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Dear :

This letter is in response to a request for a ruling submitted on behalf of City, that (1) the expenditures for the Charges (as described below) to be financed with Bonds are extraordinary items pursuant to § 1.148-6(d)(3)(ii)(B) of the Income Tax Regulations and, therefore, not subject to the proceeds-spent-last method in § 1.148-6(d)(3)(i); and (2) pursuant to § 1.148-10(a)(4), the Bonds will not be outstanding longer than is otherwise reasonably necessary.

### **Facts and Representations**

Utility is a provider of electricity and natural gas and a department and component unit of City. Utility's operations are independent of any other unit of City. Utility owns generating and transmission facilities, and it also has purchase agreements for electric power that it obtains through the grid operated by Grid Operator (the Grid). Grid Operator serves municipal utilities including Utility, as well as other entities such as independent power producers and investor-owned utilities. Utility is a wholesale purchaser of gas for resale to its retail gas customers and to power some of its electric generation facilities. Utility recovers its electricity and natural gas costs by a direct pass-through of costs to its customer base and by entering into hedges for a portion of its forecasted natural gas purchases with third party hedge providers (the "Gas Hedges").

Utility does not maintain reserves specifically intended to deal with the fluctuating nature of the cost of power, although it has reserves for all of its other operational needs ("Utility's Operating Reserves"). City maintains reserves for its other standard operational needs ("City's Operating Reserves"), which are specifically isolated from the liabilities of Utility. City's Operating Reserves are necessary to maintain the operation

of City at the current level, including its ability to fund additional capital improvements as well as maintain its day-to-day operations. All of the debt issued by City for Utility is secured by a lien on, and is solely payable from, revenues of Utility, and under State law cannot be cross collateralized with any of City's other obligations. With limited exceptions, State law prohibits City from using any Utility revenues to pay any other debt, expense, or obligation of City.

In Month, the Occurrence took place and resulted in significant and unprecedented power loss in State, including in City. The Occurrence caused severe physical damage to electric power generation and transmission equipment supplying electric power to the Grid, rendering the equipment unusable. It also caused some gas wellheads, pipelines, and gas processing plants to be nonoperational. The State and the Federal Governments issued disaster declarations with respect to the Occurrence.

A direct result of the Occurrence was that spower became extremely scarce and much more expensive to obtain. Customarily, Utility has budgeted, and managed the Gas Hedges, for a price to obtain power of approximately \$a/Megawatt-hour ("MWh"). Utility's average price of power prior to the Occurrence was \$b/MWh. During the Occurrence, Utility's payments to the Grid Operator to obtain power (the "Power Charge") were based on prices averaging approximately \$c/MWh, or more than 13 times \$a). Because of Utility's essential service responsibilities coupled with the failure of its generation facilities for significant durations throughout the Occurrence, Utility was a net power buyer during this period (meaning it bought more power from the Grid than it sold into the Grid).

As a result of the size and scope of the Grid's power charges during the Occurrence, some utilities divested their interests in transmission operations and some utilities sought bankruptcy or other remedies, including non-payment. Under the Grid's pricing mechanism, in the event of bankruptcy or defaulting counter parties within the Grid, the Grid Operator may impose fees on the remaining utilities to cover the charges of such other defaulting counter parties ("uplift charges"). Utility's average uplift charge in the previous five years had been \$d. The fee imposed on Utility in the aftermath of the Occurrence (the "Uplift Charge") was significantly greater.

Utility ensures delivery of natural gas to its customers by executing contracts with various natural gas suppliers (the "Gas Providers"). The average price of natural gas purchased by Utility prior to the Occurrence had been approximately \$e per million British thermal units ("MMBtu"), and Utility budgets for approximately \$f/MMBtu. The highest price for natural gas ever paid by Utility prior to the occurrence was \$g/MMBtu, or eight times \$f. Due to the scarcity of available natural gas during the Occurrence, the cost of natural gas to Utility as charged by the Gas Providers during the Occurrence increased to more than \$h per MMBtu (which is 60 times \$f/MMBtu), plus related transmission charges predicated on the increased gas price. Although Utility withdrew natural gas from its storage facilities and received payments on the Gas Hedges, which together reduced its costs for natural gas by approximately 25 percent, Utility's costs for

natural gas during the Occurrence equaled approximately \$i million (the “Gas Charge,” and together with the Power Charge and the Uplift Charge, the “Charges”).

