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Department of the Treasury

Washington, DC 20224

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CC:FIP:2-PLR-102587-02

Date:

January 29, 2002

Legend:

Parent =

Company =

SPE =

State A =

State B =

State C =

State D =

State E =

State F =

Commission =

Bonds =

The Act =

Month A =

Date 1 =

Date 2 =

Year 1 =

Year 2 =

a =

b =

c =

d =

e =

f =

This letter is in reply to your letter dated June 11, 2001, as well as subsequent materials furnished to this office on November 7, 2001, and November 20, 2001.

FACTS

Parent is a State A corporation that is the common parent of an affiliated group of corporations which includes Company. Company, a State A corporation, is a regulated public utility engaged in the generation, purchase, transmission, distribution and sale of electric energy over large areas in State A and in State B. Company is under the regulatory jurisdiction of the public service commissions of States A, B, D and E, and the Federal Energy Regulatory Commission (FERC). Company's retail rates are established under the jurisdiction of the state regulatory agencies and its wholesale and transmission rates are regulated by the FERC.

The State A public service commission (Commission) previously approved a power cost adjustment (PCA) mechanism to enable the Company to collect, or require it to refund, a percent of the difference between net power supply costs actually incurred and those allowed in base rates. Retail customer rates in State A are increased or decreased annually to reflect any forecasted changes in the Company's net supply costs for the current PCA year (Month A to Month A) and to true-up any deviation between forecasted and actual costs for the previous PCA year. For the PCA year from Month A of Year 1 to Month A of year 2, the State A public service commission authorized the Company to recover through rate increases approximately \$b which represented a rate increase to Company's business customers of c percent.

Company relies heavily on hydroelectric power for its generating needs and is one of the nation's few electric public utilities with a predominantly hydroelectric generating base. In circumstances of lessened hydroelectric generation, Company is required to use more expensive thermal generation and to purchase power on the wholesale spot market. Deregulation of the electric industry in State C resulted in sharp increases in the wholesale price of replacement power that Company was geographically compelled to purchase. In these circumstances, the Commission and legislators in State A became concerned that an increase in the Company's rates sufficient to cover its increased costs would not be politically or economically feasible. Accordingly, on Date 1, the State A legislature enacted the Act with the intent to provide utilities with a mechanism for recovery of their increased costs while leveling the rate impact of such increase on the utilities' customers.

The Act authorizes the Commission to issue energy costs financing orders in favor of a public utility, pursuant to which energy cost property is created and Bonds secured by this property may be issued by the utility and sold to investors to finance specified energy cost amounts. Energy cost amounts include a utility's fuel or power cost adjustments, the costs of issuing, supporting and servicing Bonds, any costs of

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retiring and refunding the utility's existing debt and equity securities in connection with the issuance of Bonds, as well as taxes related to the recovery of the energy cost bond charge.

As a mechanism to recover energy cost amounts, the Act provides for the imposition and collection of a non-bypassable energy cost bond charge on State A customers of the Company. The energy cost bond charge will be payable by retail consumers of electricity within Company's service territory who use Company's transmission and distribution system, even if those customers elect to purchase electric supply from a third party supplier. Bonds are secured by and payable from energy cost property which includes the right to receive revenues arising from the energy cost bond charge. Under the Act, Bonds must have an expected maturity date no later than five years after issuance and a legal maturity date no later than seven years after issuance. Scheduled principal payments must be made, to the extent practicable, in approximately equal amounts during each year of the term of the Bonds.

The Act authorizes the Commission to issue energy cost financing orders only if the sum of (i) any PCAs then in effect, (ii) any energy cost bond charges then in effect and (iii) the amount (identified by the Company in its application for the financing order) by which the PCA would need to be increased absent the issuance of Bonds would exceed a minimum threshold amount previously approved by the Commission. On Date 2, the Commission approved the Company's application and issued an order establishing a one cent per kilowatt hour as the Company's minimum threshold amount. Thus, any financing order issued by the Commission to Company would be for the recovery of costs in excess of this minimum amount.

