. [__].

We note that the transition rule for open access is not the only provision of the regulation under which subsequent acts can be disregarded. Under section 1.141-2(d)(5), subsequent acts of many general obligation issuers can be disregarded.

Accordingly, while the IRS may or may not have the authority to impose a change in use rule that requires accelerated retirement of bonds, the IRS clearly has the authority not to impose such a requirement in cases where the change in use results directly from a change in national policy.

In addition, extending the provision to current refundings is clearly within the authority of the IRS. For 27 years the regulations have provided that in a refunding the proceeds of the refunding issue are deemed to be used for the purpose for which the proceeds of the refunded issue were used. Reg. § 1.103-7(d). Further, preventing a current refunding of this type would merely prevent a reduction of the amount of tax-exempt interest being paid.
**Technical Comments – Section 1.141-7T(f)(5)(i)(B).** Temporary Regulations section 1.141-7T(f)(5)(i)(B) requires that, in order to be disregarded as a deliberate action, the contracts must be bona fide and arm’s length and the consideration paid must be consistent with the Federal Power Act. These requirements are neither clear nor necessary. There is no reason to believe that contracts would not be bona fide, at arm’s length and consistent with the provisions of the Federal Power Act. As the requirements are written, however, bona fide arm’s length contracts consistent merely with state law would not qualify. At a minimum, the provision should allow for contracts which are consistent with state law provisions.

**Section 1.141-7T(f)(5)(ii)–Actions Taken to Implement Nondiscriminatory Open Access.** This provision appears to be intended, based on Example 5 of section 1.141-7T(h), to permit the transfer of control of transmission facilities to an ISO or other open access arrangements without adversely affecting the tax status of outstanding bonds issued to finance the transferred facilities.

**Section 1.141-7T(f)(5)(iii)–Application of Reasonable Expectations Test to Refundings.** This section provides in significant part that an action is not taken into account as a deliberate act under the reasonable expectations test for an issue if “(B) The bonds of the issue are current refunding bonds that directly or indirectly refund bonds issued before July 9, 1996…” Given the novelty of the Temporary Regulations and the numerous bonds issued based on prior law, this rule should extend to advance as well as current refundings, as was the case in section 1313 of the 1986 Tax Act.

In addition, the July 9, 1996 date should be amended to February 23, 1998. Bonds issued to finance transmission facilities between July 9, 1996 and February 23, 1998, should be permitted to be refunded. There seems no federal policy reason to impose new restrictions on
bonds which met the reasonable expectations test at the time such bonds were issued. Note that the July 9, 1996 date has no clear relevance to action taken pursuant to state regulations. Absent an extension of maturity, such refundings normally are undertaken solely to reduce interest rates (a requirement of reduction in interest rates could be imposed) and no federal purpose is served by preventing such refundings. The lack of notice of the terms of the provisions is apparent.

Further, for refunding bonds issued after February 22, 1998, an issuer should be permitted to elect to apply these provisions of the Temporary Regulations without opting into all the other novel rules contained in the Temporary Regulations. This approach is necessary because many of the refunding issues will involve generation as well as transmission facilities, and it will be impossible in many cases to comply with the new rules as a result of actions taken in the past.

In addition, the Temporary Regulations should be amended to provide that commercial paper programs that had not elected single issue treatment under section 1.150-1(c) of the Regulations should nonetheless be treated as having the same maturity as if such an election had been made.


Temporary Regulation section 1.141-7T(b)(1)(ii)(B) provides as follows:

Measurement of the available output of all or a portion of electric transmission facilities may be determined in a manner consistent with the reporting rules and requirements of the transmission networks promulgated by FERC. For example, for a transmission network the use of aggregate load and load share ratios in a manner consistent with the requirements of the FERC may be reasonable. In addition, depending on the facts and circumstances measurement of the available output of
transmission facilities using thermal capacity or transfer capacity may be reasonable.

In an open access regime there is little need for a transmission contract, so that the use of allocable available output is not particularly significant. On the other hand, if contracts are entered into, the above methods, if consistently applied, should suffice, although a formal definition of many of the terms used, e.g., “a thermal capacity or transfer capacity,” is difficult to find. Though the provisions of this section may be difficult to apply, no more reasonable method for measuring transmission capacity seems available.

In addition, with respect to distribution, network capacity is probably the only useful basis measuring use. However, it should be emphasized that a distribution facility, just like the single road that leads to a user’s plant, see Reg. Sec. 1.141-3(f) Ex. 11, should never be considered privately used in the absence of a specific contract which meets the benefits and burden test. Therefore, a general provision in the regulations that distribution facilities are not privately used unless there is a contract for use that creates a lease or private loan should be added.

**Definition of Transmission Project**

Under section 1.141-8T(b)(4), project means “functionally related or contiguous property and property for ancillary services,” but “separate transmission facilities” are not part of the same project if one facility is reasonably expected, on the issue date of each issue that finances the project, to be placed in service more than two years before the other. There is ambiguity in “functionally related or contiguous” and “separate transmission facilities.” In the broadest sense, all transmission facilities are “functionally related” and “contiguous.” That view, however, would render the following two-year rule inoperative. Probably this ambiguity can best be
clarified by example. Thus, two transmission construction projects in different parts of a transmission network would be separate projects though done at the same time, and transmission projects done in discrete stages would be separate projects if done more than two years apart, even though adjacent.

We question whether facilities for ancillary services should be within the definition of project unless they are specifically constructed for that purpose. For example, if a new transmission facility is constructed and a ten year old plant is used to provide spinning reserves, it is not clear what purpose beside complexity is served by requiring an allocation of a portion of the cost of the plant to the transmission project for purpose of applying the $15,000,000 limit to the bonds issued to finance the transmission.

**COMMENTS AFFECTING GENERATION AND TRANSMISSION**

**Definition of Output Contract**

The general rule relating to output contracts under § 1.141-7T(c)(1) should be amended by inserting the phrase “pursuant to a contract” in the first sentence after “The purchase.” As it is, the defined term “output contract” has no antecedent.

**Contracts With Specific Performance Rights**

Section 1.141-7T(c)(5) of the Temporary Regulations provides that an output contract that provides the purchaser with specific rights to control the output of a facility or with other specific performance rights to the use of output of a facility is generally taken into account even if the issuer does not reasonably expect that it is substantially certain that payments will be made under the contract; however, a customer’s normal entitlement to receive utility service (for example, an entitlement to reasonable protection against blackouts in times of high demand
through rotating the effect of blackouts) is not treated as a specific performance right for this purpose.

We do not understand what specific performance rights are. If they are intended to cover preferential rights to output, that concept is already covered in the benefits portion of the benefits and burdens test, making the specific performance rights rule redundant.

Former IRS personnel have explained that this rule reflects the notion that contracts resembling leases should be subject to a more restrictive standard than simple contracts for service. We agree with this notion. We suggest, however, that the specific performance standard alone is not reflective of the nature of a contract as a lease, as well as being uncertain as to its meaning. If the theory is to treat contracts resembling leases as leases, the Code already provides section 7701(e) for that purpose. Concepts from that section should be used, rather than a vague and novel specific performance standard.

In many plants with joint ownership, the operator of the plant is also a purchaser of some of a municipal participant’s output from the facility. Typically such purchases would be under take or take or pay contracts and would be counted in any event. In some instances, however, the operator may purchase surplus energy from the municipal participant to the extent it is available. If the effect of this provision is to require that those purchases be taken into account because of the de facto control of the operator, it would be a radical departure from existing law that would preclude a party from such a contract from opting into the Temporary Regulations. If this test is retained, it should be modified to clarify that it does not apply by reason of an agreement to manage or dispatch a plant owned by multiple participants in accordance with prudent utility practice.
Short-Term Contract Safe Harbor

Under the Temporary Regulations, the time limitation on sales that are treated as “uses” of the facility are the same as they would be if the purchaser of the output actually leased the plant, used its employees to operate it and sold the output, even if in fact the purchaser of the output pays a market price, has no involvement in the operation or financing of the plant, has no participation in the profits or cost savings from its operation and has no risk of loss with respect to the plant. There is no other area of tax law in which it could even be imagined that a purchase of service on such terms for a period of 31, 91 or 181 days might be treated as a use of the facility or the funds that financed it, and there is nothing in the 1986 Act that supports reaching that result simply because property is governmentally owned. By contrast, an investor-owned utility has been allowed to purchase 41 percent of the output of a facility owned by a cooperative for a term of 15 years under a “take” contract without any portion of the facility becoming public utility property.29 PLR 8521163 (Feb. 28, 1985).