Utility has challenged the amounts of the Charges by initiating various litigation proceedings against the Grid Operator and the Gas Providers. In its litigation, Utility has challenged the portion of the Charges in excess of what the Charges would have been if calculated at the prices determined by its experts to be reasonable. Utility’s experts determined that a reasonable price for power during the Occurrence would have been \$j/MWh and a reasonable price for gas would have been \$k/MMBtu. Litigation with most, but not all, of the Gas Providers has been resolved. The outcome of these litigation proceedings will establish the final amounts of the Charges that Utility will finance (or refinance). Any amount still in dispute that is determined by the litigation proceedings to be owed by Utility (the “Legal Judgment”) will be paid by Utility at that time. City expects that the overall amount it will end up paying to settle these cases will be approximately \$l million for the Gas Charge and approximately \$m million for the Power Charge and Uplift Charge.

During and after the Occurrence, Utility has financed (and refinanced) a portion of the cost of the Charges with proceeds of taxable commercial paper (the “Short-term Taxable Debt”). City determined that, for financial accounting purposes, the Charges are a regulatory asset under Generally Accepted Financial Principles, allowing Utility to capitalize and recover these costs on its books over a n-year period. Under this determination, Utility is authorized to refinance these costs with fixed long-term debt. Prior to the filing of the request for this private letter ruling with the Internal Revenue Service (the “Service”), Utility refinanced a portion of the Short-term Taxable Debt with long-term taxable debt that has a final maturity of n years and a weighted average maturity of o years (the “Taxable Bonds”).

Upon obtaining a favorable response from the Service to its private letter ruling request, City will issue the Bonds and use the proceeds to refund the portion of outstanding Short-term Taxable Debt representing any Legal Judgment not refinanced with the Taxable Bonds. The Bonds will be secured solely by, and will be repaid solely with, Utility’s revenues comprised of generally applicable rates and charges. The Bonds will have a final maturity date that is n years from the date of issue and a weighted average maturity of o years. Utility will not apply the safe harbor for longer-term working capital financings under § 1.148-1(c)(4)(ii).

City represents that issuing the Bonds with a term of n years and a weighted average maturity of not more than o years provides Utility with a reasonable debt service expense over the term of the issue which considers the economic impact of the Occurrence and the Charges without causing further downgrades in its credit rating while preserving customer affordability. By providing a debt service payment that is expected to be manageable, the term and weighted average maturity of the Bonds will also assist Utility in meeting its budgetary requirements.

## **Law and Analysis**

Section 103(a) of the Internal Revenue Code provides that, except as provided in § 103(b), gross income does not include interest on any state or local bond. Section 103(b) provides, in part, that § 103(a) shall not apply to any arbitrage bond (within the meaning of § 148).

Section 148(a) defines an arbitrage bond as any bond issued as part of an issue any portion of the proceeds of which are reasonably expected (at the time of issuance of the bond) to be used directly or indirectly (1) to acquire higher yielding investments, or (2) to replace funds which were used directly or indirectly to acquire higher yielding investments. Section 148(a) further provides that a bond is an arbitrage bond if the issuer intentionally uses any portion of the proceeds of the issue of which such bond is a part in a manner described in (1) or (2).

Section 1.148-1(b) defines proceeds, in part, to mean any sale proceeds, investment proceeds, and transferred proceeds of an issue. Transferred proceeds are defined in § 1.148-9. Section 1.148-9(b) provides, in part, that when proceeds of the refunding issue discharge any of the outstanding principal amount of the prior issue, proceeds of the prior issue become transferred proceeds of the refunding issue and cease to be proceeds of the prior issue.

Section 1.148-6(d)(3)(i) provides that, except as otherwise provided in § 1.148-6(d)(3) or (d)(4), proceeds of an issue may only be allocated to working capital expenditures as of any date to the extent that those working capital expenditures exceed available amounts (as defined in § 1.148-6(d)(3)(iii)) as of that date (*i.e.*, a “proceeds-spent-last” method). For this purpose, proceeds include replacement proceeds described in § 1.148-1(c)(4).

