June 7, 2021

Tom West
Deputy Assistant Secretary (Tax Policy)
Office of Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C.

Re: **<u>Private use rules for output facilities</u>**

Dear Tom:

We are writing to follow up on behalf of the Large Public Power Council ("LPPC") on our recent meeting with you and other Treasury and Internal Revenue Service personnel concerning potential guidance related to the application of the private activity bond test to output facilities. We very much appreciate you and your team taking the time to meet with us on these issues. We note that we recently submitted a request that the 2021-2022 Priority Guidance Plan include guidance on the private activity bond test for output facilities under section 141 of the Internal Revenue Code. We wanted to provide you with our specific suggestions on revisions to the regulations that we discussed and address certain concerns that were raised. We believe that certain discrete changes can be made to the rules that would effectively address LPPC's most significant concerns.

As a reminder, LPPC is a national organization comprising 27 of the nation's largest public power systems. LPPC's members are locally owned and controlled not-for-profit electric utilities committed to the people and communities we serve. LPPC advocates for policies that allow public power systems to build infrastructure, invest in communities and provide reliable service at affordable rates. LPPC members provide reliable, low-cost electric service to over 30 million people and our member utilities own and operate over 30,000 circuit miles of high voltage transmission lines and over 71,000 MW of generation with a significant amount of renewables, fossil, hydro, efficiency and demand side management. LPPC's members have been and will continue to be among the largest issuers of tax-exempt bonds because of the capital intensive nature of the electric utility industry. In addition, LPPC's members are at the forefront of the movement to an energy industry that relies on renewable energy and to reduce reliance on fossil fuel generation. The changes to the "private use" rules that we are seeking will assist LPPC's members and other public power systems in these efforts.

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As we discussed, it has been over 30 years since the enactment of the private use rules for public power in the Tax Reform Act of 1986 and nearly 20 years since the related regulations Section 141 for output facilities were updated. The changes to the regulations that were made in 2002 were, in part, made in response to significant changes that had occurred in the electric industry. In light of the changes that have occurred in the electric industry since 2002, the private use rules should again be modified. We are focused on the two most significant issues affecting LPPC's members, the impact of large retail customers and the issues created by the section 141(d) "Rostenkowski Rule" on the ability of our members to use tax-exempt bonds to acquire existing electric resources needed to serve their customers. Our letter to then Associate Tax Legislative Counsel, John Cross, dated March 18, 2019, a copy of which is attached, provides greater detail on the background of these matters.

Contracts with retail customers

Background. As we discussed, a growing trend in the industry is that large retail electric customers – both existing customers and new customers – are seeking to negotiate customized contracts for electric service with public power and other utilities. As you know, the private use rules limit the ability of public power utilities to enter into customized contracts and put public power systems at the risk of losing these important customers. These customers can be extremely important to their communities and the inability provide these customers with satisfactory electric service arrangements could be devastating. At the same time, if these customers are not obligated to remain as customers for a significant enough period of time, the utility and its other customers are at risk that they will bear the cost of the improvements required to serve these customers if they go out of business or relocate.

Proposed rule. Under the current regulations, the only approach that can be used by LPPC's members with large, retail customers is to enter into contracts with terms of not more than 3 years, which is not sufficient for the public power system to ensure that its other customers will end up bearing the cost of any necessary improvements and often does not provide a long enough contract term for the customer. As we discussed, the regulations contain a more generous rule for contracts with wholesale customers that permits contracts, subject to certain conditions, with terms of up to 5 years. We believe that a similar rule that reflects the differences between wholesale purchasers of electricity and retail customers should be adopted. A wholesale customer uses the electricity from a tax-exempt financed facility directly as part of its core business of selling electricity to its customers and that facility becomes part of the utility's asset mix. In contrast to that very direct use of the electricity in the trade or business of a utility, the use of electricity by a retail customer, whether large or small, is ancillary and incidental to its core business and, for that reason, a distinction seems appropriate. We propose the adoption of an exception to the private use rules for retail requirements contracts to permit contacts even if there is an obligation of the purchaser to make payments that are not contingent on its output requirements if:

(a) the term of the contract is not more than 10 years (including renewal options);

(b) 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

(c) the output facility is not financed for a principal purpose of providing that facility for use by that nongovernmental person.

This approach would make the rules for retail contracts similar to the rules for wholesale contracts. Alternatively, the exception to the private use rules for sales of electricity with terms of up to 3 years could be modified to permit longer term contracts of up to 10 years for retail customers.

Customer benefitting from tax-exempt financing. At our meeting, concerns were expressed that customized contracts with retail customers could enable those customers to directly benefit from the lower rates on tax-exempt bonds, which is the very reason that the private use limitations exist. We believe that this concern is addressed by the manner in which public power prices electricity and the limitations that we have included in our proposal, which are similar to provisions in the existing regulations that address this type of concern.

LPPC utilities set rates by electric rate classes, with different classes and rates for different types of customers rather than entering into special contracts with particular customers.[1] When a large new customer seeks to obtain electric service, the process involves the utility putting the customer into a rate class that would apply (or establishing a new rate class that would apply to that customer and any other similar customers that come along if an existing rate class does not apply).

A key aspect of establishing the rate for the class is the amount of electricity expected to be used and the timing of the use (for example, is it a relatively constant load 24 hours a day all year round or is it mostly during ordinary business hours). A rate is established based on the cost of serving the load profile of the customers in that class.

