



Dear \_\_\_\_\_ :

This letter is in response to your letter dated June 8, 2004, as well as other correspondence, asking the Internal Revenue Service to rule on the transaction described below. The issues involved in this request are similar and related to the issues contained in letter ruling 9750018 (PLR) issued to the same taxpayer on Date 1. The facts and holdings of that letter ruling are hereby incorporated by reference.

Subsequent to the issuance of PLR, the Service published Rev. Proc. 2002-49, 2002-2, C.B. 172, setting forth a safe harbor for the treatment by an electric utility company of transactions in which the utility is issued a financing order by a State agency authorizing the recovery of certain transition costs incurred by the utility. Company has represented that the costs to be recovered and securitized under Statute 2 are, in effect, transition costs authorized to be collected under PLR and Statute 1. Although these costs appear to fall within the scope of Rev. Proc. 2002-49, due to intervening factual changes with respect to the transaction addressed in PLR, Company has requested a supplemental ruling confirming that the factual changes will not affect the legal conclusions reached in PLR.

## BACKGROUND

In PLR, the Company was authorized under Statute 1 to recover a portion of its transition costs by collecting a separate, nonbypassable, usage-based charge called fixed transition amounts (FTAs) and by issuing securities that were secured by the Company's right to collect the FTAs. Additionally, under Statute 1, Company was required to purchase electricity at short-term wholesale market rates to meet the power requirements of its customers. Beginning in the summer of Year 1, the wholesale electricity rates began to skyrocket in State and exceeded the revenue available to cover those costs from the frozen retail rates in effect for Company under State's laws and regulations implementing Statute 1. Company was not able to recover all of its electricity procurement costs and lost substantial amounts of money. Given the uncertainty of Company ever collecting these unrecovered procurement costs and various transition costs from its ratepayers, in Month 1 of Year 1, Company wrote off \$A in unrecovered procurement costs and various transition costs for financial accounting purposes, but not for tax purposes. By the beginning of Year 2, Company was unable to recover approximately \$B of costs from its customers. Company incurred additional debt to finance those unrecovered costs resulting in a large amount of defaulted debt and the downgrading of its credit ratings to below investment grade status.

Accordingly, on Date 4, Company filed for Chapter 11 bankruptcy protection, and on Date 5, Company and the Public Utility Commission (PUC) reached a proposed settlement agreement (PSA) setting forth a plan of reorganization to allow Company to

emerge from bankruptcy as an investment grade entity. The PUC recognized that the establishment, maintenance, and improvement of Company's investment grade credit ratings would directly benefit Company's ratepayers by reducing Company's immediate and future borrowing costs thereby allowing Company to finance its operations and capital expenditures at a lower cost to the ratepayers. The PUC stated that an additional purpose was to provide for the timely and full recovery of the Company's past costs. The primary means to achieve these goals was the establishment of the Regulatory Asset with an after-tax value of \$C as an additional part of Company's rate base.

Pursuant to the PSA, the Regulatory Asset is to be amortized on a mortgage style basis over nine years beginning on Date 7. Company is required to reduce the unrecovered balance of the Regulatory Asset by the net after-tax amount of any payments, offsets, or other credits that Company actually receives from energy suppliers in connection with Company's claims arising out of Company's purchase of wholesale electricity during the energy crisis of Years 1 and 2. In establishing the Regulatory Asset, unrecovered procurement costs and transition costs that were written off for financial accounting purposes in Month 1 of Year 1, were recorded as a contra-expense for financial accounting purposes.

In Month 2 of Year 2, the PUC issued Decision promulgating a new accounting rule retroactive to Date 3. This new accounting rule had the general effect of treating transition costs as the last costs recovered from all sources of revenue. Because the Decision effectively prolonged the Statute 1 freeze on Company's retail electric rates during the State energy crisis, Company petitioned the State Supreme Court to overturn Decision. The Court denied that petition, and the Decision is now final and no longer subject to judicial review. The general principle embodied in the Decision (that transition costs should be treated as the last costs recovered) means that the entire \$C after-tax Regulatory Asset is attributable to Company's remaining unrecovered transition costs as of Date 7.