Section 1.148-6(d)(3)(ii)(B) provides that § 1.148-6(d)(3)(i) does not apply to expenditures for extraordinary, nonrecurring items that are not customarily payable from current revenues, such as casualty losses or extraordinary legal judgments in amounts in excess of reasonable insurance coverage. If, however, an issuer or a related party maintains a reserve for such items (*e.g.*, a self-insurance fund) or has set aside other available amounts for such expenses, gross proceeds within that reserve must be allocated to expenditures only after all other available amounts in that reserve are expended.

Section 1.148-6(d)(3)(ii)(C) provides that § 1.148-6(d)(3)(i) does not apply to expenditures for payment of principal, interest, or redemption prices on a prior issue and, for a crossover refunding issue, interest on that issue.

Section 1.148-6(d)(3)(iii)(A) defines available amount, in general, as any amount that is available to an issuer for working capital expenditure purposes of the type financed by an issue. Except as otherwise provided, available amount excludes proceeds of any issue but includes cash, investments, and other amounts held in accounts or otherwise

by the issuer or a related party if those amounts may be used by the issuer for working capital expenditures of the type being financed by an issue without legislative or judicial action and without a legislative, judicial, or contractual requirement that those amounts be reimbursed.

Section 1.148-1(c)(4)(i)(A) provides that replacement proceeds arise to the extent that the issuer reasonably expects as of the issue date that: (1) the term of an issue will be longer than is reasonably necessary for the governmental purposes of the issue; and (2) there will be available amounts during the period that the issue remains outstanding longer than necessary. Whether an issue is outstanding longer than necessary is determined under § 1.148-10. Replacement proceeds are created under § 1.148-1(c)(4)(i)(A) at the beginning of each fiscal year during which an issue remains outstanding longer than necessary in an amount equal to available amounts of the issuer as of that date.

Section 1.148-1(c)(4)(i)(B)(1) provides, as a safe harbor, that replacement proceeds do not arise under § 1.148-1(c)(4)(i)(A) for the portion of an issue that is to be used to finance restricted working capital expenditures, if that portion is not outstanding longer than 2 years. For the portion of an issue that is a refunding issue, § 1.148-1(c)(4)(i)(B)(3) provides that replacement proceeds do not arise if that portion has a weighted average maturity that does not exceed the remaining weighted average maturity of the prior issue, and the issue of which the prior issue is a part satisfies § 1.148-1(c)(4)(i)(B)(1) or (2). Section 1.148-1(c)(4)(ii) provides a safe harbor against the creation of replacement proceeds for longer-term working capital financings. This safe harbor requires annual testing for available amounts and application of the available amounts to reduce the burden on the tax-exempt bond market.

Section 1.148-10(a)(4) provides that an action overburdens the tax-exempt bond market if it results in issuing more bonds, issuing bonds earlier, or allowing bonds to remain outstanding longer than is otherwise reasonably necessary to accomplish the governmental purposes of the bonds, based on all the facts and circumstances. Whether an action is reasonably necessary to accomplish the governmental purposes of the bonds depends on whether the primary purpose of the transaction is a bona fide governmental purpose (*e.g.*, an issue of refunding bonds to achieve a debt service restructuring that would be issued independent of any arbitrage benefit). An important factor bearing on this determination is whether the action would reasonably be taken to accomplish the governmental purpose of the issue if the interest on the issue were not excludable from gross income under § 103(a) (assuming that the hypothetical taxable interest rate would be the same as the actual tax-exempt interest rate). Factors evidencing an overissuance include the issuance of an issue the proceeds of which are reasonably expected to exceed by more than a minor portion the amount necessary to accomplish the governmental purposes of the issue, or an issue the proceeds of which are, in fact, substantially in excess of the amount of sale proceeds allocated to expenditures for the governmental purposes of the issue. One factor evidencing an early issuance is the issuance of bonds that do not qualify for a temporary period under

§ 1.148-2(e)(2), (e)(3), or (e)(4). One factor evidencing that bonds may remain outstanding longer than necessary is a term that exceeds the safe harbors against the creation of replacement proceeds under § 1.148-1(c)(4)(i)(B). These factors may be outweighed by other factors, however, such as bona fide cost underruns, an issuer's bona fide need to finance extraordinary working capital items, or an issuer's long-term financial distress. Section 1.148-10(b) imposes limitations on an issue that overburdens the tax-exempt market, including the mandatory application of the proceeds-spent-last rule under § 1.148-6(d)(3)(i).

