FAX COVER SHEET

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Part I: To Be Completed By Requesting Office

Date: December 23, 2013 Control Number: PLR 147299-13

Taxpayer: LONG ISLAND POWER AUTHORITY

ITEM(S) TO BE FAXED:

[X] Ruling

[ ] ______

FAX TO:

Name: Jay Eustis FAX Telephone No.: (212) 820-9666

Firm/Company ______

FROM:

Chief Counsel Employee: Jim Jones/David White

Symbols: CC:FIP:5 Phone: (202) 317-4563

PART II: To Be Completed By Communications & Records Unit

FAX TRANSMISSION

Date: ______ Time: ______

Employee: ______

Number of Pages: ______

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Internal Revenue Service

Index Number: 141.00-00, 141.07-00

Lynda Nicolino
General Counsel
Long Island Power Authority
333 Earle Ovington Blvd
Uniondale, New York 11553

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
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(202) 317-4562
Refer Reply To:
CC:FIP:B05
PLR-147299-13
Date:
December 23, 2013

LEGEND:

Act	=	the LIPA Reform Act
Authority	=	the Long Island Power Authority E.I.N. 11-2879306
Amended Agreement	=	Amended and Restated Operation Services Agreement
Board	=	the State of New Jersey Board of Public Utilities
Department	=	the New York State Department of Public Service
Electric Company	=	the Long Island Lighting Company d/b/a LIPA
Existing Agreement	=	Operations Services Agreement dated as of December 28, 2011, as amended
Manager	=	the PSEG Long Island LLC
Operator	=	a subsidiary service company formed by the PSEG Long Island LLC
Service Area	=	almost all of Nassau and Suffolk Counties, New York, and a small portion of Queens in New York City
State	=	the State of New York
Storm Event	=	Hurricane Sandy

DEC-23-2013 12:23 CHIEF COUNSEL 202 3174566 P.002

Adjustment Factor	=	CPI – 242.639/242.639 X 100, where "CPI" is the Consumer Price Index for all Urban Consumers in New York-Northern New Jersey-Long Island (1982-1984 = 100), and where "242.639" = Consumer Price Index for January 2011
Bonds	=	See Supplemental Submission No. 1 to Authority's ruling request dated November 29, 2011
Year 1	=	2011
Year 2	=	2014
Year 3	=	2015
a	=	36,300,000
b	=	58,000,000
c	=	5,440,000
d	=	8,700,000
x	=	102
y	=	50
z	=	100

Dear Ms. Nicolino:

This responds to Authority's request for a ruling that the Amended Agreement described below will not result in private business use of the Bonds under § 141(b) of the Internal Revenue Code (the "Code").

Facts and Representations

You make the following representations. Authority owns all of the stock of Electric Company, a governmental person. Electric Company owns and controls an electric transmission system and an electric distribution system (collectively referred to herein as the "T&D Systems"), and has the right to provide retail electric service to

DEC-23-2013 12:24 CHIEF COUNSEL 202 3174566 P.003

customers in the Service Area. Proceeds of the Bonds were used to finance the T&D Systems.

Electric Company and Manager entered into the Existing Agreement in December of Year 1. Pursuant to the Existing Agreement, effective January 1 of Year 2, Manager is required to operate and maintain the T&D Systems in accordance with policies established by Authority and Electric Company. To this end, Manager formed Operator as a wholly-owned subsidiary to provide substantially all of the management and operations services required under the Existing Agreement. In Year 1, Authority sought a letter ruling relating to the consequences, under Code Section 141(b), of the Existing Agreement in relation to interest on then-outstanding Bonds of Authority. A favorable ruling letter was subsequently issued.

Authority and Manager now propose to enter into the Amended Agreement in order to implement the requirements of the Act and to modify certain provisions of the Existing Agreement to improve service and reliability of the T&D Systems at rates set at the lowest level consistent with sound fiscal operating practices. The Act was enacted in response to operational difficulties encountered by the Electric Company and its current service provider in restoring service on the T&D Systems as a result of damage inflicted by the Storm Event and to a range of criticisms relating to, among other matters, storm preparedness, limited accountability, disconnected management, planning and operational policies and a lack of oversight and transparency in the ratemaking process. The Act imposes additional regulatory oversight and requirements on Electric Company and mandates additional duties for any service provider operating the T&D Systems.

The Act also establishes a separate office in Department responsible for reviewing and making recommendations regarding the operations and terms and conditions of service of, and rates and budgets established by, Authority and/or its service provider.

The Amended Agreement has a term that does not exceed 12 years. The Amended Agreement provides that in the event that Manager achieves the level of performance with respect to criteria set forth in the Amended Agreement during the initial term, the parties will negotiate in good faith an extension of the term of the Amended Agreement to 20 years from the original service commencement date on terms and conditions substantially similar to those set forth in the Amended Agreement. The Amended Agreement may be immediately terminated prior to the end of the term by either party due to specified events of default.

None of the voting power of the governing body of Electric Company is vested in Manager and its directors, officers, shareholders, and employees. There are no overlapping board members between Manager and either Authority or Electric Company. Authority represents that it is not a related party, as defined in § 1.150-1(b) of the Income Tax Regulations, to either Manager or Operator.

DEC-23-2013 12:24 CHIEF COUNSEL 202 3174566 P.004

The Act requires that a service provider prepare and maintain an emergency response plan to assure the reasonably prompt restoration of service in the case of an emergency event. Implementation of the Act further necessitates the transfer of significant operational duties and enables Manager to independently set a wide range of operational policies. Under the Amended Agreement, Electric Company will no longer have a contractual right to approve subcontractors (subject to certain limitations) and a joint operating committee will no longer exist. Manager must nonetheless operate the T&D Systems in a manner consistent with prudent utility practice and other "Contract Standards". Also, it cannot transmit or distribute electric energy using the T&D Systems other than power and energy obtained by, on behalf of, or with the approval of Electric Company, nor can it use the T&D Systems to serve any person other than Electric Company and its customers in the Service Area.

Manager will receive the following (collectively referred to herein as the "Services Fee") under the Amended Agreement: the Fixed Direct Fee; the Incentive Compensation Component; and the Reimbursement of Pass-through Expenditures.

Fixed Direct Fee. Each contract year, Manager will be paid a stated amount (the "Fixed Direct Fee") in 12 equal monthly installments. The Fixed Direct Fee, expressed in Year 1 dollars, is \$a annually, subject to a one time increase after Year 3 to \$b annually thereafter. In each contract year, the Fixed Direct Fee will be adjusted by the Adjustment Factor, which is based on the Consumer Price Index, except that if the Adjustment Factor is negative, the Fixed Direct Fee will be the same as in the previous contract year.

Annual Incentive Compensation Component. In any contract year, Manager also will be eligible to receive a payment referred to as the "Incentive Compensation Component", which will be based on neither gross revenues nor net profits of the T&D Systems. This amount will be paid from an incentive compensation pool established by Electric Company. The Electric Company will credit to the compensation pool an incentive compensation, expressed in Year 1 dollars, of \$c, an amount that will increase to \$d beginning with the Year 3 contract year. The Incentive Compensation Component may be earned by Manager based on favorable performance measured against certain performance goals outlined in the Amended Agreement. The Incentive Compensation Component earned by Manager for any year will be adjusted downward if the Manager fails to achieve stated minimums described in the Amended Agreement.

The performance goals consist of four categories: cost management performance, customer satisfaction performance, technical and regulatory performance, and financial performance. In general, Manager attains these goals by (1) close adherence to the capital and operating budgets approved for each contract year; (2) achieving high levels of end-use customer satisfaction; (3) providing safe, reliable power supply in a way that complies with regulation; and (4) meeting Electric Company's financial needs. These performance goals, and their assigned weightings, are largely

the same as under the Existing Agreement, although some of the earlier "Performance Metrics", defined below, have been consolidated. The Performance Metrics will be adjusted to account for the impact of a new outage management system which, if implemented by Manager, can be expected to improve outage identification capabilities.

The performance categories are subdivided into actual performance metrics (the "Performance Metrics"). The cost management performance category, which has the greatest potential effect on the Incentive Compensation Component, contains two Performance Metrics, one for the approved operating budget and the other for the approved capital budget. These Performance Metrics are satisfied if operating costs and capital costs in any contract year do not exceed x% of the separately approved budget levels for that year. If, in any year, Manager does not achieve the expected performance level for both of the cost management Performance Metrics, Manager will not be eligible to receive any incentive compensation for that year. If Manager does not achieve the expected performance level for the same cost management Performance Metric for two consecutive years, Manager will not be eligible to receive any incentive compensation for the second year. If, in any contract year, Manager achieves the expected performance level for only one of the cost management Performance Metrics, Manager will be eligible for a maximum of y% of the Incentive Compensation Component for that year.

For any contract year, Manager's level of performance in each performance category will be measured based on actual results achieved for that year. The performance categories other than the cost management performance category are weighted according to relative importance based on the assignment of points referred to as "base points". The weighted percentages determine the share of the incentive compensation pool that may be allocated to a performance category.

Commencing with the third contract year, the annual incentive compensation for a performance category for any contract year will be reduced by (i) y% if Manager has failed to achieve a stated minimum performance level for the same Performance Metric in that performance category in the then-current contract year and any one of the two preceding contract years, or (ii) z% if Manager has failed to achieve the minimum performance level for two or more of the same Performance Metrics in that performance category in the then-current contract year and any one of the two preceding contract years.

Also commencing with the third contract year, a failure of satisfactory performance by Manager with respect to certain Performance Metrics relating to customer satisfaction and service interruptions in the then-current contract year and any one of the two preceding contract years will result in (a) forfeiture of z% of the Incentive Compensation Component for that contract year, and (b) payment to Electric Company of a penalty equal to a certain percentage of the Fixed Direct Fee for that year.

DEC-23-2013 12:26 CHIEF COUNSEL 202 3174566 P.006

Reimbursement of Pass-through Expenditures. The Amended Agreement identifies and includes a number of Pass-through Expenditures. The term "Pass-through Expenditures" is generally defined to mean those expenditures incurred by Operator in the course of providing operations services, including capital improvements. Specifically included are wages, salaries, benefits, and other labor costs of the general workforce (chiefly management, professional, and union personnel employed by Operator); costs incurred by Operator for all materials, supplies, vehicles, purchased services; subcontractor costs, costs and fees incurred or payable with respect to leases, permits, and similar instruments; costs incurred in connection with various potential claims; certain costs related to storm events and non-storm emergencies; various taxes; costs of compliance with Department and other regulatory requirements to which Manager or Authority is subject, including as provided in the Act; initial and ongoing costs necessary to achieve efficiency savings for the benefit of Service Area customers; certain demonstrated transition costs; costs incurred in connection with an advisory committee formed under the Amended Agreement to provide advice on clean and renewable energy programs and to arrange periodic public meetings for the purpose of developing and providing input and recommendations to Manager on demand reduction goals, renewable program goals established under various State initiatives by Department for utilities and similar matters; costs incurred in connection with branding and customer and public communications; long range planning costs; and demonstrated transition costs incurred to achieve efficiency savings and costs of providing operations services related thereto on an ongoing basis. Pass-through Expenditures do not include amounts paid by Manager to or for individuals who are part of senior management and who are employed by Manager.

Manager will be reimbursed by Electric Company for the Pass-through Expenditures at its cost of service without mark-up, multiplier, or other adjustment. However, the costs to Manager, if any, of transactions with affiliates under which an affiliate agrees to provide an operations service as a shared service will be at Manager's total costs (defined as all costs of the affiliate providing the relevant service calculated using (i) a fully allocated cost methodology in compliance with the relevant rules, regulations or orders of the Board, or (ii) such other cost allocation methodology as may be required by other applicable regulatory requirements in lieu of the foregoing) incurred in connection with such transaction (including reasonable and demonstrated costs incurred which are necessary to integrate Operator with such affiliate), but will not include in any event a profit or mark-up component for the affiliate. Transactions with an affiliate under which the affiliate agrees to provide a service relating to the T&D Systems not included in the immediately preceding sentence, which must be approved by Electric Company, may include profit or mark-up paid or payable to the affiliate.

