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November 10, 2005

Gloria L. Young
Executive Director
San Francisco Local Agency Formation Commission
1 Dr. Carlton B. Goodlett Place
Room 244
San Francisco, CA 94102

Re: Community Choice Aggregation

Dear Ms. Young:

This is in response to the request of the San Francisco Local Agency Formation Commission for an independent analysis of the following matters:

a. Does the San Francisco Public Utilities Commission ("SFPUC") have exclusive authority over the implementation of a Community Choice Aggregation ("CCA") Implementation Plan ("Implementation Plan") given the relevant provisions of the City and County of San Francisco Charter ("Charter")?

b. Chapter 7 of the SEPUC's CCA Draft Implementation Plan as to the organization and disposition of duties for CCA implementation

c. How can Proposition H Bonds be used effectively to implement an adopted CCA Implementation Plan?

Conclusions

a. Only the Board of Supervisors can elect CCA for the City and County of San Francisco ("CCSF"). That authority includes the power to condition the method of implementation. Article VIIIB of the City Charter does not transfer that authority to SFPUC. It is unclear whether a court would conclude that Article VIIIB requires the Board of Supervisors to designate SFPUC to implement CCA and whether the SFPUC could, under Article VIIIB of the City Charter, decline to implement a CCA Implementation Plan adopted by the Board of Supervisors. Therefore, at most the SFPUC shares authority over CCA with the Board of Supervisors

b. Based on the SFPUC's analysis of tasks and of CCSF's internal resources at Chapter 7 of its Draft Implementation Plan, and taking into account the need for a highly focused and effective start-up commitment, CCSF would be best served by an organizational structure which initially contracts for almost all functions, retaining a limited number of discrete functions, subject to vigorous policy-level supervision. Success also requires that CCSF act as a cohesive whole and give serious consideration to a policy-level board of control integrating the objectives of the Board of Supervisors, SFPUC, and the executive branch, or some other structure to ensure effective communication from and to policymakers.

c. Proposition H Bonds provide CCSF with considerable flexibility. They can be used to finance renewable energy generating units and other revenue producing elements of CCA. They can be supported by existing assets and enterprises, such as the Hetch-Hetchy system, or by new assets or enterprises such as renewable energy generating units or revenues from a contract with an Energy Services Provider ("ESP"). Proposition H Bonds and CCA are extremely synergistic. Together, they (a) provide the means to develop renewable energy and energy efficiency resources and the market to utilize and pay for those resources and (b) provide CCA with a secure base of resources with which to serve its customers and, thus, avoid excessive dependence on a volatile energy market. Whether the bonds will qualify for tax-exempt status and other factors affecting their marketability are dependent on the structure of the transaction being financed. Specific structures are discussed below. Generally, in order to qualify for tax exemption, the facilities which are financed must be owned by CCSF (or other governmental entity) or operated by CCSF (or other governmental entity) or by a nongovernmental entity on behalf of CCSF pursuant to a contract that meets certain requirements prescribed by the Internal Revenue Service. Even if not tax-exempt, Proposition H Bonds could still be issued to finance facilities which further CCA, albeit at a slightly higher interest cost.

Analysis

a. Does the SFPUC have exclusive authority over the implementation of a CCA Implementation Plan given the relevant provisions of the Charter?

Under AB 117 (2002) only the Board of Supervisors can elect CCA for CCSF and this authority includes the power to condition the method of implementation. It is unlikely that a court would interpret City Charter Article VIIIB as depriving the Board of Supervisors of that authority. The contention that the SFPUC has exclusive jurisdiction over CCA is based on an interpretation of Article VIIIB. There is a reasonable basis for the interpretation that Article VIIIB was intended to apply to CCA, but there is also a reasonable interpretation of Article VIIIB to the contrary. Even if Article VIIIB was intended to apply to CCA, AB 117 which established CCA in California might supersede or modify Article VIIIB as it applies to CCA. It is clear, however, that under AB 117 only the Board of Supervisors can take certain critical actions under CCA and therefore, under all of the interpretations, the SFPUC does not have exclusive authority in the area. To avoid subsequent controversy and possible legal challenge, it is advisable that the Board of Supervisors and SFPUC agree upon and both adopt the same final Implementation Plan.

Article VIIIB of the Charter

Article VIIIB of the City Charter confers on the SFPUC

> "exclusive charge of the construction, management, supervision, maintenance, extension, expansion, operation, use and control of all water, clean water and energy supplies and utilities of the City…" (Sec. 8B.121).

In addition, the Preamble to Article VIIIB states, in part, that:

> "This measure is intended to enhance public confidence in the City's stewardship of public utilities by:
>
> 1. Clarifying that the Public Utilities Commission has exclusive control of water, clean water and power assets owned or maintained by the City and County of San Francisco;"

Article VIIIB was proposed as Proposition D for, and adopted at, a general election in November 2002. Clearly, Article VIIIB is a broad grant of authority applicable to many situations such as the Hetch-Hetchy system. However, a potential ambiguity exists as to the application of Article VIIIB to CCA. This is because Article VIIIB is focused on "utilities" and "power assets." CCA is a relatively new concept in the energy industry, apparently starting with a program in Massachusetts in 1997. In the energy industry, CCA is viewed as different than a utility because a CCA provider does not own or operate electric distribution facilities. In fact, AB 117, which instituted CCA in California, clearly distinguishes between CCA service and utility service. For example, PUC § 366.2.(c)(1) provides that: "…the community choice aggregator may not aggregate electrical load if that load is served by a local publicly owned electric utility…"

Thus, if Article VIIIB only referred to "utilities" or "power assets" there would be substantial reason to conclude that it did not address CCA. There is, however, also a reference to "energy supplies of the City" in Sec. 8B.121. This presents a closer question. It clearly applies to energy procured to serve the City's own loads and/or the City's utility system as it may emerge. On its face, it does not indicate whether it was intended to apply to energy purchased on behalf of residents of the City.

The Voter Information Pamphlet, dated September 12, 2002, provides some additional information on the intent of Proposition D. The Digest by the Ballot Simplification Committee, the Proponent's Argument in Favor, the Rebuttal to Proponent's Argument, the Opponent's Argument Against, the Rebuttal to Opponent's Argument Against, and the various paid arguments for and against Proposition D, covering 12 pages of text, were overwhelmingly focused on the merits of a municipal electric system and financing therefor. CCA is not mentioned by name in any of these discussions and, as explained above, CCA is usually viewed as different than a municipal utility.[1]

The Proponent's Argument in Favor does state that "[t]hrough Proposition D, the City can … enter into contracts for energy services that serve the public interest," which arguably is an oblique reference to CCA. Interestingly, the Rebuttal to Opponent's Argument Against, makes no reference to CCA, even though Assemblywoman Carole Migden, the sponsor of AB 117, is one of the co-authors of the rebuttal. The closest to a direct reference to CCA appears in the paid argument in favor submitted by The Utility Reform Network ("TURN"), a consumer advocacy group. TURN's argument states, in part, "**Community Choice** gives SFPUC the ability to buy electricity for SF residents as a group…"

It is not possible, based on the information available, to predict how a court would rule on the intent of Proposition D with regard to CCA. The failure to address CCA directly in Article VIIIB or in the arguments of the Proponent and of the Opponent raises a reasonable question whether it was intended to convey authority over CCA on SFPUC. However, as explained below, even if Article VIIIB was so intended, AB 117 confers certain critical powers over CCA on the Board of Supervisors.

<u>AB 117</u>

CCA was created by State law, AB 117, which is codified in various sections of the Public Utilities Code ("PUC") of the State of California. AB 117 defined a "community choice aggregator" as any "city, county, or city and county <u>whose governing board elects</u> to combine

[1] It is noteworthy that the Voter Information Pamphlet is dated September 12, 2002. AB 117 was enacted on September 24, 2002 but an earlier version had been passed, but vetoed, the previous year.

the loads of its residents, businesses, and municipal facilities in a communitywide electricity buyers' program." (PUC § 331.1(a); emphasis added).

AB 117 also contains a number of other provisions empowering the "governing board" to elect CCA and to govern critical aspects of CCA. AB 117 states that

> "[a] city, county or city and county that elects to implement a community choice aggregation program within its jurisdiction pursuant to this chapter shall do so by ordinance." (PUC § 366.2(c)(10)(A)).

Thus, under State law, for CCSF, the election to implement or CCA program, can only be made by the Board of Supervisors of CCSF ("Board of Supervisors"). This is a power conferred on the Board of Supervisors by State law. Under no reasonable interpretation of Article VIIIB could it be asserted that the SFPUC was empowered to elect a CCA program, and insofar as we are aware, no such assertion is being made. The Board of Supervisors, in making its election, can impose conditions reasonably related thereto, such as the method of implementation and provisions to ensure compliance with those conditions. The Board of Supervisors clearly reserved that power to itself when it enacted Ordinance 86-04, on May 18, 2004, approved by the Mayor on May 27th, which, among other things, directed SFPUC, working with the Department of the Environment, to develop a Draft Implementation Plan "for consideration by the Board of Supervisors" (Ordinance 86-04, sec. 3).