The Bonds are refunding bonds. Under § 1.148-6(d)(3)(ii)(C), the proceeds-spent-last-method does not apply to expenditures for payment of principal, interest, or redemptions prices on a prior issue. However, proceeds of the Bonds will include any transferred proceeds from the Short-term Taxable Debt to be refunded with the Bonds. The answer to the question of whether the Charges are subject to the proceeds-spent-last method will determine the amount of the proceeds of the refunded bonds, or of any transferred proceeds of the Bonds, that Utility can allocate to the Charges.

The Occurrence caused Utility to incur the Charges. The damage caused by the Occurrence resulted in unprecedented power losses, which in turn resulted in substantial and unprecedented increases in Utility's cost of electric power and natural gas. Utility is refinancing with the Bonds only the portion of the Legal Judgment not refinanced with the Taxable Bonds. The amount of the Charges that Utility challenged in its litigation with the Grid Operator and the Gas Providers, and therefore the Legal Judgment, includes only amounts beyond what Utility's experts have determined to be reasonable charges. The amounts determined to be reasonable charges are significantly greater than the charges for which Utility ordinarily budgets. Utility could not reasonably have expected or budgeted to pay out of current revenues the amounts included in the Legal Judgment. We conclude that the Charges being refinanced with the proceeds of the Bonds are extraordinary, nonrecurring expenses that are not customarily payable from current revenues and that the exception in § 1.148-6(d)(3)(ii)(B) applies to these Charges (the "Extraordinary Charges").

Utility does not maintain specific reserves for expenses such as the Extraordinary Charges. Utility's and City's Operating Reserves are not for such expenses within the meaning of § 1.148-6(d)(3)(ii)(B). Accordingly, City need not allocate amounts in those reserves prior to allocating proceeds of the prior bonds or of the Bonds to the Extraordinary Charges.

Whether the Bonds will remain outstanding longer than is otherwise reasonably necessary to accomplish the governmental purpose of the Bonds is determined based on all the facts and circumstances. In determining whether the term of an issue used to finance extraordinary working capital items is reasonable, considerations include the nature of the event giving rise to the expenditures, the size of the expenditures relative to the size of a borrower's budget, and the impact of the expenditure on a borrower's operating budget over the term of the issue that will finance the expenditures.

First, we conclude that Utility has a bona fide need to finance the Extraordinary Charges as an extraordinary working capital item. Utility did not budget or reserve for the Extraordinary Charges and the amount of the Extraordinary Charges is substantial. In addition, Utility already has financed (and refinanced) a portion of the Charges with the Short-term Taxable Debt and the Taxable Bonds.

Further, City has represented that issuing the Bonds with a term of n years and a weighted average maturity of not more than o years provides Utility with a reasonable debt service expense over the term of the issue which considers the economic impact of the Occurrence and the Charges without causing further downgrades in its credit rating while preserving customer affordability. Utility's costs, including its debt, can only be paid with revenues from its ratepayers. By providing a debt service payment that is expected to be manageable, the term and weighted average maturity of the Bonds will also assist Utility in meeting its budgetary requirements. Accordingly, we conclude that under § 1.148-10(a)(4), the Bonds will not be outstanding longer than reasonably necessary.

### **Conclusion**

Based solely on the information submitted and representations made, we conclude that (1) the expenditures for the Extraordinary Charges are extraordinary items pursuant to § 1.148-6(d)(3)(ii)(B) and, therefore, not subject to the proceeds-spent-last method in § 1.148-6(d)(3)(i); and (2) pursuant to § 1.148-10(a)(4), the Bonds will not be outstanding longer than is otherwise reasonably necessary.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any transaction or item discussed or referenced in this letter, including whether the interest on the Bonds is excludable from gross income under § 103(a).

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

The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. Because this office has not verified any of the material submitted in support of the request for rulings, such material is subject to verification on examination.

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

Sincerely,

Associate Chief Counsel  
(Financial Institutions and Products)

By: \_\_\_\_\_  
Johanna Som de Cerff  
Senior Technician Reviewer  
Branch 5

cc: