ATTACHMENT 2

Electricity Tax Agreement

LPPC/APPA and EEI

The industry agreement on electricity restructuring tax issues is intended to modify the federal tax laws to remove certain impediments to effective competition in the electric power industry. The agreement is intended to preserve the right to use tax-exempt financing to serve public power systems' own electric load and remove the current tax law impediments to opening up these systems to competition. The agreement preserves public systems' use of tax-exempt bonds to finance distribution facilities, with some limitations. The agreement eliminates taxation of customer contributions in aid of construction for shareholder-owned systems' electric transmission and distribution facilities. The agreement also facilitates FERC's open access transmission policies by allowing public systems to provide open access without violating private use rules and by providing tax relief to shareholder-owned utilities that sell or spin-off transmission facilities to businesses that join independent regional transmission organizations. Last, the agreement is intended to assure adequate financing of nuclear decommissioning activities in a competitive, restructured electric industry.

The provisions of the agreement are described more specifically below.

I. PRIVATE USE

A. Election to Terminate Issuing New Tax-Exempt Bonds

1. Termination Election

Under the agreement, public power systems can elect to permanently terminate issuing most new tax-exempt bonds, in return for an exemption from private use rules for all of their existing tax-exempt bonds issued before date of enactment. However, an electing system may continue to issue certain tax-exempt bonds which are described below.

2. Tax-Exempt Bonds that may be Issued after a Termination Election

Qualified bonds and refunding bonds. -- An electing system may continue to issue any qualified bond as defined in Section 141(e) of the tax code. (These are tax-exempt bonds that are currently free of most private use constraints.) An electing system may also issue any eligible refunding bonds. An eligible refunding bond is a state or local bond issued after the system makes the election, that directly or indirectly refunds tax-exempt bonds that were issued before the system made the election, provided the weighted average maturity of the refunding bonds does not exceed the remaining average maturity of the refunded bonds.

Qualifying transmission and distribution facilities. -- An electing system may continue to issue bonds to finance a local transmission facility over which the system provides open transmission access (a qualifying transmission facility); and a distribution facility over which the system provides open retail access (a qualifying distribution facility). New transmission and distribution bonds issued under this exception are subject to private use rules, as modified by the agreement.

Repairs. -- An electing system may continue to issue tax-exempt bonds for repair of electric generating facilities that were in service on the date of enactment or construction of which was commenced prior to June 1, 2000. Repair may include replacement of components of the electric generating facilities, but does not include replacement of a major portion of an electric generating facility. The repairs performed with the tax-exempt financing may not increase the capacity of the generating facility by more than 3% of base year capacity.

Environmental. -- An electing system may also continue to issue tax-exempt bonds to meet federal or state environmental requirements applicable to electric generating facilities that were in service on the date of enactment or construction of which was commenced prior to June 1, 2000.[1/]

Renewables. -- An electing system may issue tax-exempt bonds for renewable energy generation facilities during any period in which tax credits for the same type of facility are available to private entities. Tax credits are currently available for solar, wind, geothermal and closed-loop biomass generating facilities.

B. Updated Private Use Rules for Non-electing Systems

Under the agreement, public power systems that do not make the termination election remain subject to private use rules. However, the agreement would modify the private use rules applicable to public power systems that do not make the termination election to permit open access transmission and distribution and to permit public power systems to make certain electric sales not subject to private use rules in order to retain or replace certain load.

[1/] LPPC/APPA and EEI jointly express support for the concept that all electric utilities, public and shareholder-owned, be allowed to issue new tax-exempt bonds for air or water-pollution control facilities placed in service after the date of enactment. However, the parties are not going to propose legislative language to cover this concept.

1. Open Access

The following open access transmission and distribution activities do not constitute a private business use: (1) providing non-discriminatory open access transmission service; (2) participation in an ISO, RTO or RTG agreement approved by FERC; (3) providing nondiscriminatory open access to distribution facilities for retail delivery of electricity sold by other suppliers; and (4) other open access transactions as provided by the Secretary. Open access transmission must be provided under a FERC-approved RTO agreement or pursuant to an open access tariff approved by FERC. If the open access tariff has been filed voluntarily, the public power system must comply with requirements of FERC Order No. 2000 concerning reporting its plans for regional transmission organizations. For certain Texas utilities, approvals are by the Public Utility Commission of Texas, rather than by FERC.

2. Sales

<u>Wholesale sales by open access transmission utilities</u>. – Public power systems that do not make the termination election and that provide open access transmission service are permitted to make certain wholesale sales not subject to private use rules from generation facilities in service on the date of enactment or construction of which commenced prior to June 1, 2000. To qualify under this provision, the sale must be to a "wholesale native load purchaser" or a "wholesale stranded cost mitigation sale".

A wholesale native load purchaser is a wholesale purchaser to whom the public power system had a service obligation in the base year, or an obligation in the base year under a requirements contract or firm sales contract that has been in effect for, or has an initial term of, 10 years or more.

A wholesale stranded cost mitigation sale is a wholesale sale to an existing or new wholesale customer which replaces lost wholesale native load. Lost load is measured by the difference between base year sales to wholesale native load purchasers and the sales to such purchasers during recovery period years. The recovery period is a 7 year period beginning with the start-up year; however, there is a limited one year carry-over to an eighth year. At the election of the public power system, the start-up year is the year the system first offers open transmission access, the first year in which at least 10% of the system's wholesale customers' aggregate retail load is open to retail competition or, the year of enactment, if later. The base year is the year of enactment or, at the election of the public power system, one of the two preceding years.