In joint comments filed with the PUC on Date 6, a ratepayer advocacy group and the Company agreed to support a modified version of the PSA (the Modified Settlement Agreement or MSA) with a condition precedent to the execution of the MSA being that after exiting from bankruptcy, Company would seek as expeditiously as practical to refinance a portion or all of the Regulatory Asset and associated deferred federal and state income and franchise taxes by using up to \$D of securitized financing, to be authorized by future implementing State legislation.

## FACTS

On Date 8, the governor of State signed into law Statute 2, generally providing for the issuance of securitized bonds (Recovery Bonds or RBs) to refinance the unamortized pre-tax balance of Company's Regulatory Asset together with associated federal and state income and franchise taxes. Statute 2 authorizes the PUC to issue a

financing order to approve the issuance of RBs by Company or a special purpose subsidiary in one or more series on or before Date 9. Under the financing order, Company or its assignee will be authorized to impose, bill and collect fixed recovery amounts (FRAs) as a separate nonbypassable charge upon consumers of electricity in Company's service territory with the per unit amount of FRAs to be set and adjusted from time to time at levels sufficient to ensure the timely payment of principal, interest and other amounts in respect of the RBs. Moreover, Statute 2 directs the PUC to establish an effective mechanism to ensure collection of FRAs from existing and future consumers of electricity through Company's service territory and provides that the obligation to pay FRAs cannot be avoided by the future municipalization of any portion of the Company's service territory, subject only to limited exceptions. Additionally, Statute 2 provides that the right to collect FRAs gives rise to a separate property (Recovery Property) right under State law and provides that the Financing Order may authorize Company to sell or assign Recovery Property to an affiliate and may authorize Company or its affiliate to pledge Recovery Property as collateral for RBs. Consumers of electricity in Company's service territory will continue to pay FRAs until the RBs are paid in full. Company is required to credit consumers with the net after-tax amount of any payments, offsets, or other credits Company actually receives from generators of electricity or other energy suppliers that would have reduced the unamortized balance of the Regulatory Asset had RBs not been issued.

Pursuant to Statute 2, Company has applied for a financing order seeking to establish the Issuer, a single member limited liability company wholly owned by Company, for the purpose of issuing RBs in one or more series to refinance an amount equal to the entire unamortized balance of the Regulatory Asset. Pursuant to the Financing Order, Company will sell Recovery Property to the Issuer in exchange for cash in an amount equal to the fair market value of the Recovery Property, including all the proceeds from the issuance of up to approximately \$D principal amount of RBs (less costs of issuance) in one or more series. At or before the date of issuance of RBs, Company will also contribute equity to the Issuer in an amount no less than E of the total initial principal amount of the RBs. Pursuant to the Indenture between the Issuer and a financial institution as indenture Trustee, this capital contribution will be held by the Trustee in a Capital Subaccount and will be pledged to secure the RBs. To the extent not needed to pay principal, interest or other amounts due in respect of the RBs and not needed to replenish the Capital Subaccount or to fund or replenish the Overcollateralization Subaccount, earnings from the Trustee's investment and reinvestment of the Issuer's capital in the Capital Subaccount may be released from the pledge of the Indenture to the Issuer and may be distributed by the Issuer to the Company.

The Issuer will issue the RBs to a syndicate of underwriters for resale to public Investors. The RBs will be either recourse or non-recourse to the Issuer, but in either case will be secured by the Recovery Property and by amounts held by the Trustee in the Collection Account, including all amounts held in the Capital Subaccount, the Overcollateralization Subaccount and the Reserve Subaccount. Company and the

Issuer will enter into an administration agreement pursuant to which Company will provide administrative services to the Issuer. Company and the Issuer also will enter into a servicing agreement pursuant to which Company will provide FRA billing, collection and related services to the Issuer. Company will act as servicer and will remit FRAs on a monthly or more frequent basis to the Trustee for the account of the Issuer. The Trustee will deposit these remittances to the General Subaccount in the Collection Account established pursuant to the Indenture. Amounts in the General Subaccount will be pledged to secure the RBs.

The financing order will provide that FRAs are to be set and periodically adjusted to produce collections sufficient not only to pay scheduled principal, interest and certain expenses, but also to fund a scheduled Overcollateralization Requirement that will grow over time to not less than E of the initial principal amount of the RBs. Pursuant to the Indenture, this Overcollateralization Requirement will be held by the Trustee in an Overcollateralization Subaccount and will be pledged to secure the RBs. If actual FRA collections during any period exceed the amount of scheduled payments of principal, interest, expenses, the amount necessary to fund the scheduled Overcollateralization Requirement, and any amount required to replenish the Capital Subaccount, the excess will be held by the Trustee in a Reserve Subaccount. The Reserve Subaccount will be pledged to secure the RBs. Amounts in the Reserve Subaccount will reduce the RB revenue requirement for purposes of adjusting the FRA for the next period.

