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### Legend

Agency =

ISO =

State =

Bonds =

Y =

Dear

This is in response to your request on behalf of Agency for a ruling that permitting the transfer of "firm transmission rights" (as described below) with respect to transmission facilities financed with proceeds of the Bonds will not be treated as a deliberate action that causes the Bonds to be private activity bonds under § 141 of the Internal Revenue Code of 1986 (the "1986 Code") or as industrial development bonds under § 103(b) of the Internal Revenue Code of 1954 (the "1954 Code").

#### FACTS AND REPRESENTATIONS

Agency is a joint powers agency and a public entity organized under the laws of the State. Agency has Y members, each of which is a political subdivision of the State. Agency currently has outstanding bonds, the Bonds, which financed or refinanced costs

associated with several electric power transmission projects (the "Projects"). Some of the Bonds are subject to the 1986 Code and others are subject to the 1954 Code.

Agency owns an undivided ownership interest in, or is otherwise entitled to the transfer capacity of, each of the Projects. Each Project is operated for Agency by another entity. Several of Agency's members participate in each of the Projects. Every participating member in each Project has entered into a take-or-pay contract with Agency for the purchase of the member's ratable portion of the transmission capacity provided by the Project. Under these contracts, each participating member in a Project is entitled to a specific portion of the transmission capacity provided by that Project (the "Entitlements"). The contracts are for a term of years sufficient to amortize Agency's debt burden with respect to the particular Project.

The electric industry is in the midst of significant changes to the way transmission services are purchased and sold as a result of the Energy Policy Act of 1992 and various orders of the Federal Energy Regulatory Commission (the "FERC"), including Order Nos. 888 and 2000 (referred to as "open access"). A primary purpose of open access is to bring about increased competition at the wholesale energy level and, therefore, reduce the cost of wholesale electric energy.

To achieve this purpose, the FERC in Order No. 888 required, among other items, (1) the provision of open access transmission services on a non-discriminatory basis by all FERC-jurisdictional utilities that own, operate, or control interstate transmission facilities, and (2) that a nonFERC-jurisdictional utility that purchases transmission services from a FERC-jurisdictional utility and that owns or controls transmission facilities must make available open access transmission service to the FERC-jurisdictional utility under terms that are comparable to the service the nonFERC-jurisdictional utility provides itself. In Order No. 2000, the FERC required, among other items, each FERC-jurisdictional utility to make certain filings with the FERC with respect to forming and participating in a regional transmission organization (an "RTO"), which includes independent system operators. Order No. 2000 provides the required characteristics for RTOs such as independence, scope and regional configuration, operational authority, and short-term reliability. The Agency and its members are not subject to the jurisdiction of FERC under §§ 205 and 206 of the Federal Power Act, 16 U.S.C. § 824d and 824e (2001) (the "Act").

Several of Agency's members signed an agreement (the "Agreement") to become members of the ISO, a nonprofit public benefit corporation that provides non-discriminatory access to the transmission facilities of its members. Accordingly, the transmission capacity held by those ISO members are now under the operational control of the ISO. The Agreement provides that each ISO member retains the right to dispose of the ISO member's transmission facilities or entitlements to capacity, subject to the consent of the ISO, and consent may not be unreasonably withheld. In PLR 200240028, we ruled that the members' joining the ISO would not be treated as a

deliberate action that causes the Bonds to be either private activity bonds under § 141 of the 1986 Code or as industrial development bonds under § 103(b) of the 1954 Code. However, the ruling did not address whether the auction or transfer of a firm transmission right (an "FTR") would be a sale or exchange of a Bond financed Project to a non-governmental person. The Agreement requires the participating Agency members to allow the auction or other sale of FTRs if Agency obtains a ruling that such a disposition would not cause the participation in the ISO to be a sale, exchange, or other disposition of the Bond financed property. Agency is requesting such a ruling.