It is sometimes suggested that any purchase of output from an output facility is a use because the output is the only value produced by the facility. That reasoning is fallacious. As previously noted, the provisions of the Code denying investment credits and limiting depreciation deductions for property used by tax-exempt entities (including governmental entities) stem from policy concerns that are comparable to the limitations on private use in the tax-exempt financing area. Yet no one has suggested that a government contractor that uses its

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29 PLR 8521163 involved sections 46(f) and 46(c)(3)(B), which limited the investment credit for “property used predominantly in a [rate regulated] trade or business of the furnishing or sale of ... electrical energy,” and sections 168(g)(1) and 167(1)(3)(A), which limited depreciation on similarly defined property. Noting that the regulations under section 46 included property leased to a rate-regulated utility, the ruling concluded that the property was not public utility property. See also PLR 8918012 (Jan. 27, 1989) (20 year “take” contract for one-way wheeling services to be rendered to the United States with
plant to produce widgets for the government, or a manufacturer that sells to a tax-exempt entity under a 61-day contract, should lose tax benefits associated with the plant, even if the contract is a cost plus contract. Ford does not lose tax benefits just because half its Crown Victorias are sold to the police pursuant to contracts. A payroll service does not lose a portion of the tax benefits associated with its computers because it has contracts with governments or 501(c)(3) organizations. The mere purchase of output from a plant is not the use of the plant.

We think a common sense approach should be applied to the short-term use of output facilities. In particular, without specifying the exact outlines of what constitutes use, we believe a contract that (1) is of a relatively short term duration, such as 3-5 years, (2) is at an arm’s length market or tariff price rather than direct cost pass-through price, (3) was not a material factor in the financing of a facility and (4) gives the purchaser of the output no possessory interest or ability to control the manner of operation of a facility cannot be considered to give rise to use of the facility on any reasonable basis and that a safe harbor should be established along those lines.

In that connection, we note that the economic beneficiary of any contract of the nature described would not be the purchaser under the contract, who would be paying an arm’s length price. Rather, the benefit would go to the other customers of the MOU, whose rates would otherwise be increased to pay the fixed costs of unused capacity.

15-year extension, does not make property “used” by the United States for purposes of investment credit provision.)
Short-Term Contract Limits Should Treat All Months Equally. The 30 day, 90 day and 180 day safe harbors should be changed to one month, three months and six months. It is impossible to explain to clients that they can make sales for some months, but not others.

Other Transactions. Other transactions that should not give rise to private use include seasonal sales, typically for one or more 6 month periods that do not take the form of swaps and thus do not qualify for the swapped output exception, and sales of excess energy, including sales of so-called financially firm energy at arm’s-length rates for limited periods. These transactions in no sense pass to the purchaser the benefits of ownership or burdens of paying debt service, substantial or otherwise.

De Minimis Contracts

The rule of the 1994 Proposed Regulations was a reasonable approach. It scaled down the 3 percent rule in proportion to the reduction in permissible private use from 25 percent to 10 percent. In addition, it explicitly recognized what was implicit in the term “annually” in the Subparagraph 5 Regulations: that the average annual guaranteed payment during the contract term should be compared to the average annual debt service.

By reducing the limit to half of one percent, making it a comparison between the payment in any one year and the average annual debt service, by (perhaps inadvertently) suggesting that it be compared to debt service on any bond issue or at best leaving this issue vague, and by requiring that these miniscule payments be evaluated to determine if they are substantially certain, the Service has created a nullity.
The rule of the 1994 Proposed Regulations should be adopted, but should be limited to “guaranteed minimum payments.”

**Relationship to Payments Test.** Given the reliance placed by the Temporary Regulations on Reg. § 1.141-4 (see § 1.141-7T(e)), the *de minimis* rule should explicitly state that Reg. § 1.141-4(c) is to be applied before application of the *de minimis* rule. Thus, payments should be allocated to O&M as well as sources of funding before determining whether the payments allocable to particular bonds meets the *de minimis* threshold.

**Rules Regarding Measurement Period.**

The Temporary Regulations provide that “the rules of 1.141-3(g)” are used to determine the measurement period, thus replacing the “contract term” concept of the Subparagraph 5 Regulations. It appears that the reference should be to section 1.141-3(g)(2), since most of the other portions of section 1.141-3(g) deal with subjects other than the “measurement period” or deal with subjects that are covered by the concept of available output. Moreover, the provisions of section 1.141-3(g)(7) should not apply to output facilities. Under that provision, if an issuer enters into an arrangement for private use of a facility a substantial period (10 percent of the measurement period) before the right to actual private use commences, and “the arrangement is an arrangement for ...long term use,” the measurement period begins on the date the arrangement is entered into. Under this rule, an issuer issuing 30 year bonds to finance a facility with a three year construction period and having an agreement from the beginning to sell 20 percent of the output of the facility for 13.5 years (10 percent of the available output over the term of the

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30 In “financially firm” energy sales, the seller need not establish reserves against such sales, because there is no obligation to provide the energy if the seller does not have it; in that event, however, the seller must pay the buyer the buyer's cost to replace the undelivered energy.
bonds) in a transaction giving rise to private use would apparently exceed the permissible limit because the construction period would count as private use. That result is inappropriate. We note that Example 1 of section 1.141-7T(h) of the Temporary Regulations, where 25 year bonds are issued to finance a facility with a four year construction period, correctly ignores the application of section 1.141–3(g)(7).

Under section 1.141-3(g)(2)(i), the measurement period ends on the earlier of the maturity date of the latest maturity date of any bond of the issue that financed the facility or the reasonably expected economic life of the facility. Output facilities are often financed with more than one issue, each of which has a different final maturity. As a result, there may be different private activity limits for the same facility for each issue. This complexity could be avoided if the last maturity of any issue financing the facility were used for all issues financing that facility. The anti-abuse rule of section 1.141-3(g)(2)(v) should protect against manipulation through multiple issues.

“The reasonably expected economic life” of the facility is to be determined “as of the issue date.” This should be the issue date of the first substantial issue of obligations issued to finance the facility. It should not be retested in the event of a refunding of one or more of the issues. See “Time for Applying Rules – Involuntary Charges,” above.

The special rule of section 1.141-(g)(2)(iii) for reasonably expected mandatory redemptions is discussed below under “COMMENTS REGARDING REMEDIAL ACTION.”

31 A similar issue arises in a partial refunding of the shorter maturities of a single issue or in a refunding which shortens maturities. As we discuss in connection with refundings, we believe an issuer should be able to use the original measurement period as the measurement period for the refunding.
Application of the Payments and Security Tests

The Temporary Regulations provide that the measurement of payments made or to be made by nongovernmental persons under output contracts as a percentage of debt service is determined under the rules provided in section 1.141-4. Section 1.141-4(c)(2) provides that payments for a use of property include payments (whether or not to the issuer) in respect of property financed directly or indirectly with those proceeds “even if not made by a private business user.” This rule is sensible in the context of a bond financed facility subject to a “bad” management contract; in such a case, since the manager in effect has the benefits and burdens of ownership, it is as if the payments by the general public are the manager’s payments. This rule, however, should not be applied where, for example, a private user is taking 20 percent of the output of a bond financed facility but is only making payments equal to 10 percent of debt service, to treat an additional 10 percent paid by the general public as private payments. To interpret the rule in that fashion would render the payments test a nullity. In the past, the regulations have never articulated a basis for different treatment of general public payments in the management contract context as opposed to the output context. The reason for the difference is that in the management contract situation the particular facility is entirely privately used by reason of the management contract, and the general public is making payments for its use of the very property that is privately used. By contrast, in the output context, where the general public makes payments with respect to output, it is only with respect to the output of the portion of the facility that is not being used by a private user. Thus, such payments should not be considered private payments. The regulations should articulate this difference.
Allocation of Payments to Debt Service

There are several different rules regarding the amount of payments that must be taken into account. Under section 1.141-4(c)(2)(i)(B), payments are not taken into account to the extent that the present value of those payments exceeds the present value of debt service on the proceeds being used. Thus, if a purchaser is using 10 percent of the output of a facility for the first 10 percent of the life of the facility, the payments taken into account would not exceed an amount equal to 10 percent of debt service during that period. Under section 1.141-4(c)(2)(i)(C), payments by a person for a use of proceeds do not include the portion of any payment that is properly allocable to the operation and maintenance of the financed property used by that person, but operation and maintenance do not include general overhead and administrative expenses. Accordingly, if the contract referred to above required the purchaser to pay for 10 percent of all costs, including general overhead and administrative, the overhead and administrative payments would not be excluded under section 1.141-4(c)(2)(i)(C), but they would be excluded under section 1.141-4(c)(2)(i)(B). If, on the other hand, the contract required the purchaser to pay 80 percent of 10 percent of all costs, and 20 percent of the costs were overhead and administrative, the payments allocable to debt service would include the full amount of debt service even though that was not the agreement of the parties. In other words, even though the parties had agreed that the purchaser would only pay 80 percent of the actual costs, including debt service, the regulation would allocate payments to debt service in the full amount of debt service.