FRAs will be set and adjusted at least annually to yield forecasted collections by the next adjustment date equal to the sum of (a) accrued interest, (b) scheduled principal, (c) Trustee fees and expenses, administration fees, servicing fees and other periodic fees and expenses (d) the amount (if any) by which the Capital Subaccount has been depleted, and (e) the difference between the Overcollateralization Subaccount, less any amount held in the Reserve Subaccount. FRAs will be calculated based on the servicer's projections of electricity deliveries and resulting FRA collections in amounts for each period sufficient to fund the amounts described in the preceding sentence.

Company anticipates the RBs will be issued in several classes with the scheduled final maturity of the last class being as late as 15 years from the date of issuance. Cash available on each payment date will be applied to scheduled principal payments on each class of RBs in the order specified in the Indenture until the outstanding principal balance on that class has been reduced to the principal balance specified in the expected amortization schedule for that payment date. Company expects that the legal final maturity for each class will be approximately two years following the scheduled final maturity for that class. Interest and principal will be payable either quarterly or semi-annually, and interest will be set at traditional fixed or floating rates.

If the principal balance of the RBs has been reduced to five percent or less of the original principal amount, the Issuer might be entitled to redeem the RBs then

outstanding. The optional redemption price for the RBs will be the outstanding principal amount plus accrued interest.

The FRAs will be levied through applicable PUC tariffs in the form of a usage-based charge as a portion of each consumer's monthly electric utility bill. The FRAs may or may not be separately identified on each bill. In either case, published tariffs will separately identify the portion of the rate attributable to FRAs.

No further FRAs will be billed after the RBs have been paid in full. When setting other electric rates for Company, the PUC is authorized to take into account any collection of FRAs in excess of amounts actually required to pay recovery costs financed by the RBs.

To the extent collections of FRAs during any period are less than the forecasted amounts and to the extent amounts in the Capital Subaccount, The Overcollateralization Subaccount and the Reserve Subaccount are insufficient to cover the shortfall, the RBs may be amortized more slowly than scheduled. However, the Financing Order will require the PUC to adjust tariffs at least annually in order to minimize this variability.

The RBs will provide that an event of default occurs if (a) all accrued interest is not paid within a precise number of days after each periodic payment date, or (b) principal for any class is not paid by the legal final maturity date for that class. If an event of default has occurred and is continuing, the Trustee or holders of a majority of the outstanding principal of the RBs may declare all principal and accrued interest on the RBs to be immediately due and payable. If this should occur, the Trustee may either sell the Recovery Property with the consent of a majority of the holders of outstanding RBs or may direct the Issuer and the servicer to apply to the PUC for adjustment of the FRA tariff and continue to apply FRA remittances to interest and principal that is due and payable.

Pending remittance of FRA collections to the Trustee, Company may commingle FRA collections with Company's other funds. Company will retain any investment income earned on these amounts during such time as additional servicing compensation.

Company's customers may or may not be notified of Company's transfer of the Recovery Property to the Issuer. Company will pay any franchise fees due in respect of the FRAs and Company will collect and remit to the appropriate governmental authorities any utility use taxes imposed in respect of the FRAs. Company may be liable for any actions brought against the Issuer arising out of the failure by Company properly to perform its servicing function (unless due to the Issuer's negligence or willful misconduct) as well as for any damages suffered as a result of Company's failure to perform its duties under the administration agreement or under the servicing agreement. Company will continue to service the consumer accounts that are subject to the FRAs

and, as servicer, will retain all books and records regarding the FRAs, subject to a right of inspection.

#### 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 FRAs is of significant value in producing income for Company. Moreover, State’s action in making the FRA 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. (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 PUC financing order authorizing the collection of Fixed Recovery Amounts and the creation of Recovery Property does not result in gross income to Company.
2. The issuance of Recovery Bonds will not result in gross income to Company.
3. The Recovery 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.

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

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

Sincerely,

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