It is also important to note that CCSF as a whole, not just the resources under the SFPUC's jurisdiction, will be subject to certain liabilities in implementing CCA. This is because the "city and county" (PUC § 331.1(a)), not SFPUC, will be the aggregator. *(Id.)*. In particular, CCSF will be liable to PG&E for "any costs reasonably attributable" to the aggregator (PUC § 366.2.(c)(17)), and for reentry fees imposed on end-use customers (with some exceptions) which are involuntarily returned to PG&E (PUC § 394.25(e)) and required to post a bond sufficient to cover reentry fees *(Id.)*. Similarly, service agreements to "facilitate the sale and purchase or electricity and other related services" may be entered into by a "city or county, a city or county, or group of cities, cities and counties, or counties," (PUC § 336.2.(c)(1)).

While it is clear that a CCA program can only proceed with the approval of the Board of Supervisors it is less clear whether Article VIIIB authorizes the SFPUC to decline to proceed with a CCA program if it disagrees with the conditions imposed by the Board of Supervisors. As a general principle, when State law conflicts with a local charter provision, State law governs. AB 117 confers on the Board of Supervisors the power to elect CCA for CCSF and a refusal to proceed with such a plan would effectively nullify the authority granted by State law. However, there is an exception in that a charter city may enact regulations that conflict with general state laws if the subject of the regulation is a "municipal matter" rather than one of "statewide concern". Cal. Const, art. XI, §5[2]; see, e.g., Sherwin-Williams Co. v. City of Los Angeles, 4 Cal. 4th 893 (1993), ("Sherwin").

California courts have frequently wrestled with the question of whether a city provision conflicts with a State law and, if so, whether the matter is of statewide concern. Sherwin, supra.

A court will typically attempt to interpret the local regulation and the State law in such a way to avoid conflict. Johnson v. Bradley, 4 Cal. 4th 389, 400 (1992); California Federal Savings and Loan Ass'n v. City of Los Angeles, 54 Cal. 3d 1, 16 (1991). In the instant case, a court could reasonably, but not necessarily, conclude, for reasons discussed above, that Article VIIIB does not address CCA, and that, therefore, no conflict exists. If a court concludes that a conflict exists, it then engages in an analysis of the specific situation.

In this case, assuming that Article VIIIB vests exclusive authority over CCA in the SFPUC, the court would have to resolve whether a statewide interest in empowering "governing boards" to regulate this aspect of California energy markets outweighed the argument that CCSF had elected to regulate its internal affairs in a particular manner. In deciding that question, a Court would be balancing two important considerations: the fact that the Legislature has made it clear on a number of occasions that a stable and efficient system to deliver electricity throughout California is a matter of great statewide concern and extensively organized at the State level, by provisions of the State Constitution and elaborate legislation[3] versus the importance of permitting charter cities to organize their internal affairs which is recognized by the State Constitution. If the court concluded that this was predominantly a municipal matter, then the SFPUC could decline to act on the Implementation Plan adopted by the Board of Supervisors.[4] It would be speculative to predict a court's decision, as the cases turn on fairly close distinctions. See, e.g. Doe v. City and County of San Francisco, 136 Cal App. 3d. 509 (1982), pet. for rehearing denied (1983) (ordinance banning handguns held implicitly preempted by state law, despite city's agreement that State law did not directly address the matter). If the local provision "does not deal strictly with 'municipal affairs' it is a matter 'subject to general [state] laws' and must be declared unconstitutional and preempted either if it contradicts state law or if it enters a field fully occupied by state law." Northern California Psychiatric Society v. City of Berkeley,

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2 "It shall be competent in any city charter to provide that the city governed thereunder may make and enforce all ordinances and regulations in respect to municipal affairs, subject only to restrictions and limitations provided in their several charters and in respect to other matters they shall be subject to general laws, City charters adopted pursuant to this Constitutions shall supercede any existing charter, and with respect to municipal affairs shall supercede all laws inconsistent therewith." Cal Const, art. XI, §5(a).

3 These include the Public Utilities Code, the Warren-Alquist Bill (creating the California Energy Commission), AB 1890 (1996 legislation re-structuring the California electric market), AB 1-X (2001 legislation authorizing the State to incur billions of dollars of indebtedness to respond to the 2000-2001 energy crisis) and AB117. This is relevant because there is a rebuttable presumption that where there is State legislation covering a matter, in whole or in part, that the matter has been preempted.