In addition, output contracts frequently call for separate charges for energy and capacity. Since capacity charges are fixed and energy charges vary with the energy taken, the allocations can generally be relied on to determine the payments that should be counted under the payment test.
There are well established rules for accounting for costs in the electric industry. We think an issuer should be able to use those rules in determining the amount of payments allocable to debt service.

Under section 1.141-4(c)(3)(iv), payments made under an arrangement entered into in connection with the issuance of bonds are generally allocable to that issue. Presumably, this rule does not change the amounts of payments that are taken into account, as described above.

Allocation to Equity Financed Portion of a Facility

The Temporary Regulations also indicate that where facilities have been financed with multiple funding sources, the allocation rules provided in the 1997 Final Regulations may be utilized to allocate private use and private payments. These rules generally provide for pro rata allocations to sources. We are concerned that these rules foreshadow a rule that private sales might have to be allocated pro rata to the equity and debt financed portions of facilities. Clarification is needed that, where private sales are allocated to a particular unit that has been partly financed with bond proceeds and partly financed with equity, the “bad” sales may be allocated to the equity-financed portion of the facility. Such a result is consistent with Congress’ intent as reflected in the 1986 Tax Act legislative history, which effectively treated the private use and governmental use portions of facilities as separate facilities. Thus, the Conference Report states that, where 10% of the output of a $500,000,000 facility is to be sold to an IOU, $465,000,000 of tax-exempt debt can be issued to finance the facility. If the private sales had to be allocated pro-rata to tax-exempt debt and equity, only $150,000,000 of bonds could have been issued without exceeding the $15,000,000 limit. The example only works where the private sales are allocated first to equity. The example is properly reflected in the example in section
1.141-8T(c) of the Temporary Regulations. Thus, both Congress and the IRS have recognized that private sales can be allocated first to equity.

Clarification also would be useful with respect to the allocation of private payments from bad contracts. The Temporary Regulations refer to the rules of the 1997 Final Regulations relating to the allocation of payments which generally require that where a facility is financed from two or more sources, payments with respect to that facility must be allocated among the sources according to the relative amount of proceeds of each such source. Here again, the 1986 Tax Act legislative history referenced above would allow for allocation of both private use and private payments to the equity-financed portion of facilities.

Transmission facilities are often financed in part with equity and in part with debt. In addition, in anticipation of contracts for transmission, a MOU may redeem part of its debt with equity or taxable bonds. The regulations should recognize that private use is permitted with respect to facilities to the extent financed with other than tax-exempt bonds. For example, if a particular transmission line is financed 75 percent with tax-exempt bonds and 25 percent with taxable bonds or equity, subsequent private use of 25 percent of the capacity on such line should not result in any of the bonds having to be redeemed. If the facility had been 100 percent tax-exempt financed and subsequently 25 percent of it is privately used, then only 25 percent of the bonds would have to be redeemed. 75 percent of the facilities could continue to be financed with tax-exempt bonds. The order in which the equity or taxable bonds are applied to finance the facilities should not change the percentage that can be tax-exempt bond financed.

Similarly, recognizing the ability to have 10 percent private use, if 60 percent of the facility is to be used by the MOU and 40 percent is used by private persons, then approximately
66 percent of the facility can be bond financed and 34 percent would have to be financed with taxable debt or equity. Consistently, if 100 percent of the facilities is bond financed and 40 percent becomes privately used, the issuer should only be required to retire 34 percent of its debt, not 40 percent. Again, the order in which the private use arises, particularly in a changing industry, should not change the amount of facilities which can be tax-exempt bond financed.

**Examples 5 and 6 of Section 1.141-14(b) Should Be Modified**

Example 5 concludes that where 30 percent of the output of a facility is taken by a private utility and 70 percent by a governmental utility and each party pays its proportionate share of the costs, the allocation of the 30 percent private use portion to the taxable financing having a weighted average life of 15 years does not reflect economic substance where the tax-exempt financing has an average life of 26 years.

The example misconstrues the intent of the private activity limitations, which is to limit the amount of tax-exempt financing rather than to specify the type of financing arrangements that may be entered into. This is clear from the example in the legislative history, incorporated into the Temporary Regulations, of the $500,000,000 plant. The example concludes that only $465,000,000 of bonds may be issued on a tax-exempt basis. It says nothing about how the remaining 35 million is to be financed. Reg. §1.141-8T(c).

Example 5 does not state what would have happened if the issuer had financed the transaction with 30 percent equity and a tax-exempt financing having an average life of 26 years. However, based on the $500,000,000 example in the legislative history, it must be possible to finance the facility in that manner. If an issuer finances 30 percent with equity and 70 percent with debt, there is no rule that the equity cannot be “amortized” faster than the debt; that is, that
the debt could be interest only for some period of time or involve slower amortization than level debt service in the early years so as to allow a return of all or some part of the equity. There is no reason taxable debt should be treated less favorably than equity.

Example 6 indicates the peril of attempting to dictate how parties acting at arms-length should negotiate their deals. In that example, the allocation is upheld where the private utility pays all the taxable debt service and the MOU pays all the tax-exempt debt service. This ignores the fact that, depending on the term of the taxable debt and the relationship of taxable to tax-exempt rates, the private utility might pay less than it would have had it paid 30 percent of all debt service, because the taxable debt service is shorter than the tax-exempt. The regulations should leave these matters to arm’s length negotiation.

**Financial Contracts.**

The Preamble to the Temporary Regulations requested comment upon the proper treatment of options. There are also other emerging financial transactions that may have relevance. We are not in a position to deal exhaustively with these matters, but we offer the following comments.

**Purely Financial Transactions.** In general we believe that financial transactions that hedge positions but do not involve the actual use of output of facilities should be disregarded. One example of this type of transaction is a swap from a fixed price to a variable price based on notional amounts of energy. In such transactions, no actual energy changes hands nor even need be generated. We believe such transactions should be disregarded.
Transmission Congestion Charges. Another example of a financial contract that should be disregarded as not involving the use of facilities to which they seemingly relate is the Transmission Congestion Charge (“TCC”).

At least under some models, TCCs are not charges for transmission service at all. Rather, they are increased costs of power over and above the cost of generation and transmission that are caused by reason of the unavailability of transmission and that are collected from purchasers of electricity and paid to the holders of the TCCs. Because the TCCs do not involve actual transmission, they can be held by persons other than transmission owners and, in fact, synthetic TCCs can be traded.

One place where TCCs are being used is New York. We have enclosed a description of the New York TCCs as Appendix C because we believe it is similar to what is being, or will be, done elsewhere. This description indicates that these types of arrangements are purely financial and are not tied to any provision of transmission service.

Options. Options where the MOU agrees to purchase power or energy when put to it generally do not involve the use of the MOU’s facilities and should not give rise to private activity bond concerns. Options where the MOU agrees to sell power or energy pursuant to an option to purchase may, however, give rise to such concerns. If the option, when entered into, is at a bargain price such that there is economic compulsion that it be exercised, the option may be analyzed under the underlying arrangement rubric of the Subparagraph 5 Regulations or the substantial certainty of payment rule consistent with the interpretation we have suggested in these comments. Authorities distinguishing options from disguised sales are also relevant. Where the option price is such that there is no substantial certainty of exercise, however, it is
hard to see how the option in and of itself could pass the benefits and burdens of ownership to the option holder.

A second level of analysis may, however, be required depending on the effect of the exercise of the option. If the exercise of the option itself creates a long term obligation that would itself be taken into account, the fact that it arose from an option should be immaterial.