<u>On-system sales by open access transmission and distribution utilities</u>. – Public power systems that do not make the termination election and that provide open access transmission **(**if the system owns or operates transmission**)** and open access distribution service may also make sales not subject to private use rules to an "on-system purchaser" from generation facilities in

service on the date of enactment or construction of which commenced prior to June 1, 2000. An on-system purchaser is specifically defined as one whose facilities or equipment are directly connected with the public power system's transmission or distribution facilities and who purchases electricity from such system and is either a retail purchaser within the area in which the system provided distribution services in the base year or is one to whom the system has a service obligation, or who is a wholesale native load purchaser from the system.

C. Limits on New Tax-Exempt Financing for Certain Transmission and Distribution Facilities

1. Transmission

Local transmission facilities limitation. -- Under the agreement, whether or not they make the termination election described above, public power systems may issue new tax-exempt bonds for transmission facilities only if the facilities are "local transmission facilities." Local transmission facilities are transmission facilities located in a public power system's existing distribution area or facilities which are, or will be, necessary to serve its wholesale or retail native load. A system's retail native load is the load of end-users served by its distribution facilities. A system's wholesale native load is its wholesale sales to its wholesale native load purchasers (or purchasers under wholesale requirements or other firm contracts that were in effect in the base year), or the electric load of end-users served by any such wholesale purchaser's distribution facilities. Electric reliability standards of national or regional reliability organizations, or decisions of RTOs or state or federal agencies shall be taken into account in determining whether facilities are or will be necessary to serve wholesale or retail native load. Transmission siting and construction decisions of RTOs and state and federal agencies shall be presumptive evidence as to whether transmission facilities are necessary to serve native load.

Exceptions. -- Tax-exempt bonds may also be issued to finance any repair, replacement or qualifying upgrade of an existing transmission facility that is not a local transmission facility or to comply with an obligation under an existing shared transmission agreement. However, repair or replacement may not increase the voltage level nor may it increase thermal load limit by more than 3%. A qualifying upgrade is defined as an improvement to existing transmission facilities ordered or approved by an RTO or ordered by a state or federal regulatory or siting agency.

2. Distribution

As under current law, a public system can use tax-exempt financing to construct distribution facilities to serve its customers or existing customers of other utilities as governed by state law. However, under the agreement, a public power system which begins operation after the date of enactment would be precluded from issuing tax-exempt bonds for distribution facilities until it has been in operation for 10 years. In addition, except for certain voluntary transactions, public power systems could no longer issue tax-exempt bonds under the state volume cap to purchase distribution facilities owned by non-governmental utilities.

II. SHAREHOLDER-OWNED UTILITY TAX RELIEF

A. Contributions in Aid of Construction

Tax relief for investor owned utilities in the form of contributions in aid of construction (CIAC) would be as proposed in H.R. 2464 (the Watkins bill), but limited to electric distribution and transmission. Contributions in aid of construction (CIACs) for electric transmission and distribution facilities (including contributions for customer connection fees) would be exempt from income tax. However, fees received for starting and stopping service would not be CIACs and would still be subject to income tax. A utility would not obtain basis in property constructed with the proceeds of CIACs (to the extent of the CIAC received).

B. Transco Tax Relief

The transco tax relief provision of the agreement would defer taxes attributable to certain gains on sales (IRC Sec. 1033) and would permit tax-free spin-offs (IRC Sec. 355) by a utility of transmission facilities to an entity which FERC determines is not a market participant and which is either a FERC-approved RTO or is part of a FERC-approved RTO, or which a state commission, in ERCOT only, approves as consistent with state law regarding an independent transmission organization. The agreement would permit the deferral of tax on the entire proceeds of sale of transmission facilities to an independent transco; but with a savings provision that makes it clear that the tax treatment of the acquisition is not intended to affect FERC or state policy with respect to the extent to which any acquisition premium paid in connection with the purchase of the facilities can be recovered in the buyer's rates. FERC's longstanding policy in the context of facilities that remain under cost of service regulation has been to restrict buyer's rate base to the seller's depreciated original cost of the facility unless the buyer shows that the investment decision is prudent and can demonstrate that the acquisition provides measurable net benefits to ratepayers.

C. Nuclear Decommissioning

The nuclear decommissioning provisions of the agreement would be identical to the nuclear decommissioning tax provisions found in H.R. 2038 (which was introduced by Rep. Weller). These provisions would eliminate the requirement that amounts contributed to a qualified nuclear decommissioning fund come solely from amounts specifically collected from ratepayers under cost-of-service regulation. The provision would also define nuclear decommissioning costs and acknowledge that all such costs are currently deductible when paid or incurred, allow contributions to a qualified fund on an accelerated basis if such funding is required in connection with the transfer of a nuclear power plant, allow taxpayers to use a qualified fund to accumulate all monies needed for decommissioning irrespective of the age of a generating plant and discontinue the requirement that taxpayers obtain a ruling from the Internal Revenue Service before making contributions to a qualified fund.