4 This would not, however, empower the SFPUC to elect CCA as that was granted to the Board of Supervisors by State law.

178 Cal. App.3d 90, 99 (1986), paraphrasing People ex rel. Deukmejian v. County of Mendocino, 36 Cal. 3d 476 (1984).

The potential uncertainty and delay that could arise if this matter is not promptly resolved could be extremely detrimental to CCSF's ultimate success with CCA. For that reason we strongly encourage that an Implementation Plan be developed collaboratively and formally adopted by both the Board of Supervisors and the SFPUC.

b. Comments on Chapter 7 of the SFPUC's CCA Implementation Plan as to the organization and disposition of duties for CCA implementation

Chapter 7 of SFPUC's Draft Implementation Plan provides a useful analytic model on organization of the CCA enterprise. (See, Table 2, Chapter 7) and inventory of City capabilities (See, Table 3, Chapter 7).

One element that bears particular emphasis is that, at this stage, CCA is a start-up activity. Success will demand a much greater concentration of skilled resources than will be required when the enterprise has been in operation. It is also noteworthy that, according to Table 3 of Chapter 7, the City does not possess the critical early-stage skill of sales and marketing. The importance of this cannot be overstated: retention of customers during the initial opt-out period is essential to CCA success. Chapter 7 also identifies limited experience in a number of other critical areas such as power delivery scheduling and risk management.

Most enterprises facing the facts set forth in Chapter 7 would adopt an organizational approach which either acquires another enterprise with the requisite skills or contracts for almost all functions, retaining a limited number of discrete items, probably reserving the flexibility to evolve into additional functions in the future. The first strategy, acquisition of a going enterprise, is probably not available to CCSF. If CCSF adopted a contracting out strategy, it would be well-advised to establish and vigorously maintain policy-level supervision during the start-up period.

Success also requires that CCSF act as a cohesive whole. This will be important to customer confidence (and retention) and deterring or minimizing political/regulatory/legal attacks on the CCA program. For these reasons, CCSF should consider a board of control consisting of one or more members of the Board of Supervisors, one or more Public Utilities Commissioners and/or the General Manager of the SFPUC, and an empowered representative of the Mayor's Office and/or other part of the executive branch, such as the Department of the Environment. This board of control would integrate, on an on-going basis, the objectives of policy makers, could closely supervise a small staff specifically dedicated to ensuring successful start-up, with the specified objective of transitioning to regular operations, presumably within the SFPUC. We recognize that key potential members of the board of control have competing demands on their time. If it is not feasible to make a protracted commitment to the board of control, an alternative would be to limit that commitment to the initial portion of the start-up period, with a transition to empowered representatives, until CCA has commenced regular operations.

c. How can Proposition H Bonds be used effectively to implement an adopted CCA Implementation Plan?

Application of Proposition H to CCA

On November 6, 2001, CCSF voters approved Proposition H ("Prop H"), a Charter amendment allowing the Board of Supervisors to issue revenue bonds (Prop "H Bonds") to buy, build or improve renewable energy facilities or energy conservation facilities without voter approval. Prop H amended the City Charter to add Section 9.107.8 which provides that the Board of Supervisors is authorized to provide for the issuance of revenue bonds, without further vote of the voters, to "finance or refinance the acquisition, construction, installation, equipping, improvement or rehabilitation of equipment or facilities for renewable energy and energy conservation." The Proposition allows the Board of Supervisors to issue unlimited amounts of revenue bonds for the purposes set forth therein.

Ordinance 86-04 was adopted to establish a CCA program to allow CCSF to aggregate the electric load of its electricity consumers and to accelerate renewable energy, conservation and energy efficiency programs. Section 3, Paragraph B of this ordinance directed SFPUC and the Department of the Environment to work with CCSF finance staff to determine how Proposition H bonds may be used to augment CCA by providing financing for renewable energy and conservation projects.

Prop H can be used in a variety of ways to implement and further the CCA program outlined in Ordinance 86-04. From a strategic business perspective, Prop H Bond and the Ordinance 86-04 CCA program are extremely synergistic. Without CCA, the renewable energy and energy efficiency projects envisioned by Prop H would have to search for a market for the output. Without resources of the sort authorized by Prop H Bonds, the CCA program could not achieve the objectives of Ordinance 86-04; moreover, without a secure base of resources, CCSF's CCA would be extremely dependent of the energy market to serve its customers. The energy crisis of 2000-2001 dramatically demonstrated the danger of over-dependence on a volatile energy market, a lesson reinforced by fossil fuel price fluctuations this year. The specifics of how Prop H Bonds are used in connection with CCA depends on what types of projects are to be financed. Prop H Bond proceeds can only be used for items of the type delineated in Prop H. Because a driving factor behind Ordinance 86-04 is to utilize renewable energy and energy conservation, a number of projects which meet the requirement of Prop H would probably be part of CCSF's CCA plan. Those projects can be financed with Prop H Bonds.