APPLICATION OF SECTION 141(b)(5) (AS APPLICABLE TO OUTPUT FACILITIES THROUGH SECTION 1313(b)(5) OF THE 1986 ACT) TO MULTI-PROJECT ISSUES

Section 141(b)(4) of the Code imposes a $15,000,000 limitation on the nonqualified amount with respect to bonds outstanding to finance a “project.” Section 141(b)(5) imposes a similar limitation (but only involving the volume cap) with respect to an issue. The question arises as to how section 141(b)(5) should be applied where one issue finances two or more projects. In Notice 87-69, the Service in effect provides that, in such a case, there would be a permissible non-qualified amount for each project, as follows:

(e) NONQUALIFIED AMOUNT, ETC. If proceeds of an issue (hereinafter referred to as the “multi-project issue”) are to be used with respect to more than one project, section 141(b)(4), (5), and (8) of the Code are applied by treating the portion of the proceeds of the multi-project issue to be used with respect to each project as a separate issue; provided that, if any bond issued as part of the multi-project issue is thereby treated as a private activity bond, all bonds issued as part of the multi-project issue are treated as private activity bonds.

Under this rule, an issuer with two $100,000,000 projects, each with 10 percent private use, could finance both projects together without having to use volume cap. Without this rule, an issuer could still finance the two projects without using volume cap, but would have to finance the projects with two separate issues.
The rule of the Notice seems a sensible one, and because the rule provides that, if any bond issued as part of the multi-project issue is treated as a private activity bond, all bonds issued as part of the multi-project issue are treated as private activity bonds, the rule does not allow an issuer to bury an impermissibly large amount of private use for a project in a large issue.

Section 1.150-1(c)(3) provides a rule that is very similar to the rule of the Notice except that it explicitly excludes section 141(b)(5). It is understood that, when section 1.150-1(c)(3) was adopted, there was no intent to override Notice 87-69. Now that Notice 87-69 has been declared obsolete, however, we recommend that the exclusion of section 141(b)(5) be removed from section 1.150-1(c)(3) of the regulations.

**COMMENTS REGARDING REFUNDINGS**

**Period for Testing Refundings**

A large portion of the public power bonds currently outstanding and to be issued in the foreseeable future are refunding bonds, the treatment of which was reserved in the Final Regulations. The only guidance in the existing regulations is contained in section 1.103-7(d), which provides generally that “the proceeds of the refunding issue will be considered to be used for the purpose for which the proceeds of the issue to be refunded were used. The rules of this subparagraph shall apply regardless of the date of issuance of the issue to be refunded and shall apply to refunding issues to be issued to refund prior refunding issues.” This regulation is ill
equipped to cope with change in use and gives no guidance at all as to the application of the payment test.\textsuperscript{32} Thus, guidance is needed as to the proper treatment of these obligations.

Any regulation on this subject needs to deal with both measurement of use and payments over time, and changes in use. For example, it should be possible to issue a governmental bond to refund or advance refund a private activity bond provided that the private involvement has ended or been brought within allowable limits for governmental bonds.\textsuperscript{33} Similarly, it should not be possible to issue exempt facility or other private activity bonds to advance refund governmental bonds. These examples suggest that use and payments should be measured only over the term of the refunding issue. Other examples, however, suggest that the entire term should be the measurement period. If the original issue is structured so that the permissible private use for the entire term is put into the front end of the issue, it should not be possible to refund and have additional private use in the second part of the financing. Similarly, if the original issue has no private use, the permissible private use after the refunding bonds are issued should not be limited by the shorter term of the refunding issue.

\textsuperscript{32} Proposed Regulation section 1.103-7(e), which did address the payments test, was withdrawn over ten years ago, and although its concepts were subsequently applied in one private ruling, the proposed regulation can no longer be given any particular weight.

\textsuperscript{33} On first impression, it might appear that this transaction would violate the prohibition against advance refunding private activity bonds found in section 149(d)(2) of the Code. However, under the change in use rules, a bond can change its spots. Thus, just as a governmental bond can become a taxable or tax-exempt private activity bond, so too should a private activity bond become a governmental bond and thus be eligible for advance refunding. Note that in many instances a refunding of a private activity bond will not meet the definition of refunding in section 1.150-1 of the regulations because there will be a change in obligors within the meaning of that provision. In those cases there will be no question that governmental bonds can be issued to defease the prior bonds. The result should be similar where the governmental involvement before as well as after is sufficient that the definition of refunding is met because the obligor is the same before as after.
Finally, an issuer that originally front loaded its private use, but now wishes to issue refunding bonds with accelerated debt service because of concern about future competition should not be worse off than an issuer that simply retires an existing bond early. For example, an issuer that originally financed a facility with bonds having a 30 year term for normal business reasons, but who sells the first 3 years of output to a private user, is not precluded from retiring the bonds early because the measurement period is suddenly shorter. The result should be the same where the issuer issues shorter refunding bonds.

We suggest that the issuer should be able to test either the use during the period of the combined issue or during the term of the refunding issue alone, but that the ability to test the term of the refunding issue alone should be limited to those cases where the use during the period of the refunding would not adversely affect the status of the refunded bonds had they remained outstanding. In addition, we believe issuance of refunding bonds with shorter terms than the refunded bonds should not reduce the measurement period.

**Application of Section 1.150-1(c)(3) to Refundings.**

This section allows an issuer to treat multipurpose issues as separate for most purposes except the $15,000,000 per issue limit of section 141(b)(5). We have previously suggested that it be amended to clarify that it does not change the express rule of Notice 87-69 allowing an issuer to bifurcate a multipurpose issue for purposes of that limitation. In addition, however, there is an issue with the effective date of the section 1.150-1(c)(3) multipurpose issue rule. The rule itself provides that “all allocations under this paragraph (c)(3) must be made in writing on or before the issue date.” In addition, section 1.150-1(a)(2) provides that:
Except as otherwise provided in this paragraph (a)(2), this section applies to issues issued after June 30, 1993 to which § 1.148-1 through 1.148-11 apply. In addition this section (other than paragraph (c)(3) of this section) applies to any issue to which the election described in § 1.148-11(b)(1) is made.

While the purpose of this limitation is not clear, it probably was intended to prevent an issuer from claiming that a bond changed its nature after the fact. For example, an issuer might claim that bonds subject to the alternative minimum tax were partially governmental so a refund should be due on the governmental part. The rule could, however, be read to have unintended consequences in the case of a refunding.

Where an issuer wishes to refund a multipurpose issue where the election under -1(c)(3) was not made, either because the issue predated the effective date of the election and so the election was impossible, or because no election was considered necessary at the time of the issuance of the prior issue, it seems clear that there is no problem because the issuer can simply make the election with respect to the refunding. Where, however, the issuer only wishes to refund one portion of that prior issue, it would appear that literally no election can be made since the refunding issue itself is not a multipurpose issue. The absurdity of this result can be seen by following this interpretation to its logical conclusion. If, for example, an issuer wishes to refund the governmental portion of a prior issue, for purposes of the rule prohibiting advance refundings of a private activity bond, it can do so under section 1.149(d)-1(1). However, for other purposes, it would appear that, while the advance refunding could be tax-exempt, it would be a private activity bond and thus subject to the alternative minimum tax.

Section 1.150-1(c)(3) should be clarified to indicate that it permits partial refundings of prior issues that were not themselves the subject of an election.
COMMENTS REGARDING REMEDIAL ACTION

Rules Regarding Mandatory Redemption for Expected Intentional Action

Substantial Period of Time. Section 1.141-2(d)(2)(ii) provides that an action that is reasonably expected on the issue date may be disregarded if, among other things, the issuer is required to take remedial action when the action occurs and if the issuer reasonably expects, as of the issue date, that the financed property will be used for a governmental purpose for a substantial period before the action.

Since the rule does not apply when there is an arrangement with a non-governmental person as to private use of the issue date, we think a year (or perhaps even less) can be a substantial period of time.

Also, there are gaps between this rule and the general rule that an issuer must reasonably expect to meet the governmental use requirements for the entire term of the issue in that the mandatory redemption rule assumes the issuer has reasonable expectations that some identifiable intentional act will occur and when it will occur. The case where the issuer expects “something” to happen, but does not know what or when, is not covered. For the foreseeable future, that is the plight of issuers in the utility industry. In these cases the requirement that governmental use continue for a substantial period of time should be satisfied by an expectation that it will continue for an unknown period of time. This interpretation provides adequate protection against abuse since the mandatory redemption provision requires that there not be any arrangement with a non-governmental person regarding intentional action as of the issue date.
Special Rule for Reasonably Expected Mandatory Redemptions

Measurement Period. This rule provides that, if on the issue date the issuer reasonably expects that an action will occur during the term of the bonds to cause the private business or loan test to be met and is required to redeem bonds to meet the reasonable expectations test of 1.141-2(d)(2), the measurement period ends on the reasonably expected redemption date.

It appears that the reference to “reasonably expected redemption date” is a reference to expectations on the date of issue. Frequently, the redemption date will not be known. In such cases, the reasonably expected redemption date probably is a moving target and the burden is on the issuer to be sure that, at any given time, the cumulative private use is not so high as to exceed the limitation if the bonds have to be redeemed on the soonest reasonably expected date.

The Percentage of Nonqualified Bonds Should Exclude Permissible Private Use and Be Based on Use Over Time

The Temporary Regulations contain no special rules for determining the percentage of nonqualified bonds for output facilities. Under the general rule of section 1.141-12(j)(1), the percentage of outstanding bonds that constitutes nonqualified bonds “equals the highest percentage of private business use in any one year period commencing with the deliberate action.” This rule is inappropriate for two reasons: first, it takes no account of permissible private use, and second, it bases the impermissible use on use during a measurement period that includes only the time after the deliberate act and only the worst single year within that period.

This approach can yield capricious results. For example, an issuer that sold 10 percent of the output of the facility for the 30 year term of a financing and then sold an additional 10 percent for one-year would be required to redeem 20 percent of the bonds although the private use was less than 11 percent over the term of the issue and the impermissible use under the law

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was only 1 percent. On the other hand, an issuer who sold 30 percent of the output for 10 years of the 30 year term and then sold 10 percent of the output for the last 20 years would be required to redeem only 10 percent of the bonds although the total private use was over 16 percent and the impermissible use under the law was six percent.

These arbitrary, contradictory results have been rationalized on the ground that the rule is justified given the generous approach to “use over time” in the new Final Regulations. Whatever virtue this justification may have for other bonds, it has no application to output facilities. Use of output facilities has always been determined over time. There is no suggestion in the 1986 Act or the legislative history thereof that Congress intended to change this approach. The IRS has recognized this lack of congressional intent in at least two private rulings.

Nonetheless, the measurement of use over time does involve special considerations with respect to the amount of nonqualified bonds. Where the percentage of private use in the early years exceeds the statutory percentage so that the use is permissible only because there is to be a lower percentage in the later years, that aspect must be taken into account in determining the nonqualified percentage. For example, assume an issuer finances an output facility over 30 years and sells 20 percent of the output for 15 years with $150,000,000 of bonds. In the 16th year, the issuer sells 10 percent of the output per year for the remaining 15 years. In this case the total private use of the bond proceeds is 15 percent. The nonqualified percentage of bonds should be five percent, but it should probably be applied against the original amount of bonds.

A similar approach should be applied to the $15,000,000 nonqualified amount rule. In the above example, if the original bond issue was $150,000,000, the original sale was within the $15,000,000 limit. The second sale increases the nonqualified amount to $22,500,000. Since the
nonqualified amount is applied to the original amount of the bonds, the issuer would be required to take corrective action with respect to $7,500,000 of bonds.

**Allocation of Disposition Proceeds**

Section 1.141-12(c)(3) of the 1997 Final Regulations provide:

If property has been financed by different sources of funding, for purposes of this section, the disposition proceeds from that property are first allocated to the outstanding bonds that financed that property in proportion to the principal amounts of those outstanding bonds. In no event may disposition proceeds be allocated to bonds that are no longer outstanding or to a source not derived from a borrowing (such as revenues of the issuer) if the disposition proceeds are not greater than the total principal amounts of the outstanding bonds that are allocable to that property. [emphasis added]

**Anticipatory Remedial Action.** The rule that disposition proceeds may not be allocated to bonds that are no longer outstanding should not apply where, rather than taking deliberate action and then defeasing bonds, the issuer adopts a plan of retiring bonds early so as to be able to make private sales later.\(^{34}\) In fact many MOUs are adopting plans to retire their debt early. This strategy should not be disadvantaged as compared to leaving the debt out (perhaps backed by a sinking fund) until the private transaction actually occurs. There may be other cases where an issuer acquires additional governmental property in anticipation of a disposition of property. We think there is little possibility of abuse of a rule that allows deliberate action to be cured by anticipatory remedial action as long as the remedial action meets the applicable requirements (such as retiring a strip or longer of the maturities) and the issuer documents the purpose of the remedial action. We do not believe, however, that the documentation requirement should apply

\(^{34}\) We understand that this strategy has already been implemented by some issuers and has been recommended by counsel to many more.
to remedial action taken prior to any notice of such a requirement. We suggest an addition to Treasury Regulations section 1.141-12(l) as follows:

(3) if a remedial action is taken prior to the date that the deliberate action resulting in private business use or a private loan occurs, such remedial action will be treated as meeting the requirements of paragraph (d),(e) or (f) of this section if it would have met the requirements of one of those paragraphs if the deliberate action had been taken on the date the remedial action was taken and if the issuer documented its intention that the remedial action was taken in anticipation of the possibility of future deliberate actions that may result in the private business use or private loan tests being met. The documentation requirement shall not apply to remedial action taken prior to [the date the final regulations are final.]

Allocation of Disposition Proceeds First to Obligations. The provision that requires an allocation of disposition proceeds first to borrowings (presumably including taxable borrowings) up to the amount thereof is bad policy to the extent it foreshadows a rule that requires an issuer to allocate private use of a facility financed with a combination of debt and equity first to the debt, or pro rata to the debt and equity.

TRANSITION RULES

The Change in Use Rules Should Not Apply to Bonds Subject to the 1954 Code

The change in use rules were developed in the early 1990s. Prior to that time, it was relatively settled law that eligibility for tax-exempt status was generally determined on the basis of arrangements in place or expected on the date of issue. See Rev. Rul 77-416. See also G.C.M. 36555, note 4, supra, which stated that it was long established policy to determine eligibility for tax-exempt status on the date of issue absent some scheme to pass on the benefits of the financing to a private party. Congress expressly reflected the notion that the determination is made on the date of issue in its discussion of the advance refunding rule of section 1313(b) of the 1986 Act. Thus, the Conference Report states:
Generally, the portion of the proceeds of the refunding bonds attributable to private use will be determined at the time the original bonds are issued. Similarly, in the case of a second advance refunding, this private use portion is determined by reference to the original bond issue, including bonds issued before 1986. However, if there is a change in facts or circumstances, not originally anticipated at the time of the original issuance, which alters the percentage of private use of the underlying facility, the percentage of private use of the refunding bonds is to take into account the change in circumstances. Thus, for example, if a governmental participant owner of an output facility sells a portion of its ownership interest in the facility to an investor-owned utility (which sale was not anticipated at the time of original issuance), the percentage of private use of refunding bonds issued after such sale must reflect the increased percentage of private use resulting from the sale. Similarly, if a private participant sells its interest to a governmental participant, the reduction in percentage also is to be taken into account in a later refunding issue. Conference Report at II-738,739.

Based on this legislative history, the change in use rules should not apply to 1954 Code bonds, a clarification that would go a long way toward solving the problems of the public power industry with respect to present and future excess power generation from large output facilities financed in the early and mid-1980s.

**ELECTING THE REGULATIONS IN WHOLE SHOULD NOT BE REQUIRED FOR PRE-EXISTING TRANSACTIONS**

In these comments, we have generally attempted to identify cases in which the Temporary Regulations change existing law in such a manner as to create private use where none previously existed. In many instances, the effect of those changes will be to preclude election of the Temporary Regulations in whole because the election would be fatal to bonds already outstanding and future refunding bonds because of transactions that have already occurred. The reason for requiring the election in whole presumably is to encourage compliance with the requirements of the regulations along with allowing that which the regulations permit. Nothing can be done, however, about what occurred in the past. Therefore, we suggest that the requirement that the regulations be elected in whole not apply to transactions entered into before the effective date of the regulations.
Effective Date of Regulations for Purposes of Applying Sections 141(a)(4) to Refundings

Section 141(a)(4) requires that the nonqualified amount with respect to an issue and all prior outstanding issues not exceed $15,000,000. Where refunding bonds are issued under the Temporary Regulations, an issue arises as to how the nonqualified amount with respect to prior issues not subject to the Temporary Regulations should be determined, i.e., whether the nonqualified amount of the prior issue should be determined under the Temporary Regulations, notwithstanding that the Temporary Regulations did not exist at the time of the prior issue. We think the answer should depend on whether the issuer elects to apply the Temporary Regulations to the prior issue. For example, assume bonds were issued to finance half the cost of a facility prior to the publication of the Temporary Regulations and contractual arrangements were structured in such a manner as to allow the balance to be financed without exceeding the $15,000,000 limit. Now the issuer wishes to finance the balance of the cost and, under the Temporary Regulations, the nonqualified amount of the first issue would be greater than was expected. The nonqualified amount of the first (but not the second) issue should be determined without application of the Temporary Regulations unless the issuer elects to apply the Temporary Regulations to the prior issue.

Effective Date – Application to 1954 Code Bonds

There is an ambiguity in the effective date provision of both the 1997 Final Regulations and the Temporary Regulations regarding their application to refunding bonds that are grandfathered under section 1313 of the 1986 Act.

Under section 1.141-15(b), the 1997 Final Regulations apply to bonds issued on or after May 16, 1997 “that are subject to section 1301” of the 1986 Act. Section 1.141-15(c) provides that the Final Regulations do not apply to any bonds issued on or after May 16, 1997 to refund a
bond to which the Final Regulations do not apply unless the weighted average maturity of the refunding bonds is longer than the weighted average maturity of the refunded bonds or, in the case of short-term financings such as bond anticipation notes, longer than 120 percent of the weighted average economic life of the facilities financed. Parallel provisions apply to the Temporary Regulations. Thus, under section 1.141-15T(f), the Temporary Regulations apply to bonds issued on or after February 23, 1998 “that are subject to section 1301” of the 1986 Act. With respect to refunding bonds, section 1.141-15T(g) provides that the Temporary Regulations do not apply to bonds issued on or after February 23, 1998 to refund bonds to which the Temporary Regulations do not apply unless the weighted average maturity of the refunding bonds is longer than the weighted average maturity of the refunded bonds, or, in the case of short-term financings such as bond anticipation notes, longer than 120 percent of the weighted average economic life of the facilities financed. In neither case is the application to refunding bonds explicitly limited to refundings to which section 1301 applies.

Under section 1313, current and advance refundings of bonds subject to the 1954 Code are not subject to section 1301 of the 1986 Act if, among other things, the 120 percent average life limit is met. Thus, where a refunding of a 1954 Code bond has weighted average maturity greater than that of the refunded bonds, the 1997 Final and the Temporary Regulations might be interpreted as applying, even though the weighted average maturity does not exceed the statutory 120 percent limit of section 1313. That this result was not intended is suggested by the provisions applying the 120 percent limit to refundings of short-term obligations. It would be most peculiar if refunding bonds with a term of 120 percent of the life of the assets financed could escape the Final and Temporary Regulations, if the refunded issue was short, whereas a refunding of a longer issue could not if it extended the maturity by even a day.
Moreover, to apply the Final and Temporary Regulations, with their myriad rules that had no counterparts under the 1954 Code, to refundings grandfathered by Congress would clearly violate legislative intent. Congress provided the exemption from the limitations of section 1301 of the 1986 Act. The IRS should not take that exemption away by regulation without authority from Congress to do so. The Final and Temporary Regulations should be clarified to limit their mandatory application to refunding bonds issued after the relevant date that not only extend maturity, but that also are subject to section 1301 of the 1986 Act.

**Election of Regulations in Whole – Should Not Apply to 1954 Code Bonds**

A large portion of the public power bonds currently outstanding are bonds governed by the transition rules of section 1313 of the 1986 Act. Many of the rules of the Temporary Regulations are different than those under which such financings were structured. An issuer of such bonds wishing to take advantage of provisions such as the stranded cost rule or the open access rule (in the latter case with respect to bonds issued after May 23, 1998) cannot be reasonably expected to have complied with all of the new rules of the new Regulations, many of which are specific to the 1986 Act or its legislative history, and are not applicable to those grandfathered transactions in any event. Thus, the requirement for electing in whole should not apply to these bonds.

**Cross Reference to Discussion of Other Transition Provisions**

At page 21 we discuss the need to broaden the transition rule for requirement contracts if the new rule is retained. At pages 50-57 we discuss the transition provisions relating to open access to transmission.
APPENDIX B

REFERENCES IN 1986 LEGISLATIVE HISTORY
TO TAX-EXEMPT BONDS BECOMING TAXABLE

Set forth below are all the references to tax-exempt bonds becoming taxable in the legislative history of the 1986 Act.

HOUSE REPORT

Failure to comply with the set-aside and rental requirements at any time during the qualified project period results in the interest on the bonds becoming taxable, retroactive to the date of issue. Under Treasury Department regulations, however, if noncompliance with the requirements is corrected within a reasonable period (60 days) after the noncompliance reasonably should have been discovered, the tax-exempt status of the bond interest is not affected (Treas. Reg. sec. 1.103-8(b)(6)). House Report at 498.

The above was a discussion of an existing special statutory provision applicable only to housing bonds.

If the $40 million limit is exceeded for any owner or principal user as a result of a change during the test period, interest on the issue of IDBs that cause the limit to be exceeded is taxable from the date of issue. The tax-exempt status of interest on other, previously issued, IDBs is not affected. House Report at 500, n.14.

The above describes an existing statutory provision.

Issuers of IDBs, student loan bonds, bonds for section 501(c)(3) organizations and all mortgage subsidy bonds must report certain information to the Internal Revenue Service about the bonds issued by them during each preceding calendar quarter…Interest is taxable on bonds with respect to which the required report is not made. House Report at 514.

The above discussion reflects a specific statutory rule.

Many States provide for the creation of tax or utility districts that are themselves qualified governmental units to provide essential governmental functions to an area within a larger such governmental unit. During an initial development period, the land in such a district may be owned by a single developer (e.g., a redevelopment agency), or a limited group of developers, who are proceeding with all reasonable speed to develop and sell the land to members of the general public for residential or commercial use. The committee intends that bond proceeds used in such situations to finance facilities for essential governmental functions such as extensions of municipal water systems; street paving, curbing (including storm water collection), and sidewalk and street-light...
installation; and sewage disposal generally not be treated as used in the trade or business of the developers. Rather the tax status of the bonds generally will be determined by reference to the ultimate (i.e., after the initial development period) use of the facilities. Such bonds may be treated as essential function (i.e., governmental) bonds, or as exempt-facility bonds, provided that (1) the facilities are designed to serve members of the general public in the governmental unit on an equal basis; (2) ultimate ownership and operation of the facilities is with persons other than the developers (e.g., the governmental unit); and (3) development of the district for sale and occupation by the general public proceeds with reasonable speed. Failure of the developers to complete the district for use and occupancy by the general public, or financing of any facilities to be used by one or a limited group of persons, results in interest on the bonds being taxable from the date of issue. See also, the discussion of the private loan bond restriction, below, for rules regarding the treatment as ‘excluded loans’ of mandatory taxes or other assessments of general application that may be levied in connection with certain types of improvements. House Report at 523.

The above discussion is an expression of intent addressing a special situation not previously addressed.

The bill provides two penalties for failure to comply with the set-aside and rental use requirements during the qualified project period. First, as under present law, interest on the bonds used to finance the project becomes taxable, retroactive to the date of their issuance. In addition to this present-law rule, failure to correct any noncompliance with the set-aside requirement after it is discovered or reasonably should have been discovered, or termination of use as rental property, results in all interest on bond-financed loans being nondeductible, effective from the first day of the taxable year in which the noncompliance occurred. If the noncompliance arises solely because of failure to satisfy the set aside requirement, interest incurred on bond financed loans after a project is again in compliance with that requirement is deductible. Interest on the bonds, however, remains taxable (as under present law). House Report at 534.

46 For a more complete discussion of new rules governing deductibility of interest on bond–finance loans, see the discussion in 7, below, regarding changes in use of property with respect to which tax–exempt financing is provided.
The above is a discussion of statutory rules specific to single family housing.

If an issue of section 501(c)(3) organization bonds causes the $150 million limitation to be exceeded, only the issue that causes the limitation to be exceeded is taxable. If the $150 million limitation is violated with respect to an issue by a change of owners or principal users of bond-financed facilities at any time during the three-year test period, the interest on that issue is taxable from the date the bonds were issued. In no case does this restriction affect the tax-exemption of interest on bonds issued prior to January 1, 1986...House Report at 540.

The above discussion describes the operation of a specific statutory provision.

The bill codifies the application of the present-law reasonable expectations test as it applies to subsequent acts to earn arbitrage. As under present law, the determination of whether bonds are arbitrage bonds generally is based upon the reasonable expectations of the issuer on the date of issue. If subsequent intentional acts are taken after the date of issue to earn arbitrage, however, the reasonable expectations test will not prevent the bonds from being arbitrage bonds. See, e.g., Rev. Rul. 80-91, 1980-1 C.B. 29, Rev. Rul. 80-92, 1980-1 C.B. 31, and Rev. Rul. 80-188, 1980-2 C.B. 47.

For purposes of this continuing requirement, any investment with respect to which impermissible arbitrage earnings accrue will result in the bond interest becoming taxable, retroactive to the date the bonds are issued. The committee intends that the determination of whether intentional actions to earn arbitrage have been taken is made on a case-by-case basis, taking into account all facts and circumstances that a prudent investor would consider in determining whether to invest bond proceeds. House Report at 553.

The above discussion describes a statutory provision applicable only to arbitrage.

The bill includes new rules to prevent the early issuance of bonds. Under these rules, an amount equal to at least five percent of bond proceeds must be expended for the governmental purpose of the borrowing within 30 days after the date the bonds are issued. Additionally, an amount equal to all bond proceeds (other than amounts invested in a reasonably required reserve or replacement fund) must be expended for that purpose within three years after the date of issuance. The Treasury Department is permitted, upon specific request of the issuer, to extend the 30-day and 3-year periods in cases where the delay in expenditures results from events not within the control of the beneficiary of the bonds or the issuer (e.g., Acts of God). Failure to comply with this restriction renders the interest on the bonds taxable, retroactive to the date of issue. House Report at 558.
The above discussion describes a provision that was not enacted.

The committee understands that, in certain cases, statements (i.e., accounts payable) may not have been received in the normal course of business within 30 days after construction is more than 90 percent completed. The committee intends that where undue hardship otherwise would result, the Treasury Department may upon application by the issuer permit retention of bond proceeds in an amount not exceeding these accounts payable until the amounts may be ascertained with certainty and paid at the earliest date after being so ascertained. For purposes of this rule, so-called ‘retainage’ is not treated as an unascertained amount payment of which may be delayed. Any unreasonable delay in payment of all accounts payable accompanied by a failure to redeem excess bonds renders the interest taxable from the date of issue. House Report at 559.

The above discussion describes a provision requiring expenditure of all proceeds which was not enacted.

Under present law, interest on bonds may become taxable, either retroactively to the date of issue or (if specifically provided in the Code) prospectively, if certain events occur. The bill provides, that in addition to any loss of tax-exemption provided under present law, certain expenditures by persons using property financed with nonessential function bonds are nondeductible for Federal income tax purposes in certain circumstances.\textsuperscript{70} Under this provision, interest (including the interest element of user fees) becomes nondeductible if property financed with the proceeds of these bonds is used in a manner not qualifying for tax-exempt financing at any time before the bonds are redeemed.\textsuperscript{71} The interest or other user charges are nondeductible, effective from the first day of the year in which the change of use occurs and continue to be nondeductible until the date on which the property again is used in the use for which the bonds were issued, or the date on which the bonds are redeemed, if earlier.

\textsuperscript{70} These additional restrictions do not apply to property financed with essential function bonds; however, those bonds remain subject to all present–law rules under which the bond interest may become taxable.

\textsuperscript{71} This requirement applies throughout the prescribed qualified project period to the case of projects for residential rental property financed with exempt–facility bond.
If the use of governmentally owned bond-financed property changes from a use qualifying for tax-exempt financing to a nonqualified use and a governmental unit continues to own the property, a portion of any rent or other user fee paid by the non-governmental person using the property in the nonqualified use is nondeductible. The nondeductible portion is an amount of rent or other user fees equivalent to the interest payments on that portion of the bonds attributable to the portion of the facility used in a nonqualified use. For example, if a governmentally owned airport terminal were converted to an office or retail complex, each non-governmental user of the converted property would be denied deductions for rent and other user fees with respect to the property, to the extent of the interest payments on an allocable portion of the bonds. If the allocable bond interest payments exceed otherwise deductible any rent or other user charges, the full amount of those deductions is denied. If bond-financed property is required to be governmentally owned, but ceases to be, interest (including the portion of any rent or other user charges that is treated as interest for Federal income tax purposes) paid by the new owner with respect to the property is nondeductible. House Report at 560-1.

Neither paragraph of this discussion of the proposed change in use rules denying tax deductions states any general rule of taxability for change in use, although a general rule might be an inference from the structure of the first sentence. In this respect, however, the text of the Conference Report, quoted on page B-9, clarifies that there is no general rule of taxability. It is unclear what footnote 70 is referring to but it states no general rule.

SENATE REPORT

As indicated above, the low- or moderate-income occupancy requirement is reduced from 20 percent to 15 percent in targeted areas. For purposes of this reduced low- or moderate-income occupancy requirement, the term targeted area means (1) a census tract in which 70 percent or more of the families have incomes that are 80 percent or less of the applicable statewide median family income, or (2) an area of chronic economic distress as determined under statutory criteria (sec. 103A(k)(3)). Failure to comply with the low- or moderate-income occupancy and rental requirements at any time during the qualified project period results in the interest on the bonds becoming taxable, retroactive to the date of issue. If noncompliance with the requirements is corrected within a reasonable period (at least 60 days) after the noncompliance reasonably should have been discovered, the tax-exempt status of the bonds is not affected (Treas. Reg. sec. 1.103-8(b)(6)). Senate Report at 815-16.

The above is a discussion of a specific statutory provision.
Issuers of IDBs, student loan bonds, bonds for section 501(c)(3) organizations, and all mortgage revenue bonds must report certain information to the Internal Revenue Service about bonds issued by them during each preceding calendar quarter. This report is due on the 15th day of the second month after the close of the calendar quarter in which the bonds are issued. Interest is taxable on bonds with respect to which the required information report is not made. Senate Report at 824-5.

The above discussion describes an existing statutory provision.

Ninety percent of the rebate required with respect to any issue must be paid at least once each five years, with the balance being paid within 30 days after retirement of the bonds. Failure to rebate arbitrage profits as required renders the bonds taxable as of the date of issue. Senate Report at 21.

The above is a discussion of a specific provision.

The bill provides two penalties for failure to comply with the low- or moderate-income occupancy and rental use requirements during the qualified project period. First, as under present law, interest on the bonds used to finance the project becomes taxable, retroactive to the date of their issuance. In addition to this present-law rule, failure to correct any noncompliance with the low- or moderate income occupancy requirement within a reasonable period after it is discovered or reasonably should have been discovered, or termination of use as rental property, results in all interest on bond-financed loans being nondeductible, effective from the first day of the taxable year in which the noncompliance occurred. If the noncompliance arises solely because of failure to satisfy the low- or moderate income occupancy requirement, interest incurred on bond-financed loans after a project is again in compliance with that requirement is deductible. Interest on the bonds, however, remains taxable (as under present law). Senate Report at 835-6.

The above is a discussion of a specific provision.

The bill codifies the application of the present-law reasonable expectations test as it applies to subsequent deliberate and intentional acts to earn arbitrage. As under present law, the determination of whether bonds are arbitrage bonds generally is based upon the reasonable expectations of the issuer on the date of issue. If subsequent deliberate and intentional acts are taken after the date of issue to produce arbitrage, however, the reasonable expectations test will not prevent the bonds from being arbitrage bonds. (See, e.g., Rev. Rul. 80-91, 1980-1 C.B. 29, Rev. Rul. 80-92, 1980-1 C.B. 31, Rev. Rul. 80-188, 1980-2 C.B. 47, and Rev. Rul. 85-182, 1985-46 I.R.B. 4 (Nov. 4, 1985).)

35 For a more complete discussion of new rules governing deductibility of interest on bond–financed loans, see the discussion below regarding changes in sue of bond–financed property.
Violation of this continuing requirement results in the bond interest becoming taxable, retroactive to the date the bonds are issued. The committee intends that the determination of whether deliberate and intentional actions to earn arbitrage have been taken is made on a case-by-case basis. 48 Senate Report at 844-5.

The above is a discussion of a specific statutory provision.

The bill provides that a special penalty, in lieu of loss of tax-exemption, applies to certain failures to rebate arbitrage profits in the case of governmental bonds and qualified 501(c)(3) bonds. Under this rule, issuers are liable for a penalty equal to 100 percent of any amount not rebated when due. The penalty may be waived by the Treasury Department if the error is due to inadvertence on the part of the issuer. If an issuer corrects any underpayment (and pays any penalty due) within six months of being notified by the Treasury Department, the bonds do not become taxable (assuming no willful disregard of the rebate requirements). If the issuer fails to pay all amounts due within this six-month period or acts in willful disregard of the rebate requirement, the bonds are taxable retroactive to the date of issuance. Senate Report at 847.

The above is a discussion of a specific statutory provision.