The issuance of a financing order creates energy cost property. A financing order, energy cost amounts, and energy cost bond charges that have been determined by the Commission become irrevocable and binding upon the Commission and the Commission does not have authority to revalue or revise the energy cost amounts. Upon its sale or transfer, energy cost property constitutes a current and irrevocably vested property right notwithstanding the fact that the value of the property right will depend upon consumers using electricity and/or the public utility performing certain services. Once the Commission determines the energy cost bond charge, it cannot determine in a later proceeding that the charge is unjust or unreasonable or in any way reduce or impair the value of energy cost property either directly or indirectly by taking the energy cost bond charge into account when setting other rates for the utility. Nor may the amount of revenues arising with respect to the energy cost bond charge be subject to reduction, impairment, postponement or termination, except as contemplated by periodic adjustments to the energy cost bond charge authorized by the Act.

The Act requires each Commission financing order to provide for mandatory adjustment of the energy cost bond charge at least once a year and at such additional intervals, as are specified in the order, upon petition of the electric public utility or its assignee. These adjustments are formula-based to ensure receipt of revenues

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sufficient to provide for the full recovery of energy cost amounts including the timely payment of the principal of, and interest on, and acquisition or redemption premium on, the Bonds in accordance with the expected amortization schedule. The Company, acting as servicer of the energy cost property, will agree in the servicing agreement to file with the Commission each proposed energy cost bond charge adjustment calculated in accordance with the formula.

State A pledges and agrees that neither State A nor any of its agencies, including the Commission, will by legislative action, ballot initiative or other similar process, limit, alter, restrict or impair the energy cost amounts, the energy cost bond charge, the energy cost property, the financing orders or any rights thereunder or ownership thereof or security interest therein or in any way impair the rights or remedies of any Bondholder until the Bonds, including all principal, interest, premium, costs, expenses and arrearages thereon, are fully met and discharged. The Bonds or any financing order will not constitute either a debt or liability of State A or any political subdivision thereof, or constitute a pledge of the full faith and credit of State A or any of its political subdivisions.

The Act provides procedures for assuring that the sale, assignment or other transfer of energy cost property from the Company to the SPE will be perfected under State law and that the security interest granted by the SPE to the trustee (under the indenture pursuant to which the Bonds are issued) in the Energy cost property will be perfected under State A law. The Act further provides that for state law purposes, a transfer by the utility or an assignee of energy cost property will be treated as a sale or other absolute transfer of all of the transferor's right, title and interest, as in a true sale, and not as a pledge or other financing secured by the energy cost property.

PROPOSED TRANSACTION

The Company will file a petition with the Commission requesting a financing order authorizing the issuance of a series of Bonds by the SPE in an aggregate principal amount that will not exceed \$ d.¹ The financing order will authorize energy cost bond charges in an amount needed to service the Bonds, pay transaction costs and provide for credit enhancement for the related series. The financing order will create energy cost property representing the right to collect energy cost bond charges from customers.

The financing order may also authorize the recovery of federal income taxes and state corporate business taxes the Company will incur as it bills customers for energy cost bond charges. If the recovery of taxes is authorized in the financing order, the

¹The Company represents that the costs to be recovered through the issuance of Bonds will consist only of the power supply costs includible in the Year 2 power costs adjustments.

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Company's tax liability will be collected under separate, non-bondable charges and, as such, the Company will receive the full amount of the energy cost bond charges collected without diminution of federal income taxes or state corporate business taxes.

Company will form the SPE under State F law as a bankruptcy remote limited liability company solely for the purpose of effectuating the proposed transaction. Company will own all of the equity of the SPE which will not elect to be treated as an association taxable as a corporation pursuant to treasury regulation § 301.7701-3(a). The Company will transfer the energy cost property and associated energy bond costs under the financing order to the SPE. The SPE will be capitalized initially at e percent of the aggregate principal amount of the Bonds through a cash contribution from the Company. The SPE will issue Bonds secured by the energy cost property.

Upon issuance of a financing order, the Company will sell the energy cost property to the SPE in exchange for the net proceeds from the issuance of no greater than \$ d principal amount of Bonds. The sale of the energy cost property to the SPE will transfer all of the Company's right, title and interest in and to the energy cost property.

Upon the issuance of a series of Bonds, a capital subaccount will be established for that series into which the Company will contribute as equity to the SPE cash in an amount equal to at least e percent of the initial outstanding principal balance of the series. The Company's capital contribution to the SPE will be retained by the SPE in the capital subaccount for the series until all Bonds of the series have been paid, redeemed or defeased, and all obligations of the SPE with respect to the series have been satisfied.