As nonprofit, governmental entities, LPPC's members set their rates to cover their costs, including the costs of the infrastructure used to serve the customers in each customer class and to provide an additional cash cushion ("coverage") required to satisfy covenants with bondholders. Debt service is only one such cost. The electric rate for a particular customer class is not tied to a particular facility but, instead, is based on average costs to serve the customers in that class as allocated to each class of customer. In effect, all of a public power system's customers benefit from tax-exempt financing in the same way: these bonds provide the funding for the facilities that serve customers and the electric rates for all customers reflect the lower interest rates on tax-exempt bonds.

There are circumstances where public power systems impose the cost of specific improvements necessary to only serve a particular customer directly to that customer in establishing its rate. Should a public power system construct or operate a facility or improvement for the benefit of only one customer, it would typically impose a direct charge on that customer for that investment. That would result in private use and as such would not qualify for or benefit from the use of tax exempt debt. That issue is distinct from our proposal on customized contracts.

[1] Although there are some circumstances where contracts are entered into with particular customers, typically those contracts are based on a rate class and the rates are determined in the same manner as for other customers.

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We believe that the above-described method of setting electric rates provides comfort that the changes to the private use rules that we are suggesting will not lead to contracts with large retail customers that are inconsistent with the purposes of section 141. In addition, the proposed requirement that the contract is either a negotiated, arm's-length arrangement that provides for compensation at fair market value, or is based on generally applicable and uniformly applied rates would ensure that the contract rate is set in the manner described above or, if not, that the rate is set without regard to the debt service on the utility's tax-exempt bonds) Second, the requirement that the related facility is not financed for a principal purpose of providing that facility for use by that nongovernmental person ensures that a contract is not designed so that a particular customer is paying for the cost of a facility that is being built or acquired for the benefit of that customer. In addition, limiting the term of these contracts to 10 years for facilities that are typically financed over 20 to 30 year periods, also helps demonstrate that the bonds are not being issued for a particular customer since there is no assurance that the customer will be around for more than half of the term of any particular bond issue.

We have drafted our proposal to contain the same types of restrictions as apply to wholesale requirements contracts (section 1.141-7(c)(3)(iii)(C)) and to permitted short-term sales of electricity (section 1.141-7(f)(3)), which are also designed to prevent the benefit of tax-exempt financing from being passed on to a nongovernmental purchaser. Similar restrictions are also contained in the special exceptions for private use related to transmission and distribution facilities used to provide "open access" (that is, that the facilities not being financed for a principal purpose of providing that facility for use by that nongovernmental person). See section 1.141-7(f)(2). This "principal purpose" limitation is also part of two private use exceptions that apply outside of the output context. See section 1.141-3(d)(3)(i) and (ii), which relate to short term use exceptions to private use. Another exception for mandated "wheeling" of electricity as a result of open access is conditioned on the terms of the contract being bona fide and arm's-length, and the consideration paid is consistent with the provisions of section 212(a) of the Federal Power Act. See section 1.141-7(f)(4)(i). Each of these rules demonstrates that Treasury has, in the past, been willing to provide exceptions to the private use rules conditioned on the satisfaction of restrictions designed to limit the sharing of the benefit of tax-exempt bonds with a nongovernmental person.

Acquiring existing output facilities

Section 141(d) (the "Rostenkowski Rule") was enacted in 1987 and regulatory guidance on this provision has yet to be provided. Although designed to prevent tax-exempt bonds from being used to "municipalize" privately owned facilities, the rule contains an exception designed to permit the acquisition of existing facilities by a public power system to serve its existing customers. As we have discussed, the exception is difficult and burdensome to apply: the utility must use virtually all of the electricity from the acquired facility to serve customers in its historic service area throughout the term of the bond issue and monitor compliance with this rule. More importantly, the rule forces the utility to use its various electric generation assets in a manner that may be uneconomic and that can tie its hands in how it operates those assets.

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We suggest two possible approaches that can be used to address these issues. The first is to simply provide that the short-term sale exception to private use of output facilities applies to section 141(d). At the time that the Rostenkowski's Rule was enacted, the legislative history stated that the 30-day short term sales that do not result in private use under the 1986 Act would not create noncompliance under section 141(d). Since that time, the short term sale exception for private use purposes has been changed to a 3-year exception but it has never been made clear whether this rule applies under section 141(d). This change would provide public power with the flexibility needed to comply with the section 141(d) restriction.

Alternatively, a safe harbor could be adopted that permits public power systems to base compliance on their historical use of electric generation to satisfy customers in their historic service areas. This approach would be modeled after section 148(b)(4)(B), related to bonds issued to finance natural gas prepayments. The same types of compliance-related issues under section 141(d) also arose after the adoption of the regulations related to financings of prepayments for natural gas. In recognition of the difficulties created by the regulatory approach, Congress enacted a statutory safe harbor under which compliance with the rules for gas prepayments could be based on historical use in the service area of the gas purchaser. This rule has proven to be much more workable than the regulatory approach and could be extended to apply to section 141(d). Under this approach, a new safe harbor would permit public power systems to use their historic sales of electricity over the prior 5 years to customers in their service areas to determine compliance with the existing service area exception of the Rostenkowski Rule.

Conclusion. We very much appreciate your working with us on these issues. We would be happy to have a further discussion with you and your team about these issues and our proposals.

Sincerely,

John Di Stasio, President
Large Public Power Council

cc: Mark Mazur
Krishna Vallabhaneni
Johanna Som de Cerff

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