The specific use of Prop H Bonds to most effectively further CCA depends on the particular projects. Three of the threshold questions that must be addressed are (i) what assets or programs would best assist with the implementation of CCA, (ii) what revenue source will secure repayment of the Prop H Bonds, and (iii) whether the Prop H Bonds are tax-exempt or taxable. These items are discussed briefly below. The first two are somewhat related in that if the items financed do not have an independent or sufficient revenue stream to support the bonds to be issued, a separate revenue stream for the Prop H Bonds must be identified. The question of tax exemption will turn generally on the specific facts relating to ownership and use of the financed items.

(i) Items Financed

CCSF's energy plan contemplates a number of elements which should fall within Prop H. These include renewable energy generation from wind farms, distributed generation utilizing photovoltaic technology and energy efficiency programs. This also includes the developmental costs such as preparation of requests for proposals, environmental studies, and permitting, accounting and legal expenses, in addition to "hard-costs" of construction.

(ii) Sources of Repayment

Prop H authorizes the issuance of "revenue bonds" which are to be secured by the revenues derived from fees and charges associated with the operation of an enterprise. Revenue bonds are commonly issued by state or local governmental entities and secured by the revenues of electricity or water enterprises or other revenue producing enterprises such as ports. The major point is that Prop H Bonds may not be secured by or payable from the CCSF's general funds. Rather, revenues from an operating enterprise must be the source of security or repayment. Prop H clearly contemplates, but does not mandate, the potential use of revenues produced by a facility to be built with proceeds of Prop H Bonds to secure and repay those bonds but it is also clear from the Voter Information Pamphlet that revenues from other revenue producing enterprises may be used as security in lieu of or in connection with revenues from a Prop H Bond financed facility. Under California law, revenue bonds such Prop H Bonds are excluded from the voter approval requirement of Art. XVI, Section 18 of the California Constitution if they meet the requirements of the so-called "special fund doctrine." Under this exception, a debt otherwise requiring voter approval is not required if such debt is solely payable from and secured by revenues produced by an appropriate enterprise. No general fund or other tax revenues may be pledged to the repayment of such bonds.

In order to constitute permitted "revenue bonds," CCSF will need to identify a dedicated revenue source by which Prop H Bonds are to be secured and repaid, whether revenues of a new source or an existing source. As noted, CCSF can structure Prop H Bonds to be secured by the revenues from an existing revenue producing entity. For example, Hetch Hetchy was discussed in Chapter 5 of the SFPUC Draft Plan. As we have no disagreement with the points made in that discussion, we will not reiterate those points here. However, other financing scenarios, not discussed in that report, also exist and are discussed below.

Prop H Bonds can be secured by revenues from a new enterprise such as the CCA or facility such as a renewable energy source which has not yet commenced producing revenues.

This has the advantage of a logical nexus between the bonds' purpose and source of repayment. A disadvantage is the need to borrow additional moneys to pay interest on Prop H Bonds during the construction period until such time as the facilities can produce revenues to pay the bonds. Such a structure also has "construction" or "completion" risk which may result in a slightly higher interest rate on the bonds. In addition, the revenue production of a new facility to be built is uncertain which may also affect the interest costs which are attainable.

Securing the Prop H Bonds with the revenues of an existing revenue producing entity avoids the disadvantages discussed above. However, such a structure does "tie up" a revenue producing enterprise of the CCSF. This is discussed in Chapter 5 of the draft Implementation Plan regarding likely covenants required with respect to the enterprise securing Prop H Bonds.

A potential "hybrid" structure is to use a combination of the foregoing structures. Under this alternative structure the Prop H Bonds could be issued secured by both a pledge of revenues from an existing enterprise and from any new enterprise. The pledge on the existing enterprise could be limited to the construction period during which the new facilities are not producing revenues or could be for the life of the Prop H Bonds.[5]

Another possibility would be to secure Prop H Bonds with revenues available from a contract with an ESP providing CCA services. Such revenues could be structured to constitute revenues of the enterprise(s) which would be the security for the Prop H Bonds. For example, lease payments received from an ESP would constitute revenues that could be pledged as security.

Ultimately, the projects the CCSF desires to finance with Prop H Bonds will have a strong bearing on the security structure chosen. For example, if a significant portion of the proceeds of Prop H Bonds will be used to acquire or implement non-revenue producing programs, the use of an existing revenue producing enterprise will be required. On the other hand, if a significant portion of the proceeds are used to acquire revenue producing facilities, such facilities or related activities could serve as the security and source of repayment for the Prop H Bonds.

In any event, as discussed in Chapter 5 of the SFPUC Draft Plan, a bond rating will be required for Prop H Bonds secured by new or existing enterprises that do not already have a rating. The credit quality analysis conducted by the rating agency will, among other things, focus on the "coverage" provided by the pledged revenues. Generally, the rating agencies prefer pledged revenues which are 125% or more of the scheduled debt service on the bonds.

(iii) <u>Tax Exemption</u>

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[5] A variation of this alternative structure would be to create a single "enterprise" of the combined existing enterprise and the new facilities.

CCSF has a wide degree of discretion regarding the use of Prop H Bond proceeds for renewable energy and conservation projects. However, the particular programs and users of facilities financed with the proceeds of Prop H Bonds will impact whether the interest on such bonds will be tax-exempt under the provisions of the Internal Revenue Code of 1986, as amended (the "Code").

In general, the "use" of facilities or items financed with the proceeds of Prop H Bonds by an entity other than a state or local government could result in such bonds constituting "private activity bonds." In that case, under Section 141 of the Code, the interest is not tax-exempt. Such use is often referred to as "private use". Private use is present where there is any type of privately held "legal entitlements" with respect to the financed facility. Nongovernmental ownership constitute private use as does long term contracts regarding the output to be produced by the facility. For example, a long term contract with a nongovernmental entity in which that entity agrees to purchase the energy output of a facility will generally constitute private use. In addition, contractual arrangements with nongovernmental entities regarding the operations and maintenance of a financed facility will constitute private use, unless such contractual arrangement is consistent with certain contract parameters approved by the Internal Revenue Service and described below.[6] Last, it should be noted that loans of the proceeds of Prop H Bonds to a nongovernmental person or entity will generally cause the Prop H Bonds to fail to qualify for tax exemption.

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[6] Generally, bonds constitute private activity bonds if they meet either of the following tests:

A. Both the private business use test ("Private Use Test") AND the private security or payment test ("Private Payment Test" and together with the Private Use Test, the "Private Business Tests")); or
B. the private loan financing test "("Private Loan Test").

A bond issue meets the Private Use Test if more than 10 percent of the proceeds of the issue are to be used for any private business use. A bond issue meets the Private payment Test if the payment of the Implementation Plan of, or the interest on, more than 10 percent of the proceeds of such issue is (under the terms of such issue or any underlying arrangement) directly or indirectly --

A. secured by any interest in property used or to be used for a private business use, or 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.

For purposes of these tests, the term "private business use" means use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit. Use as a member of the general public shall not be taken into account.

A bond issue meets the Private Loan Test if the amount of the proceeds of the issue which are to be used (directly or indirectly) to make or finance loans to persons other than governmental units exceeds the lesser of X) 5 percent of such proceeds, or Y) $5,000,000.

Therefore, the facts regarding the ownership and operational structure of the financed facility will determine whether the bonds may be issued as taxable or tax-exempt. If CCSF (including SFPUC) owns and operates the facility, and if the power is delivered to customers of CCSF, then the facility will probably qualify for tax-exempt financing. It will also be possible to qualify for tax-exemption if CCSF contracts the management of that facility to a private party, provided the management contract requirements of Internal Revenue Service Revenue Procedure 97-13 (discussed below) are satisfied. On the other hand, if an ESP or other nongovernmental entity owns the financed facility or operates it pursuant to an arrangement that does not meet the requirements of Revenue Procedure 97-13. , it will probably not qualify for tax-exempt financing.

Prop H Bond proceeds can be used to fund energy conservation programs. However, to the extent such purpose is accomplished through a loan program wherein residential and business customers can make use of low interest loans in a CAA program to make energy conservation and efficiency improvements the loans of bond proceeds will cause the program to not qualify for tax exempt financing. Grants of bond proceeds could be made to individuals and businesses for conservation and other expenditures so long as an adequate project revenue stream is identified to secure and pay the bonds.

The fact that such Prop H Bonds are not tax-exempt does not in and of itself make such a program nonviable. Taxable rates on such Prop H Bonds could potentially still be substantially less that the rate of interest otherwise available on loans to residential and business customers. However, as pointed out in Chapter 5 of the Draft Implementation Plan there are other potential issues with such a program.

There are a number of ways Prop H Bonds could be used to finance renewable energy facilities. This can accomplished either in a structure wherein the CCSF (or other local government) undertakes acquisition, construction, ownership and management of the facilities or through structures wherein an energy service provides ("ESP") undertakes some or all of the activities. As noted, the tax-exempt status of Prop H Bonds varies depending on the structure.

Structures wherein an ESP takes on one or more of the roles present issues under the Private Business Tests discussed above. Any lease or other similar arrangement with an ESP would likely result in the Prop H Bonds being categorized as taxable "private activity bonds." Again, such a result would not prohibit the structure but rather would result in a higher cost for the program.

An alternative involving an ESP would be to utilize the management contract provisions under IRS Revenue Procedure 97-13 ("Rev Proc 97-13"). Rev Proc 97-13 describes safe harbor contractual arrangements that may be made with nongovernmental entities to provide management, operations or other services with respect to a tax-exempt bond financed facility. Pursuant and subject to the requirements of Rev Proc 97-13, CCSF could engage an ESP to manage and operate renewable energy facilities financed with Prop H Bonds without the ESP's involvement being in violation of the Private Business Tests discussed above. As discussed below, Rev Proc 97-13 would permit a contract between CCSF and an ESP for managing and operating a renewable energy facility financed and owned by CCSF for as long as 20 years. Rev Proc 97-13 defines “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.”

Rev Proc 97-13 focuses generally on the term of the contract and the manner and amount of compensation paid to the service provider. Generally, the more fixed in periodic amount the compensation paid to the service provider, the longer the permitted term of contract. Contracts pursuant to which the service provider’s compensation is 80% fixed may be as long as 20 years in the case of service contracts relating to “public utility property”. On the other hand, contracts pursuant to which the service provider’s compensation is 50% fixed may not have a term in excess of five years.

“Public utility property” is defined as property used predominantly in the trade or business of the furnishing or sale of (i) water, sewage disposal services, electrical energy, (ii) gas or steam through a local distribution system, and (iii) certain telephone services and communication services.

Thus, for example, if the ESP is paid an annual fee equal to 8x and is also paid additional compensation in each year based on a variable component not in excess of 2x, then the contract can be for as long as twenty years. In addition, the ESP may be paid a one-time incentive award during the term of the contract, equal to a single, stated dollar amount, under which compensation automatically increases when a gross revenue or expense target, but not both, is reached. Further, a contract that satisfies the requirements of Rev Proc 97-13 may be renewed at the expiration of its term.

The full text of Rev Proc 97-13 is attached to this memorandum as Appendix A.

A variety of the foregoing structures involving Prop H Bonds could be used in tandem. For example, the CCSF could enter into am energy supply contract with an ESP which would not directly require the use of Prop H Bonds. The CCSF could then issue Prop H Bonds to construct renewable energy facilities to be owned by the CCSF. The CCSF could then enter into a management contract permitted under Rev Proc 97-13 to manage and operate the facilities. Such a structure would allow for the Prop H Bonds to be tax-exempt.

Conclusion

Our conclusions are set forth at pages 1 and 2, above. Please let us know if you have any questions or comments concerning this matter.

Sincerely,

Howard V. Golub

cc: Nancy Miller, Esq.

Appendix A
Rev Proc 97-13

Revenue Procedure 97-13, 1997-1 CB 632, January 10, 1997.

[Code Secs. 141 and 145]

Private activity bonds**:** Private business use: Qualified 501(c)(3) bonds**:** municipal service contract. A revenue procedure sets forth the conditions under which management service contracts will not result in private business use under Code Sec. 141(b). The procedures also apply to determinations of whether a management service contract causes the test in Code Sec. 145(a)(2)(B) to be met for qualified Code Sec. 501(c)(3) bonds. Rev. Proc. 93-19 is obsoleted. BACK REFERENCES: ¶7707.033, 7707.60, 7830.01 and 44,360.10.

SECTION 1. PURPOSE

The purpose of this revenue procedure is to set forth conditions under which a management contract does not result in private business use under §141(b) of the Internal Revenue Code of 1986. This revenue procedure also applies to determinations of whether a management contract causes the test in §145(a)(2)(B) of the 1986 Code to be met for qualified 501(c)(3) bonds.

SECTION 2. BACKGROUND
.01 *Private Business Use*.