The Amended Agreement covers additional categories of costs and capital investments which will or may be paid to or through Manager or made by or for Manager and calls attention to ancillary agreements under which payments will be made to an affiliate of Manager. The additional categories of costs involve major storm and non-storm emergency expenditures in circumstances beyond the reasonable

DEC-23-2013 12:27 CHIEF COUNSEL 202 3174566 P.007

control of Manager. The permitted capital investments would involve investments in such things as energy efficiency, demand response, renewable energy, energy storage, distributed generation, and electric vehicle charging stations, and can be made only if authorized by Electric Company in its sole discretion. The ancillary agreements, each among Authority, Electric Company and an affiliate of Manager, provide for fuel management and power supply management services. Such costs, investments and agreements all involve circumstances or activities in respect of which Manager (or an affiliate) will take on responsibilities or assume a role engendered by uncontrollable events or otherwise far removed from the regular, day-to-day operation and management of the T&D Systems and related services. Based on all the facts and circumstances, we conclude that they need not be taken into account in our evaluation of the Amended Agreement for purposes of Code Section 141(b).

Law and Analysis

Section 103(a) 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, among other requirements, it is a qualified bond (within the meaning of § 141). Section 141(a) provides that a bond is a private activity bond if the bond satisfies the private business use test and the private security or payment test of § 141(b).

Under §§ 141(b)(1) and 141(b)(6)(A), the private business use test is met if more than 10 percent of the proceeds are used, directly or indirectly, in a trade or business carried on by any person other than a governmental unit. Under § 141(b)(6)(B), any activity carried on by a person other than a natural person is treated as a trade or business.

Section 1.141-3(b)(1) provides that both actual and beneficial use by a nongovernmental person may be treated as private business use. In most cases, the private business use test is met only if a nongovernmental person has special legal entitlements to use the financed property under an arrangement with the issuer. In general, a nongovernmental person is treated as a private business user of proceeds and financed property as a result of ownership; actual or beneficial use of property as pursuant to a lease, or a management or incentive payment contract; or certain other arrangements such as a take or pay or other output-type contract.

Section 1.141-3(b)(4)(i) provides that a management contract with respect to financed property may result in private business use of that property based on all of the facts and circumstances. A management contract with respect to financed property generally results in private business use of that property if the contract provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operation of the facility.

DEC-23-2013 12:28 CHIEF COUNSEL 202 3174566 P.008

Section 1.141-3(b)(4)(ii) defines a management contract as a management, service, or incentive payment contract between a governmental person and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility. Under § 1.141-3(b)(4)(iii)(C), a contract to provide for the operation of a facility or system of facilities that consists predominantly of public utility property, if the only compensation is the reimbursement of actual and direct expenses of the service provider and reasonable administrative overhead expenses of the service provider, is generally not treated as a management contract that gives rise to private business use. Similarly, § 1.141-3(b)(4)(iii)(D) provides that a contract to provide for services generally does not give rise to private business use if the only compensation is the reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated third parties.

Revenue Procedure 97-13, 1997-1 C.B. 632, as modified by Revenue Procedure 2001-39, 2001-2 C.B. 38 ("Rev. Proc. 97-13"), sets forth operating guidelines for contracts to manage bond-financed facilities which, if satisfied, allow management services to be provided under the contract without causing the facilities to be treated as used in a private business use under § 141(b). Rev. Proc. 97-13 requires that management contracts conform to guidelines relating to (1) compensation arrangements, (2) contract term, and (3) any circumstances substantially limiting the qualified user's ability to exercise its rights. Section 5.02(1) of Rev. Proc. 97-13 provides that reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated third parties is not by itself treated as compensation.