The ISO participants hold the rights to transmission capacity of transmission facilities that they have placed under the operational control of the ISO (the "ISO grid"). The ISO was created to provide open and non-discriminatory access to the ISO grid pursuant to a transmission tariff, which has been approved by the FERC as being consistent with its rules promulgated under the Federal Power Act, 16 U.S.C. § 824d and 824e (2001) (the "Act").

Under the transmission tariff, the ISO will allocate the transmission capacity under its operational control and collect fees from the recipients. If the capacity of the ISO grid exceeds demand, access to the ISO grid will be open to all entities seeking transmission service. The ISO expects that certain transmission lines within the ISO grid will experience times of congestion (when the amount of transmission service requested exceeds the capacity). At times of congestion of those transmission lines, the ISO will provide open and non-discriminatory access through a regime that employs FTRs and market based pricing of usage fees (also known as "congestion fees"). This methodology has been approved by FERC as consistent with its rules.

The holders of FTRs with respect to a transmission line have first priority to use of the transmission line during times of congestion. To the extent that the holders of the FTRs do not exercise their priority rights during times of congestion, access is given to those willing to pay the highest usage fees in addition to the other standard fees for use of the transmission lines. The ISO distributes substantially all of the usage fees to the FTR holders to the extent they did not exercise their priority right. In other words, during times of congestion, the holder of an FTR will either use the transmission line or collect the premium paid by the entity who uses the transmission line.

The ISO determines the amount of FTRs to be assigned to each transmission line subject to usage fees. The ISO allocates the FTRs among the ISO participants that hold the right to transmission capacity along the transmission line. At a prescribed time, the ISO will sell a pro rata portion of each participants' FTRs at auction. At the auction, the FTRs may be purchased by anyone, and the purchaser will hold the FTR for a one year period. After the one year period has expired, the ISO will place the FTRs up for auction again. The ISO participants who have been allocated the FTRs receive the proceeds of the auctions.

Agency further represents that: (1) each Agency member retains all benefits of ownership and its rights and responsibilities in relation to its own transmission lines and facilities that it places under the operational control of the ISO; (2) the ISO exercises operational control for purposes limited under the Agreement; and (3) the compensation earned by the ISO is limited to the grid management charge that is intended only to recovery annual operating expenses and capital costs without a profit. In accordance with the Agreement and additional ISO operating protocols, each participating Agency member must operate and maintain the facilities. Additionally, each Agency member is liable for the risk of loss of its transmission facilities unless the damage is directly caused by the negligent performance of the ISO.

Agency chooses to apply § 1.141-7(g) to the Bonds, as permitted under § 1.141-15(i).

## LAW AND ANALYSIS

Generally, under § 103(a) of the 1986 Code, gross income does not include interest on any state or local bond. Section 103(b)(1) provides that interest on a state or local bond is not excluded from gross income if the bond is a private activity bond which is not a qualified bond (within the meaning of § 141).

Section 141(a) defines the term private activity bond to mean any bond issued as part of an issue which meets either (1) the private business use test and the private security or payment test (the “private business tests”), or (2) the private loan financing test.

Section 141(b)(1) states that except as otherwise provided, an issue meets the private business use test if more than 10 percent of the proceeds of the issue are to be used for any private business use. Section 141(b)(2) provides that an issue meets the private security or payment test if the payment of the principal of, or the interest on, more than 10 percent of the proceeds of such issue is (under the terms of such issue or any underlying arrangement) directly or indirectly (A) secured by any interest in property used or to be used for a private business use, or in payments in respect of such property, or (B) to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used or to be used for a private business use.

Section 141(b)(6)(B) defines private business use to mean use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit. Section 141(b)(6)(A) provides that use as a member of the general public is not taken into account.

Section 1.141-2(d)(1) (of the Income Tax Regulations) provides that an issue is an issue of private activity bonds if the issuer reasonably expects, as of the issue date, that the issue will meet either the private business use tests or the private loan financing test. Section 1.141-2(d)(1) further provides that an issue is also an issue of private

activity bonds if the issuer takes a deliberate action, subsequent to the issue date, that causes the conditions of the private business tests or the private loan financing test to be met.

Sections 103 and 141 to 150 of the 1986 Code were enacted by § 1301 of the Tax Reform Act of 1986. Interest on bonds which are not subject to § 1301 may be excluded from gross income under 103 or 103A of the 1954 Code, which provide similar rules.

Section 1.141-7(g)(4)(ii) provides that an action is not treated as a deliberate action under § 1.141-2(d) if it is taken to implement the offering of non-discriminatory, open access tariffs for the use of electric transmission or distribution facilities in a manner consistent with rules promulgated by the FERC under sections 205 and 206 of the Act (or comparable provisions of state law). Section 1.141-7(g)(4)(ii) does not apply, however, to the sale, exchange, or other disposition (within the meaning of section 1001(a)) of transmission or distribution facilities to a nongovernmental person. Section 1.141-15(i) allows issuers to apply § 1.141-7(g) to any bonds.

Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized.

Incidents of ownership include (1) legal title, (2) contractual duty to pay for capital investment, (3) responsibility to pay maintenance and operating costs, (4) duty to pay taxes, (4) risk of loss, and (6) risk of diminution of value. See Revenue Ruling 79-264, 1979-2 C.B. 92. The benefits and burdens indicative of ownership include (1) right to possession, (2) obligation to pay taxes, (3) responsibility to insure property, (4) duty to maintain property, (5) right to improve property, (6) risk of loss, and (7) legal title. See Keith v. Commissioner, 115 T.C. 605, 611-12 (2000).

The holder of an FTR is entitled to the usage fees on that transmission line for a defined period. An FTR also gives the holder a scheduling priority on the transmission line for a defined period. However, the FTR holder does not have ownership of the underlying transmission facilities.

Under the FTR regimen, the participating Agency members will retain ownership of the underlying Bond financed transmission facilities or entitlements to capacity and the burdens of ownership associated therewith (including the obligation to make payments to Agency sufficient to provide for payment of the debt service on the Bonds and for payment of the costs of operating and maintaining the associated transmission lines). The participating Agency members also retain the right to dispose of Bond financed transmission facilities or entitlements to capacity, subject to the consent of the ISO, and consent may not be unreasonably withheld. Accordingly, because there will

be no change in ownership, there will be no sale of either the underlying Bond financed transmission facilities or the entitlements to capacity under § 1001.

Section 1.141-7(g)(4)(ii) will be applied to the Bonds. Providing open access consistent with a plan approved by FERC depended upon the ability of the ISO to resolve transmission congestion. The ISO resolves transmission congestion by using the FTR auction process and assigning transmission services based on market pricing. This methodology has been approved by FERC as consistent with its rules. Thus, taking part in the FTR system is an action to implement the offering of non-discriminatory, open access tariffs for the use of electric transmission or distribution facilities in a manner consistent with rules promulgated by the FERC under sections 205 and 206 of the Act. Furthermore, there is no sale, exchange, or other disposition (within the meaning of § 1001(a)) of the Bond financed Projects to a nongovernmental person. Therefore, we conclude that the sale of FTRs pursuant to the Agreement will not be treated as a deliberate action with respect to the Bonds because it is an action described in § 1.141-7(g)(4)(ii).

## CONCLUSION

Permitting the sale of FTRs with respect to transmission facilities financed with proceeds of the Bonds will not be treated as a deliberate action that causes the Bonds to be either private activity bonds under § 141 of the 1986 Code or as industrial development bonds under § 103(b) of the 1954 Code.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for rulings.

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

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of

the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Timothy L. Jones  
Senior Counsel, Tax Exempt Bonds Branch  
(Exempt Organizations/Employment Tax  
(Tax Exempt & Government Entities)

cc: