Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Number: **200306001**
Release Date: 2/7/2003
Index Number: 103-02-01, 141.01-04
141.03-00

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Refer Reply To:
CC:TEGE:EOEG:TEB/PLR-145483-01
Date:
October 24, 2002

LEGEND

Issuer

Company

City

State

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Date 1

Date 2

Date 3

Date 4

Date 5

Date 6

Date 7

Date 8

Year 1

Taxable Bonds

Dear :

This responds to your request for rulings that: (1) the Issuer is an instrumentality for purposes of § 141 of the Internal Revenue Code; and (2) the Proposed Bonds (hereinafter defined) will be treated as financing property used for governmental purposes under §§ 103 and 141.

FACTS AND REPRESENTATIONS

The Issuer was organized for the purpose of obtaining economical, reliable wholesale electric power supplies and transmission services for its members (the "Members"). To fulfill this purpose, the Issuer: (1) purchases, sells, generates, and transmits electricity for Members; (2) provides technical services to Members; and (3) serves as an information clearinghouse for Members. In addition, the Issuer also sells electricity, steam, and service water to certain industrial customers (the "Non-members").

The Issuer was formed by its Members and is organized under the non-profit corporation laws of the State for the purpose of benefitting its Members. The Issuer's governing documents provide that membership in the Issuer is limited to political subdivisions of the State or another state that own or operate a utility system (electric, natural gas, or communication). The governing documents also provide that membership is not transferable or assignable and terminates on dissolution or other termination of a Member or the Member's utility system. There are currently a

Members of the Issuer.

The Issuer is controlled by a Board of Trustees (the "Board") that is composed exclusively of representatives of the Members. Members elect a particular Member to serve on the Board and the elected Member chooses an individual to represent the Member. Elections are held at regularly scheduled Member meetings. Each trustee serves a 3-year term. The Issuer's governing documents do not provide for removal of a trustee. In the event that a vacancy occurs before a regularly scheduled election, a Member is selected to fill the vacancy.

The Issuer's income consists of annual Member dues, revenues from sales of electricity to Members, fees for technical services provided to Members, and revenues from sales of electricity, steam, and service water to Non-members. The Issuer's governing documents provide that the Issuer shall at all times be operated on a not-for-profit basis for the benefit of its Members.

The Issuer's governing documents provide that its annual budget is developed by a committee of the Board and is approved by both the Board and by the Members. The Board establishes the amount of fees for sales of electric power, steam, and service water to Members and Non-members and for services provided to Members. The Issuer is subject to an annual audit performed by a certified public accountant selected by the Board. The results of the annual audit are provided to each Member.

To the extent that the Issuer's annual revenues exceed expenses, the excess revenues are applied to reduce the costs of services to Members in subsequent years. The excess revenues may, alternatively, be treated as increases to Members' patronage capital, which would be distributed to Members in the event of the Issuer's dissolution or liquidation. In the event of the Issuer's dissolution or liquidation, the Issuer's assets would be used in the following order: (1) to pay all debts of the Issuer; (2) to pay Members' initial capital contributions; (3) to refund membership fees, including dues paid by Members or former Members, in the order of receipt; and (4) to make distributions to Members and former Members on the basis of patronage while a Member.

On Date 1, the Internal Revenue Service determined that the Issuer is exempt from Federal income tax under § 501(c)(12). Ruling letters issued on Date 2 and Date 3 determined that the Issuer continued to qualify as a § 501(c)(12) corporation. In addition, according to a private letter ruling that the Issuer received on Date 4, the Issuer is empowered to issue tax-exempt bonds under § 103(a) on behalf of its Members under Rev. Rul. 57-187, 1957-1 C.B. 65.