Each series of Bonds may consist of more than one class. Such classes will differ, inter alia, as to interest rate, amortization of principal and maturity date. The terms of all Bonds of the same series will be identical, unless a series includes more than one class, in which case the terms of all Bonds of the same class will be identical. The Bonds may have a legal final maturity date of no more than seven years after issuance. The Company expects that all of the Bonds will receive a AAA credit rating from at least two nationally recognized credit rating agencies. The SPE or its affiliates may enter into additional forms of credit enhancement to support the Bonds.

Interest on each series of Bonds will accrue from the date of issuance at the interest rate for each class within such series, and will be payable quarterly or semiannually. Principal payments will be scheduled to be made quarterly or semiannually. In the case of sequential classes, to the extent that more than one class of a series is to receive payments of principal legally due or scheduled to be paid on any payment date, the applicable funds will be allocated in a sequential manner, until the outstanding principal balance of the class is reduced to the amount set forth in the applicable expected amortization schedule, to the extent funds are available.

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Within a series, the SPE will pay interest on the Bonds for all classes prior to paying principal on any class. If, on any payment date, amounts allocable to a series of Bonds are not sufficient to pay interest due, principal legally due, or principal scheduled on all of the outstanding Bonds in a series, amounts available will be allocated within that series, in each case until paid in full, as follows: (i) payment of interest due on all of the outstanding Bonds within that series, followed by (ii) payment of principal legally due on all of the outstanding Bonds within that series, followed by (iii) payment of principal scheduled on all of the outstanding Bonds within that series.

The Bonds will not be secured by the assets of the Company. The Bonds will be recourse to the SPE and will be collateralized by the energy cost property and the equity and assets of the SPE.

Energy cost bond charges collected by the Company as servicer of the energy cost property will be deposited into its accounts and remitted at least monthly to a collection account maintained by the trustee. The collection account will include a general subaccount into which the trustee will deposit energy cost bond charges remitted the Company. The general subaccount will be divided into subaccounts for each series, with each series having its own series subaccount, capital subaccount, and overcollateralization subaccount. All series, and all classes within a series will have the same payment dates and amounts will be allocated among series in accordance with their respective revenue requirements. All amounts in the collection account not allocated to any other subaccount will be allocated to a reserve subaccount, which will hold excess amounts and will be available to make payments for all series of Bonds.

The energy cost bond charges will be calculated to yield an overcollateralization amount so that collections over the period that the Bonds are outstanding will be in excess of amounts needed to repay principal, interest and costs associated with the billing and collection of the energy cost bond charges in order to avoid the risk of insufficient collections in any period. The overcollateralization amount, which will be deposited into the overcollateralization subaccount established for each series, will be scheduled to accumulate at least ratably over the expected term of the Bonds, and at the end of the term will equal at least percent of the initial outstanding principal amount of each series of Bonds.

The trustee will apply the energy cost bond charge collections remitted by the Company together with all investment earnings on the trust accounts in the following order or priority on each payment date: (i) payment of amounts owed to the trustee, including fees, expenses and indemnity amounts; (ii) payment of administration and independent managers' fees; (iii) payment of servicing fees; (iv) payment of other operating expenses of the SPE up to a capped amount; (v) payment of interest due or previously accrued but unpaid, on all series of Bonds or the gross fixed amount payable under any interest rate swap agreement, excluding any termination or similar nonrecurring payments; (vi) payment of the principal balance of all series of Bonds then legally due as a result of acceleration, final maturity or redemption; (vii) payment of the

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principal then scheduled to be paid on all series of Bonds according to the expected amortization schedule; (viii) payment of any remaining unpaid operating expenses of the SPE ; (ix) replenishment of each series' capital subaccount, pro rata, up to the required capital amount for each series; (x) replenishment and funding of each series overcollateralization subaccount, pro rata, up to the scheduled overcollateralization level for each series as of that payment date; and (xi) allocation of the remainder, if any, to the reserve subaccount. Moreover, provision will be made for the funding of any required additional credit enhancement.