Under present law, interest on bonds may become taxable, either retroactively to the date of issue or (if specifically provided in the Code) prospectively, if certain events occur. The bill provides that, in addition to any loss of tax-exemption provided under present law, certain expenditures by non-governmental persons using property financed with IDBs, mortgage revenue bonds, qualified 501(c)(3) bonds, and other private loan bonds for which tax-exemption is permitted are nondeductible for Federal income tax purposes in certain circumstances. Under this provision, interest (including the interest element of user fees) becomes nondeductible if property financed with the proceeds of these bonds is used in a manner not qualifying for tax-exempt financing at any time before the bonds are redeemed. 52 The interest or other user charges are nondeductible, effective from the first day of the year in which the change of use occurs and continue to be nondeductible until the date on which the property again is used in the use for which the bonds were issued, or the date on which the bonds are redeemed, if earlier.

48 Although the amended arbitrage rules generally apply only to bonds issued after the date of the bill's enactment, no inference is intended that such subsequent deliberate and intentional actions to earn arbitrage profits are permitted under present law.

52 This requirement applies throughout the prescribed qualified project period in the case of projects for residential rental property.
Governmentally Owned property

If bond-financed property is required to be governmentally owned, but ceases to be, interest (including the portion of any rent or other user charges that is treated as interest for Federal income tax purposes) paid by the new owner with respect to the property is nondeductible. If the use of governmentally owned bond-financed property changes from a use qualifying for tax-exempt financing to a nonqualified use and a governmental unit continues to own the property, a portion of any rent or other user fee paid by the non-governmental person using the property in the nonqualified use is nondeductible. The nondeductible portion is an amount of rent or other user fees equivalent to the interest payments on that portion of the bonds attributable to the portion of the facility used in a nonqualified use. For example, if a governmentally owned airport terminal were converted to a private office or retail complex, each non-governmental user of the converted property would be denied deductions for rent and other user fees with respect to the property, to the extent of the interest payments on an allocable portion of the bonds. If the allocable bond interest payments exceed otherwise deductible rent or other user charges, the full amount of those deductions is denied.

Facilities (other than owner-occupied housing) owned by non-governmental persons (other than section 501(c)(3) organizations). If non-governmentally owned bond-financed facilities are converted to a use not qualifying for such tax-exempt financing, interest on loans financed with bond proceeds becomes nondeductible. This restriction applies in the case of a change in ownership accompanied by a change in use as well as a change in use where the same person continues to own the property for Federal income tax purposes. The bill provides a special rule for multifamily residential rental projects that fail to meet the 20- or 25-percent low- or moderate-income occupancy requirements applicable to such projects, or which otherwise cease to be used in a manner qualifying for tax-exempt financing. Under this special rule, the owners of the project are denied interest deductions with respect to bond-financed loans. However, as under the present-law rules on loss of tax-exemption, if post-issuance noncompliance is corrected within a specified period after it is discovered or reasonably should have been discovered, there is no loss of deductions. (See, the section on IDBs for multifamily residential rental property, above, for a more complete discussion of this exception.)

53 A change in use of property financed with small-issue bonds is deemed to occur if post-issuance capital expenditures test result in the $10 million small-issue size limitation being violated. Similarly, a change in use to a use specifically prohibited under the Code results in application of these penalties, including such a change in use of facilities located on load with respect to which qualified redevelopment bond financing was provided.
Mortgage revenue bond-financed housing

If a residence financed with qualified mortgage bonds or qualified veterans’ mortgage bonds ceases to be the principal residence of at least one of the mortgagors for a continuous period of 1 year or more, the mortgagors are denied a deduction for interest paid with respect to the bond-financed mortgage loan on the residence. For purposes of these rules, the term principal residence has the same meaning as under section 1034 of the Code (regarding non-recognition of gain on the sale of a principal residence). The Treasury Department is authorized to waive this penalty in cases where undue hardship otherwise would result and the non-compliance arises from circumstances beyond the control of the mortgagors (e.g., a residence occupied by minor children of a deceased mortgagor). The committee further is aware that certain housing comprised of fewer than five units, one of which is occupied by the owner, is treated as single-family housing under the qualified mortgage bond rules. In the case of such housing, whether the owner uses the property as his or her principal residence is determined by reference to use of the owner-occupied unit (or units).

Qualified 501(c)(3) bond-financed property

If the use of property financed with qualified 501(c)(3) bonds changes to a use not qualified for such financing (at the time the bonds were issued), the section 501(c)(3) organization benefiting from the bonds is treated as using the property in an unrelated trade or business (see, sec. 511) from the first day of the year in which the change in use occurs. Interest on the bond-financed loans is treated as incurred in that unrelated trade or business and is nondeductible against any income of the business. In the case of a change in ownership of section 501(c)(3) property (other than a transfer to a qualified governmental unit or another section 501(c)(3) organization), the new owner of the property is denied deductions for interest (including all amounts treated as interest for Federal income tax purposes) incurred in connection with the acquisition of the property. Proportionate disallowance in the case of partial change in use The Treasury Department is authorized to prescribe regulations for allocating interest on bond-financed loans in the case of a change in use (or ownership) of only a portion of a facility (or a portion of the facilities financed by an issue). In the case of partial changes in use (including a change in ownership) where an interest element is imputed as a portion of another user fee (e.g., rent), the maximum amount treated as nondeductible will be the amount of the rent or other user fee. In general, the committee anticipates that these regulations will provide that interest is allocated proportionately to all users of the facility based upon factors such as relative cost, floor space occupied, relative rental value, or another comparable method. In making this allocation, each user (owner) is treated as the sole user (owner) of all common elements of a facility. Senate Report at 851-853.

See analysis of similar provisions in House Report.
CONFERENCE REPORT

Present Law

Tax-exempt bonds generally are not required to be redeemed if the use of bond-financed property changes from a use qualifying interest on the bonds for tax-exemption to a nonqualified use. In certain cases, however, interest on the bonds becomes taxable.

House Bill

The House bill provides that a change in use of property financed with private activity bonds to a use not qualifying for tax-exempt financing generally results in loss of income tax deductions for rent, interest, or equivalent amounts paid by the person using the property in the nonqualified use. Section 501(c)(3) organizations realize unrelated business income with respect to any such use. These consequences apply in addition to any loss of tax-exemption on bond interest provided under present law.

Senate Amendment

The Senate amendment follows the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment. Effective date.--This provision applies to changes in use of bond-financed property occurring after August 15, 1986, with respect to financing provided after that date. Conference Report at II-733.

The above discussion speaks for itself.

House Bill

Profit Limitations

The House bill modifies the profit limitations applicable to all tax-exempt bonds in several ways. First, the House bill clarifies that the present-law reasonable expectations test does not protect subsequent intentional acts to create arbitrage profits. Thus, if an issuer intentionally acts to create arbitrage profits in excess of that permitted under the general arbitrage restrictions after the date of issue, the bonds are taxable arbitrage bonds.
Conference Agreement

Profit limitations

Subsequent intentional acts to create arbitrage

Under the conference agreement (as under present law), the determination of whether bonds are arbitrage bonds generally is based upon the reasonable expectations of the issuer on the date of issue. If subsequent intentional acts are taken after the date of issue to earn arbitrage, however, the reasonable expectations test does not prevent the bonds from being arbitrage bonds. See, e.g., Rev. Rul. 80-91, 1980-1 C.B. 29, Rev. Rul. 80-92, 1980-1 C.B. 31, and Rev. Rul. 80-188, 1980-2 C.B. 47. For purposes of this continuing requirement, any investment with respect to which impermissible arbitrage earnings accrue may result in the interest on the issue becoming taxable, retroactive to the date the issue was issued. For example, if after the expiration of an allowable temporary period, the issuer continued to invest the bond proceeds at a materially higher yield in order to earn impermissible arbitrage, interest on the bonds would become taxable, retroactive to the date of issue. The conferees intend that the determination of whether intentional actions to earn arbitrage have been taken is made on a case-by-case basis, taking into account all facts and circumstances that a prudent investor would consider in determining whether to invest bond proceeds Conference Report at II-746.

The above discussion describes specific statutory provisions relating to arbitrage.

BLUE BOOK

While the Blue Book is not generally considered to have the same standing as Committee Reports, the Blue Book discussion is consistent with the foregoing analysis. Blue Book at 1135, 1137 n.20, 1152, 1174, 1187, 1201, 1219, 1220 n. 192.
APPENDIX C

TRANSMISSION CONGESTION CONTRACTS,

CONGESTION CHARGES AND RELATED MATTERS
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