On Date 5 (which is before October 13, 1987), the Issuer and the Company executed a preliminary agreement (the "Preliminary Agreement") that provided for the Issuer's purchase of the b percent interest in a cogeneration plant owned by the Company (the "Plant"). The Preliminary Agreement specifically identified the b percent interest in the Plant as the asset the Issuer would purchase, established the purchase price for that interest, provided general terms for Plant refurbishment, and provided additional details regarding the parties' rights and obligations. The Preliminary Agreement was a valid and enforceable contract under State law and, as such, neither the Issuer nor the Company had the unilateral right to cancel the contract. Notwithstanding, the Preliminary Agreement permitted the Company to negotiate with other potential purchasers during the period between execution of the Preliminary Agreement and completion of the sale of the b percent interest. If the Company located a different purchaser, the Preliminary Agreement permitted the Issuer to match that purchaser's bona fide negotiated offer within 30 days. To the extent that the Preliminary Agreement contained conditions within the control of the parties, each party was obligated to use good faith and best efforts to meet such conditions. Any attempt by the parties to use the conditions within their control to unilaterally terminate the contract by failing to use good faith and best efforts to meet such conditions would constitute a breach of contract under State law. Given the parties' intent to be bound by the Preliminary Agreement and the difficulty in properly ascertaining monetary damages to be awarded if either party breached its mutual obligations thereunder, the Preliminary Agreement was subject to the remedy of specific performance under State law. In addition, the Preliminary Agreement did not contain any dollar limit on damages. The Preliminary Agreement was contingent on approval by the Issuer's and the Company's boards of trustees and each board approved the Preliminary Agreement prior to Date 5.

On Date 6 (which is after October 13, 1987), the Issuer and the Company executed a subsequent agreement to finalize the Issuer's purchase of the b percent interest in the Plant (the "Final Agreement"). The Final Agreement incorporated the terms and provisions set forth in the Preliminary Agreement, provided additional details, and set forth the parties specific rights and obligations regarding Plant refurbishment and operation.

The Issuer acquired the Plant to provide economical, reliable wholesale electricity to its Members. The Issuer financed the purchase of the b percent interest with the proceeds of the Taxable Bonds, which were issued after October 13, 1987. On Date 8, the Issuer purchased the Company's remaining c percent interest in the Plant and financed this purchase with internal operating revenues. Currently, the Issuer owns 100 percent of the Plant and reasonably expects that it will continue to do so. The Issuer operates the Plant.

The Plant was designed and constructed as a single integrated facility to provide electricity and steam to an industrial complex. The Plant continues to produce steam (which is sold to customers under arrangements that give rise to private business use and private payments under § 141(b)) and electricity (which is primarily sold to certain Members). Although certain Plant components have a nameplate capacity or an equivalent rating, the Plant does not have a capacity or equivalent rating as a single integrated facility.

Generally, the Plant's components are boilers, 21 stages of turbines, generators, and related equipment. The Plant operates as follows. The boilers burn coal to produce steam. The boilers are licensed by State to produce a maximum of d pounds of steam per hour (the "boiler-licensed maximum"). A portion of the boiler-licensed maximum produces up to e pounds of steam per hour which is immediately available for sale without input into the 21-stage turbine cycle. The remaining portion of the boiler-licensed maximum (up to f pounds of steam per hour) is input into the first stage of the 21-stage turbine cycle. The steam that is fed into the 21-stage turbine cycle produces (1) up to g pounds of steam per hour at the end of the 8th turbine stage; (2) up to h kilowatts of electricity per hour at the end of the 21st turbine stage; and (3) very low pressure steam also at the end of the 21st turbine stage that is returned to the boilers. Up to g pounds of steam per hour is sold to Non-members under arrangements that give rise to private business use and private payments under § 141(b). The h kilowatt hours of electricity are sold to Members pursuant to the contracts described below and are used to provide services to Non-members.

Due to Plant design and certain other factors, producing electricity by burning coal is less efficient than producing an equivalent British Thermal Unit (BTU) value of steam.[1] As a result of these differences in efficiency, one BTU of coal input into the Plant's boilers will produce i BTU of steam, but one BTU of coal input produces only j BTU of electricity.

In order to take account of the differences in producing steam and electricity, the Issuer and the Company have measured the use of the Plant by reference to the relative BTU value of coal input that is required to produce steam and electricity.[2] Specifically, the percentage of the actual costs of the Plant (including operation, maintenance, and capital costs) that have been allocated to the production of a given quantity of steam or electricity is equal to the ratio of the BTU value of coal to produce that quantity of steam or electricity over the BTU value of total coal input required to produce all types of Plant output. Moreover, when the Issuer purchased the b percent interest in the Plant, the Issuer and the Company agreed in arm's-length negotiations that their respective entitlement to output of the Plant would be determined according to the relative BTU value of coal input used to produce the Issuer's and the Company's output (*e.g.*, the Issuer was entitled to the output that could be produced with b percent of the BTU value of coal input). The Issuer reasonably expects to continue to determine the actual costs of production and rates for sales of the Plant's output of steam and electricity based on the BTU value of coal input.

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[1] The Issuer represents that: (1) the BTU is a standard unit for measuring the quantity of heat energy equal to the quantity of heat required to raise the temperature of one pound of water by one degree Fahrenheit; and (2) the BTU is the appropriate unit of measure for comparing steam and electricity.

[2] The Issuer represents that the BTU value of the coal necessary to produce the boiler-licensed maximum is k BTUs per hour.

Plant electric output is sold primarily to a portion of the Members and to the City (collectively, the “Purchasers”) pursuant to contracts (the “Power Sales Contracts”). The Power Sales Contracts are dated Date 7, which is shortly after the Date 6 execution of the Final Agreement for the Issuer’s purchase of the b percent interest in the Plant. From the Date 7 execution date of the Power Sales Contracts until the Issuer’s Date 8 purchase of the remaining c percent interest in the Plant, other than short term sales of less than a one-year term, 100 percent of the electricity attributable to the b percent interest was sold to the Purchasers.

The Power Sales Contracts have identical terms other than each Purchaser’s respective entitlement to Plant electric output. The Contracts have 20-year terms and require the Purchaser to make full payment in any month in which any or all of the Purchaser’s commitment can be supplied from any resource available to the Issuer. In the event that output is not available from the Plant, the Issuer is entitled to deliver electricity to the Purchaser from sources other than the Plant. Each Purchaser’s payment obligation is based on the Plant’s operating expenses, including debt service. Although the Power Sales Contracts have a term of 20 years and, therefore, expire in Year 1, the Issuer reasonably expects to renew the Power Sales Contracts on the same or substantially similar terms.

Based on the Power Sales Contracts, at least l percent of the available output of the Plant (based on maximum BTU value of coal input) is reserved for use by the Purchasers while the Proposed Bonds are outstanding. With respect to the l percent reserved for use by the Purchasers, the Issuer reasonably expects that over the term of the Proposed Bonds, no Purchaser will resell Plant output under an arrangement that gives rise to private business use under § 141(b). As such, the Issuer reasonably expects that not more than m percent of the available output of the Plant (based on maximum BTU value of coal input) will be sold under contracts giving rise to private business use under Section 141(b) over the entire term of the Proposed Bonds.

The Issuer intends to issue bonds (the “Proposed Bonds”) and to use the proceeds to currently refund the Taxable Bonds and to finance l percent of certain Plant improvements (plus any costs attributable to any permissible private business use under § 141(b)). The final maturity of the Proposed Bonds is expected to be after Year 1.

LAW AND ANALYSIS

Instrumentality

Under § 1.141-1(b) of the Income Tax Regulations, the term “governmental person” means a state or local government as defined in § 1.103-1 or any instrumentality thereof. Section 1.103-1(a) provides, in part, that a state or local government includes any political subdivision of a state.

Revenue Ruling 57-128, 1957-1 C.B. 311, sets forth the following factors to be considered in determining whether an entity is an instrumentality of one or more governmental units: (1) whether the organization is used for a governmental purpose and performs a governmental function; (2) whether performance of its function is on behalf of one or more states or political subdivisions; (3) whether there are any private interests involved, or whether the states or political subdivisions involved have the powers and interests of an owner; (4) whether control and supervision of the organization is vested in a public authority or authorities; (5) whether express or implied statutory or other authority is necessary for the creation and/or use of the instrumentality, and whether this authority exists; and (6) the degree of financial autonomy of the entity and the source of its operating expenses.

The Issuer was formed by the Members to obtain economic, reliable supplies of electric power and transmission services on behalf of its Members (political subdivisions of certain states) and to provide related technical services to its Members. By obtaining electric power and transmission services and providing related technical services, the Issuer performs the same or similar functions that each Member would be required to perform individually if the Issuer did not exist. Hence, the Issuer is used for the governmental purpose of its Member utility systems and performs the governmental function on behalf of the Members.

The Members have the powers and interests of an owner. All annual revenues in excess of expenses accrue to the benefit of the Members in that they are either applied to reduce costs of services to Members or are treated as increases to Members' patronage capital. In the event of the Issuer's dissolution or liquidation, Members receive the assets of the Issuer, to the extent that any remain after payment of the Issuer's debts, based on initial capital contributions, refunds of membership fees, and their patronage capital.

Control and supervision of the Issuer are vested in public authorities and not private interests because the Members, each of which is a political subdivision, control all aspects of the Issuer's operations through the Board. The Board is composed exclusively of representatives of the Members, each of whom must be elected by the Members. In the event of an unscheduled vacancy, any replacement Board trustee would also be selected from among the Members.

The financial affairs of the Issuer are controlled by the Members. The Members, through the Board, establish the amount of all fees and energy charges and develop the Issuer's annual budget. Both the Board and the Members approve the Issuer's annual budget.

Accordingly, we conclude that the Issuer is an instrumentality of its Members for purposes of § 141.

Private Business Tests

Section 103(a) generally provides that gross income does not include interest on any State or local bond. Section 103(b)(1) provides that this exclusion does not apply to any private activity bond unless it is a qualified bond (as these terms are defined under § 141).

As material to this ruling request, under § 141(a), a bond is a private activity bond if the bond satisfies the private business use test and private security or payment test of § 141(b).

Under § 141(b)(1), an issue meets the private business test if more than 10 percent of the proceeds of the issue are to be used for any private business use.

Under § 141(b)(2), 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 an issue is (under the terms of such issue or any underlying arrangement) directly or indirectly: (A) secured by any interest in (i) property used or to be used for a private business use, or (ii) 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.

Under § 141(b)(6), private business use means use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit.

Section 1.141-7 sets forth rules to determine whether arrangements for purchases of output from an output facility cause an issue of bonds to meet the private business tests. Section 1.141-7(c)(1) provides that the purchase pursuant to a contract by a nongovernmental person of available output of an output facility financed with the proceeds of an issue is taken into account under the private business tests if the purchase has the effect of transferring the benefits of owning the facility and the burdens of paying the debt service on the bonds used (directly or indirectly) to finance the facility (the “benefits and burdens test”).

Under § 1.141-7(c)(2), the benefits and burdens test is met if a nongovernmental person agrees pursuant to a take contract or a take or pay contract to purchase available output of a facility. Section 1.141-7(b)(4) provides the following definitions of a take contract and a take or pay contract. A take contract is an output contract under which a purchaser agrees to pay for the output under the contract if the output facility is capable of providing the output. A take or pay contract is an output contract under which a purchaser agrees to pay for the output under the contract, whether or not the output facility is capable of providing the output.

For purposes of § 1.141-7 output contracts, available output for generating facilities is determined under § 1.141-7(b)(1) by reference to nameplate capacity or the equivalent (or lacking either, its maximum capacity), which is not reduced for reserves or other unutilized capacity. However, § 1.141-7(b)(1)(ii)(A) provides that the available output of a cogeneration facility is to be measured in a reasonable manner to reflect capacity.

Section 1.141-7(f)(1) provides that an output contract for the use of a facility is not taken into account under the private business tests if the average annual payments to be made under the contract do not exceed one percent of the average annual debt service on all outstanding tax-exempt bonds issued to finance the facility, determined as of the effective date of the contract.

Section 1.141-7(f)(3) provides that an output contract with a nongovernmental person is not taken into account under the private business tests if: (i) the term of the contract, including all renewal options, is not longer than three years; (ii) the contract either is a negotiated, arm's-length arrangement that provides for compensation at fair market value, or is based on generally applicable and uniformly applied rates; and (iii) the output facility is not financed for a principal purpose of providing that facility for use by that nongovernmental person.

On September 19, 2002, the Internal Revenue Service issued an advance notice of proposed rulemaking describing and illustrating rules that the Internal Revenue Service and Treasury Department expect to propose in a notice of proposed rulemaking (the "proposed regulations") as part of the 2002-2003 Guidance Priority Plan. *See* Announcement 2002-91, 40 I.R.B. 685. Issuers may rely on Announcement 2002-91 with respect to any issue that is sold before the date the proposed regulations are published in the Federal Register (or such later date as may be specified in the proposed regulations or final regulations). Announcement 2002-91 provides that tax-exempt bonds may be issued to finance costs attributable to the government use portion of a mixed-use output facility (plus any costs attributable to any permissible private business use under § 141(b)) without the bonds being characterized as private activity bonds. For this purpose, the term facility includes an undivided ownership interest in a facility. With respect to arrangements for the purchase of output, the government use portion of an output facility is determined based on the percentage of the available output of the facility that is not used for a private business use (as determined under § 1.141-7).

Announcement 2002-91 further provides that, in the case of a mixed-use output facility, output contracts that result in private business use (including any payments thereunder) are allocated first to the portion of the facility that is financed with equity. For this purpose, equity means any amount other than proceeds of a tax-exempt bond, including funds of the issuer that are not derived from a borrowing and proceeds of taxable bonds, but does not include any amount allocable to a tax-exempt bond that has been retired. With respect to each issue of bonds, the portion of the output facility financed with equity is determined based on expenditures of equity that are made contemporaneously with expenditures of proceeds of the issue as part of the same plan of financing. In order for an output contract to be allocated (in whole or in part) to the equity-financed portion of an output facility as described in this paragraph, it first must be allocable to the facility under the facts and circumstances test contained in § 1.141-7(h). For example, an output contract that is allocable to two output facilities under § 1.141-7(h) may not be allocated in its entirety to the equity-financed portion of one of the facilities.

Announcement 2002-91, Example 1, provides that the Authority, a governmental person, owns and operates an electric transmission facility. Prior to 2002, Authority incurred capital costs of $500 million for the facility, none of which were financed with tax-exempt bonds. In 2003, Authority needs to make repairs, upgrades, and improvements to the facility in the amount of $50 million. In 2003, the Authority issues $30 million in tax-exempt bonds and uses the proceeds to pay capital costs of the facility (the “2003 issue”). As part of the same plan of financing, Authority also uses $20 million of its own funds which are not derived from a borrowing to pay capital costs of the facility. With respect to the 2003 issue, 46 percent of the available output (as determined under § 1.141-7) of the facility is sold under output contracts that result in private business use. Thus, of the $50 million of new capital costs, $27 million (54 percent) are attributable to government use and $23 million (46 percent) are attributable to private business use. Because, in general, output contracts that result in private business use are allocated first to the portion of the facility that is financed with equity, $20 million of the $23 million costs attributable to private business use are allocable to Authority’s equity and $3 million are allocable to the 2003 issue. Thus, $27 million (90 percent) of the proceeds of the issue are used for a government use, and the 2003 issue does not consist of private activity bonds.

Under § 141(d)(1), bonds are private activity bonds if the proceeds of an issue that are to be used (directly or indirectly) for the acquisition by a governmental unit of nongovernmental output property exceeds the lesser of 5 percent of such proceeds or $5,000,000. Under § 10631(c) of the Omnibus Budget Reconciliation Act of 1987 (the “1987 Act”), P.L. 100-203, 101 Stat. 1330-382, 1330-455, 1987-3 C.B. 102, 175, § 141(d) applies to bonds issued after October 13, 1987 (other than bonds issued to refund bonds issued before such date). However, § 141(d) does not apply to bonds (other than advance refunding bonds) with respect to a facility acquired after October 13, 1987, pursuant to a binding contract entered into on or before October 13, 1987.

The House Report, H.R. Rep. No. 100-391(I), at 1138 (1987), accompanying the 1987 Act provides that “[t]he rules governing binding contracts contained in Title XIII of the Tax Reform Act of 1986 are to be used to determine whether such a contract exists.” The Conference Committee Report (the “1987 Conference Report”), H.R. Conf. Rep. No. 100-495, at 1011-1012 (1987), 1987-3 C.B. at 291-292, accompanying the 1987 Act provides that the conference agreement follows the House bill, with a clarification that:

> the term binding contract for purposes of the general transitional exception in the House bill does not include an option to purchase output property. Rather, as provided under the general transitional exceptions in Titles II and XIII of the Tax Reform Act of 1986, a binding contract exists only if both parties to a transaction are bound to complete the sale/purchase of specifically identified property.

The 1986 Conference Report at II-55, 1986-3 C.B. (Vol. 4) at 55, explains Title II, § 203 as follows:

> The general binding contract rule applies only to contracts in which the construction, reconstruction, erection, or acquisition of property is itself the subject matter of the contract. A contract is binding only if it is enforceable under state law against the taxpayer, and does not limit damages to a specified amount (*e.g.*, by use of a liquidated damages provisions [sic]). A contractual provision that limits damages to an amount equal to at least five percent of the total contract price is not treated as limiting damages. For purpose of the general binding contract rule, a contract under which the taxpayer is granted an option to acquire property is not to be treated as a binding contract to acquire the underlying property. In contrast, a contract under which the taxpayer grants an irrevocable put (*i.e.*, an option to sell) to another taxpayer is treated as a binding contract, as the grantor of such an option does not have the ability to unilaterally rescind the commitment. In general, a contract is binding even if subject to a condition, as long as the condition is not within the control of either party or a predecessor . . . . A contract that was binding as of [October 13, 1987] will not be considered binding at all times thereafter if it is substantially modified after that date.

The 1986 Conference Report at II-694-695, 1986-3 C.B. (Vol. 4) at 694-695, explains Title XIII, § 1312(a) as follows:

> Whether or not an arrangement constitutes a contract is determined under the applicable local law. A binding contract is not considered to have existed before [October 13, 1987], however, unless the property to be acquired or services to be rendered were specifically identified or described before that date. A binding contract . . . exists only with respect to property or services for which the taxpayer is obligated to pay under the contract . . . . A contract may be considered binding on a person even though (1) the contract contains conditions which are under the control of a person not a party to the contract, or (2) the person has the right under the contract to make minor modifications as to the details of the subject matter of the contract. A contract that was binding on [October 13, 1987], will not be considered binding at all times thereafter if it is modified (other than as described in (2) above) after that date.

In order to determine whether the Proposed Bonds will be treated as financing property used for governmental purposes under §§ 103 and 141, we first consider whether the Proposed Bonds are subject to § 141(d).

The Issuer intends to use the proceeds of the Proposed Bonds to currently refund the Taxable Bonds. Hence, the proceeds of the Proposed Bonds will be used for the same purpose as the proceeds of the Taxable Bonds (*i.e.*, to purchase the b percent interest in the Plant, an existing output facility). Because the Issuer acquired the Plant after October 13, 1987, and the Taxable Bonds were issued after October 13, 1987, § 141(d) will apply to the Issuer's Proposed Bonds unless the Issuer acquired the Plant pursuant to a binding contract entered into before October 13, 1987.

We conclude that the Preliminary Agreement constitutes a binding contract within the meaning of § 10631(c) of the 1987 Act for the following reasons. The b percent interest in the Plant is specifically identified as the subject of the Preliminary Agreement, including the purchase price of the Plant and a description of the Issuer's and the Company's rights and obligations with respect to various aspects of the subsequent joint ownership of the Plant. The Preliminary Agreement is enforceable against the Issuer under State law and thus, neither the Issuer nor the Company had the unilateral right to terminate the Preliminary Agreement. While the Preliminary Agreement provision permitted the Company to seek other potential purchasers, this is analogous to the irrevocable put described in the 1986 Conference Report wherein the Issuer granted the Company an irrevocable right to sell the Plant to the Issuer at the stated contract price. If the Company did not reach an agreement with another purchaser, the Issuer had no right to unilaterally rescind the Preliminary Agreement and, therefore, was obligated to complete the purchase at the stated contract price. The provision that granted the Issuer the right to match the bona fide offer of another purchaser provided additional assurance that the Plant would be available to the Issuer notwithstanding the bona fide offer of another purchaser. In addition, while the Preliminary Agreement contains conditions within the control of the parties, each party was obligated to use good faith and best efforts to meet such conditions. Any attempt to use the conditions to unilaterally terminate the Preliminary Agreement would be a breach of contract, subject to the remedy of specific performance. In the event damages were awarded, the Preliminary Agreement contained no limitation on the amount of damages. Because the Final Agreement incorporated the provisions of the Preliminary Agreement and provided only additional details, including details as to the parties' rights and obligations regarding Plant refurbishment and operation that were generally described in the Preliminary Agreement, any Final Agreement modifications to the Preliminary Agreement were minor modifications as to the details of the subject matter of the Preliminary Agreement. Accordingly, we conclude that § 141(d) does not apply to the Proposed Bonds.