Amounts in the overcollateralization, capital and series subaccounts for a particular series of Bonds will be available to make interest and principal payments solely for that series. Amounts in the general and reserve subaccounts will secure and be applied to make such payments on all outstanding series of Bonds. If the energy cost bond charges collected in any period are insufficient to satisfy the SPE's payment obligations on a particular series of Bonds, then scheduled principal and interest payments will be made first from any amounts in the reserve subaccount, then from amounts in the overcollateralization subaccount for that series and finally from amounts in the capital subaccount for that series. To the extent that funds from the capital or overcollateralization subaccounts are used to make scheduled principal and interest payments, future energy cost bond charges will be adjusted to restore those subaccounts.

Investment income earned on amounts in the collection account may also be used to satisfy scheduled interest and principal payments on the Bonds and to replenish the SPE's capital and overcollateralization subaccounts. Any excess revenues, up to an amount equal to the investment income on the capital subaccounts, will be remitted to the SPE and retained until all principal and interest payments on the Bonds have been satisfied.

Pending remittances to the SPE, the Company, as servicer, may commingle energy cost bond charge amounts collected from customers with its other funds. The Company will be liable for, and will pay or withhold, as applicable, any fees or taxes imposed with respect to the energy cost bond charges, including any state corporate business taxes and federal income taxes, so that the energy cost bond charge collections received by the SPE will not be reduced by any taxes. The Company will service the customer accounts subject to the energy cost bond charges and will retain all books and records regarding the charges.

At the time of issuance of a series of Bonds, the related indenture supplement for a series may provide for the optional redemption of that series, or of one or more classes within that series, on redemption dates and at redemption prices based on current market conditions. The Bonds may also be subject to optional redemption in whole on any payment date when the aggregate outstanding principal balance of a series of Bonds declines to a certain percentage of the original principal amount of the series.

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The indenture will provide for the following events of default: (a) a default for five business days in the payment of interest on any Bond; (b) a default in the payment of principal on any Bond of any series or class on the final maturity date for that series or class; (c) a default in the payment of the redemption price for any Bond on the redemption date; (d) a default in any covenant, representation or warranty of the SPE made in the indenture that continues for 30 days after notice; (e) specified events of bankruptcy of the SPE and (f) a violation by State A of its pledge and agreement with respect to the Act and the Bonds. If any default occurs and is continuing for any one series, other than a default described in (f) above, the trustee or holders of a majority of the outstanding principal balance of all series of Bonds may declare the entire principal balance of all series of Bonds to be immediately due and payable.

ISSUES

Does the issuance of the financing order and the transfer of the rights under the financing order to SPE result in gross income to Company.

Does the issuance of the Bonds and the transfer of the proceeds to Company result in gross income to Company?

Are the Bonds obligations of Company?

LAW

Section 61 of the Internal Revenue Code generally defines gross income as “income from whatever source derived”, except as otherwise provided by law. Gross income includes income realized in any form, whether in money, property, or services. Section 1.61-1(a) of the Income Tax Regulations. This definition encompasses all “accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.” Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955), 1955-1 C.B. 207.

The right to collect the energy cost bond charge is of significant value in producing income for Company. Moreover, State A’s action in making the energy cost property rights transferable has enhanced that value. Generally, the granting of a transferable right by the government does not cause the realization of income. Rev. Rul. 92-16, 1992-1 C.B. 15 (allocation of air emission rights by the Environmental Protection Agency does not cause a utility to realize gross income); Rev. Rul. 67-135, 1967-1 C.B. 20 (fair market value of an oil and gas lease obtained from the government through a lottery is not includible in income).

The economic substance of a transaction generally governs its federal tax consequences. Gregory v. Helvering, 293 U.S. 465 (1935), XIV-1 C.B. 193. Affixing a label to an undertaking does not determine its character. Rev. Rul. 97-3, 1997-1 C.B. 9. An instrument secured by property may be an obligation of the taxpayer or, alternatively, may be a disposition of the underlying property by the taxpayer. Cf. id.

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(the Small Business Administration is the primary obligor of certain guaranteed payment rights that are created under its participating security program).

CONCLUSIONS

Based on the facts as represented, we rule as follows:

(1) The issuance of the financing order and the transfer of the rights under the financing order to SPE will not result in gross income to Company.

(2) The issuance of the Bonds and the transfer of the proceeds to Company will not result in gross income to Company.

(3) The Bonds will be obligations of Company.

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.

A copy of this letter must be attached to any income tax return to which it is relevant.

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

Sincerely,
William E. Coppersmith
Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)