Section 5.02(1) of Rev. Proc. 97-13 also provides in part that the contract must provide for reasonable compensation for services rendered with no compensation based, in whole or in part, on a share of net profits from the operation of the managed facility. For this purpose, § 5.02(3) of Rev. Proc. 97-13 provides that a productivity reward equal to a stated dollar amount based on increases or decreases in gross revenues (or adjusted gross revenues), or reductions in total expenses (but not both increases in gross revenues (or adjusted gross revenues) and reductions in total expenses) in any annual period during the term of the contract generally does not cause the compensation to be based on a share of net profits.

Section 5.03 of Rev. Proc. 97-13 sets forth permissible compensation arrangements. Section 5.03(2) provides an arrangement under which at least 80 percent of the services for each annual period during the term of the contract must be based on a periodic fixed fee. The arrangement provided in § 5.03(2) also contains a term limit under which the term of the contract, including all renewal arrangements, must not exceed the lesser of 80 percent of the reasonably expected useful life of the financed property and 10 years. Section 5.03(3) of Rev. Proc. 97-13 provides that if all of the financed property subject to the contract is a facility consisting of predominantly public utility property (as defined in § 168(i)(10)), then 20 years is substituted for 10 years in applying § 5.03(2).

DEC-23-2013 12:29 CHIEF COUNSEL 202 3174566 P.009

Section 3.05 of Rev. Proc. 97-13 defines a periodic fixed fee to mean a stated dollar amount for services rendered for a specified period of time. The stated dollar amount may automatically increase according to a specified, objective, external standard that is not linked to the output or efficiency of a facility. For example, the Consumer Price Index and similar external indices that track increases in prices in an area or increases in revenues or costs in an industry are external standards.

Section 5.04(1) of Rev. Proc. 97-13 provides that the service provider must not have any role or relationship with the qualified user that, in effect, substantially limits the qualified user's ability to exercise its rights, including cancellation rights, under the contract, based on all of the facts and circumstances. Section 5.04(2) provides this requirement is satisfied if (a) Not more than 20 percent of the voting power of the governing body of the qualified user in the aggregate is vested in the service provider and its directors, officers, shareholders, and employees; (b) Overlapping board members do not include the chief executive officers of the service providers or its governing body or the qualified user or its governing body; and (c) The qualified user and the service provider under the contract are not related parties, as defined in § 1.150-1(b).

The Amended Agreement must meet all requirements of section 5 of Rev. Proc. 97-13 for that contract to be deemed under that revenue procedure not to result in private business use of the T&D Systems by Manager. If any requirement is not met, then pursuant to § 1.141-3(b)(4)(i), whether the Amended Agreement results in private business use depends on all of the facts and circumstances. In determining whether the facts and circumstances indicate private business use, the principles set forth in Rev. Proc. 97-13 are useful reference points.

Whether Manager's compensation meets the requirements of Rev. Proc. 97-13 first requires an analysis of the amounts paid to Manager under the Amended Agreement, which are: (1) the Fixed Direct Fee; (2) the Incentive Compensation Component; and (3) Reimbursement of Pass-through Expenditures.

The Fixed Direct Fee does not meet the requirements of section 5.03(2) of Rev. Proc. 97-13, since it is not a periodic fixed fee. It is subject to reductions because of poor performance. These reductions are not specified, objective, and external within the meaning of section 3.05 of Rev. Proc. 97-13. Nevertheless, based on all of the facts and circumstances, we conclude that the Fixed Direct Fee does not cause the Amended Agreement to result in private business use of the T&D Systems for purposes of § 141. A reduction based on poor performance will not be based on a change of net profits. In addition, the Fixed Direct Fee, after a reduction, will remain a stated amount for the particular annual period.

Based on all of the facts and circumstances, we also conclude that the Incentive Compensation Component of the Services Fee does not cause the Amended Agreement to result in private business use of the T&D Systems. Although the various