Pursuant to Announcement 2002-91, the Proposed Bonds may be issued to finance costs attributable to the government use portion of the Plant (plus costs attributable to any permissible private business use under § 141(b)) without the Proposed Bonds being characterized as private activity bonds.

We determine the government use portion of the Plant based on the percentage of the available output of the Plant that is not used for a private business use (as determined under § 1.141-7). Because the Plant is a cogeneration facility, we first consider the appropriate manner in which to measure the available output of the Plant in order to then determine the government use portion of the Plant. The Issuer proposes to measure the available output and use of the Plant according to the relative BTUs of coal input that are required to produce steam and electricity. The Issuer explains that this is the only reasonable manner to reflect the capacity of the Plant. For the reasons indicated below, we agree.

The Plant, as a single integrated facility, does not have a nameplate capacity or equivalent. Although the capacity could simply be determined by combining the capacity of the Plant components that produce steam with the capacity of components that produce electricity, the Issuer argues that this does not reasonably reflect the Plant's capacity as a single integrated facility. Rather, the Issuer explains that, in order to reasonably measure the available output and use of the Plant, the fact that the Plant produces two different types of output (steam and electricity) must be considered because producing steam and electricity do not require equal use of Plant assets. Instead, producing electricity requires use of more Plant components than producing steam. Moreover, in the process of producing electricity, a portion of Plant components will serve the dual purpose of producing steam. For example, producing electricity requires use of the boilers and all 21 stages of the Plant's turbines, but producing steam requires use of the boilers and only 8 of the 21 stages of the turbines.

The Issuer further explains that the Company and the Issuer have accounted for the difference in use of Plant assets to produce steam and electricity by relying on the relative BTUs of coal input that are required to produce steam and electricity. Because more BTUs of coal input are required to produce one BTU of electricity than to produce one BTU of steam, the Company and the Issuer concluded that BTUs of coal input accurately reflected use of Plant assets to produce each type of output. Hence, the Company and the Issuer determined the cost of the specific quantities of steam or electric output allocable to various users based on the relative BTU value of coal input into the boilers needed to produce a given quantity of steam or electricity. The Issuer reasonably expects to continue to determine production costs and rates for sales of output based on BTU value of coal input.

Although capacity is typically measured by reference to the output of a facility, we believe that the facts presented here support the use of input. The Plant produces different types of output that require use of different portions of the Plant for production. Moreover, the type of output that requires more components of the Plant to be created (*i.e.*, electricity) requires more BTU value of coal input and, thus, the amount of input appears to be reasonably related to the portion of the Plant being utilized to produce the output. Finally, the method has been utilized for other than tax-exempt bond purposes, as it has historically been used to allocate costs at the Plant as well as to determine the entitlement to output when the Issuer purchased its b percent interest in the Plant. Accordingly, we conclude that measuring the available output and use of the Plant by reference to the BTU value of coal input into the boilers is a reasonable manner to reflect the capacity of the Plant as a single integrated cogeneration facility. Because State has licensed the boilers to produce d pounds of steam per hour and based on the Issuer's representation that the BTU value of the coal necessary to produce d pounds of steam per hour is k BTUs per hour, we further conclude that it is appropriate to base the available output of the Plant on k BTUs per hour.

Having determined the appropriate method to measure the available output and use of the Plant, we next consider the Issuer's arrangements for the purchase of Plant output to determine the government use portion of the Plant. At all times while the Proposed Bonds are outstanding, the Issuer expects that at least l percent of the Plant's available output (based on maximum BTU value of coal input) will be reserved for use by the Purchasers. The Issuer bases this expectation on the Power Sales Contracts. Under those contracts, each Purchaser is required to take and pay for the portion of Plant output specified in that Purchaser's contract if the output is available from the Plant or, if not available, from sources other than the Plant. Although the Power Sales Contracts have a term of 20 years and, therefore, expire in Year 1 (before the Proposed Bonds mature), the Issuer reasonably expects to renew the Power Sales Contracts on the same or substantially similar terms. With respect to the l percent reserved for use by the Purchasers, the Issuer reasonably expects that over the term of the Proposed Bonds, no Purchaser will resell Plant output under an arrangement that gives rise to private business use under § 141(b). Thus, the Issuer reasonably expects that not more than m percent of the available output of the Plant (based on maximum BTU value of coal input) will be sold under contracts giving rise to private business use under Section 141(b) over the entire term of the Proposed Bonds. Therefore, we conclude that l percent of the Plant is the government use portion based on the percent of the available output of the Plant (based on maximum BTU value of coal input) that is not used for a private business use.

Because the Issuer has established that it reasonably expects that l percent of the output of the Plant will be used for government use over the entire term of the Proposed Bonds, we conclude that under Announcement 2002-91, use of the proceeds of the Proposed Bonds to finance the l percent of the costs of the Plant improvements (plus costs attributable to any permissible private business use under § 141(b)) will not cause the Proposed Bonds to satisfy the private business tests under § 141(b).

Although Announcement 2002-91 provides that bonds may be issued to finance costs attributable to the government use portion of an output facility (plus costs attributable to any permissible private business use under § 141(b)) without the bonds being characterized as private activity bonds, it does not specifically address how to analyze a refunding of bonds previously issued to acquire an interest in a facility. In particular, it does not directly address whether the portion of the Proposed Bonds used to refund the Taxable Bonds may be treated as financing the government use portion of the Plant.

The Issuer issued the Taxable Bonds to acquire the b percent interest in the Plant, which gave it rights to b percent of the capacity of the Plant. The b interest in the Plant was acquired to serve the Purchasers and it has continued to serve such Purchasers. From the Date 7 execution date of the Power Sales Contracts until the Issuer's Date 8 purchase of the remaining c percent interest in the Plant, other than short term sales of less than a one-year term to non-Members, 100 percent of the output attributable to the b percent interest was sold to the Purchasers (each of which is a political subdivision) under the Power Sales Contracts. Based on the Power Sales Contracts, the Issuer reasonably expects that l percent of the available output of the Plant will be used for government use over the entire term of the Proposed Bonds. This percentage is greater than the b percent interest originally acquired to serve the Purchasers. In these circumstances, we believe it is appropriate to treat the Taxable Bonds (and the Proposed Bonds that refund them), as financing the government use portion of the Plant. Moreover, on these facts and circumstances, the Issuer's subsequent purchase of the remaining c percent of the Plant with equity does not invoke the requirement in Announcement 2002-91 that bond proceeds and equity be expended contemporaneously with respect to mixed use facilities and thereby prohibit the refunding of the Taxable Bonds. Accordingly, we conclude that use of the proceeds of the Proposed Bonds to refund the outstanding Taxable Bonds will not cause the Proposed Bonds to satisfy the private business tests under § 141(b).

CONCLUSIONS

1. The Issuer will be treated as an instrumentality of its Members for purposes of § 141 and, therefore, the Issuer's use of the Plant will constitute government use.

2. The Proposed Bonds will not be treated as financing nongovernmental output property under § 141(d) because the Issuer entered into a binding contract to purchase the b percent interest in the Plant prior to October 13, 1987.

3. Use of the proceeds of the Proposed Bonds to finance l percent of the costs of the Plant improvements (plus costs attributable to any permissible private business use under § 141(b)) and to refund the outstanding Taxable Bonds will not cause the Proposed Bonds to satisfy the private business tests under § 141(b).

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.

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.

Sincerely yours,
Assistant Chief Counsel (Exempt Organizations/Employment Tax/Government Entities)
By:______________________________
Bruce M. Serchuk
Senior Technician Reviewer
Tax Exempt Bond Branch