(1) Under §103(a) of the 1986 Code , gross income does not include interest on any state or local bond. Under §103(b)(1) of the 1986 Code , however, §103(a) of the 1986 Code does not apply to a private activity bond, unless it is a qualified bond under §141(e) of the 1986 Code. Section 141(a)(1) of the 1986 Code defines "private activity bond" as any bond issued as part of an issue that meets both the private business use and the private security or payment tests. Under §141(b)(1) of the 1986 Code , an issue generally meets the private business use test if more than 10 percent of the proceeds of the issue are to be used for any private business use. Under §141(b)(6)(A) of the 1986 Code , private business use means direct or indirect use in a trade or business carried on by any person other than a governmental unit. Section 145(a) of the 1986 Code also applies the private business use test of §141(b)(1) of the 1986 Code , with certain modifications.

(2) Corresponding provisions of the Internal Revenue Code of 1954 set forth the requirements for the exclusion from gross income of the interest on state or local bonds. For purposes of this revenue procedure, any reference to a 1986 Code provision includes a reference to the corresponding provision, if any, under the 1954 Code.

(3) Private business use can arise by owners Implementation Plan, actual or beneficial use of property pursuant to a lease, a management or incentive payment contract, or certain other arrangements. The Conference Report for the Tax Reform Act of 1986, provides as follows:

The conference agreement generally retains the present-law rules under which use by persons other than governmental units is determined for purposes of the trade or business use test. Thus, as under present law, the use of bond-financed property is treated as a use of bond proceeds. As under present law, a person may be a user of bond proceeds and bond-financed property as a result of (1) owners Implementation Plan or (2) actual or beneficial use of property pursuant to a lease, a management or incentive payment contract, or (3) any other arrangement such as a take-or-pay or other output-type contract.

2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-687-688, (1986) 1986-3 (Vol. 4) C.B. 687-688 (footnote omitted).

(4) A management contract that gives a nongovernmental service provider an owners Implementation Plan or leasehold interest in financed property is not the only situation in which a contract may result in private business use.

(5) Section 1.141-3(b)(4)(i) of the Income Tax Regulations provides, in general, that a management contract (within the meaning of §1.141-3(b)(4)(ii)) with respect to financed property may result in private business use of that property, based on all the facts and circumstances.

(6) Section 1.141-3(b)(4)(i) provides that 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.

(7) Section 1.141-3(b)(4)(iii) , in general, provides that certain arrangements generally are not treated as management contracts that may give rise to private business use. These are:

(a) Contracts for services that are solely incidental to the primary governmental function or functions of a financed facility (for example, contracts for janitorial, office equipment repair, hospital billing or similar services);

(b) The mere granting of admitting privileges by a hospital to a doctor, even if those privileges are conditioned on the provision of *de minimis* services, if those privileges are available to all qualified physicians in the area, consistent with the size and nature of its facilities;

(c) A contract to provide for the operation of a facility or system of facilities that consists predominantly of public utility property (as defined in §168(i)(10) of the 1986 Code), 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; and

(d) A contract to provide for services, if the only compensation is the reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties.

(8) Section 1.145-2(a) provides generally that §§1.141-0 through 1.141-15 apply to §145(a) of the 1986 Code .

(9) Section 1.145-2(b)(1) provides that in applying §§1.141-0 through 1.141-15 to §145(a) of the 1986 Code , references to governmental persons include section 501(c)(3) organizations with respect to their activities that do not constitute unrelated trades or businesses under §513(a) of the 1986 Code .

.02 *Existing Advance Ruling Guidelines*. Rev. Proc. 93-19 , 1993-1 C.B. 526, contains advance ruling guidelines for determining whether a management contract results in private business use under §141(b) of the 1986 Code .

SECTION 3. DEFINITIONS

.01 *Adjusted gross revenues* means gross revenues of all or a portion of a facility, less allowances for bad debts and contractual and similar allowances.

.02 *Capitation fee* means a fixed periodic amount for each person for whom the service provider or the qualified user assumes the responsibility to provide all needed services for a specified period so long as the quantity and type of services actually provided to covered persons varies substantially. For example, a capitation fee includes a fixed dollar amount payable per month to a medical service provider for each member of a health maintenance organization plan for whom the provider agrees to provide all needed medical services for a specified period. A capitation fee may include a variable component of up to 20 percent of the total capitation fee designed to protect the service provider against risks such as catastrophic loss.

.03 *Management contract* means a management, service, or incentive payment contract between a qualified user and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility. For example, a contract for the provision of management services for an entire hospital, a contract for management services for a specific department of a hospital, and an incentive payment contract for physician services to patients of a hospital are each treated as a management contract. See §§1.141-3(b)(4)(ii) and 1.145-2 .

.04 *Penalties* for terminating a contract include a limitation on the qualified user's right to compete with the service provider; a requirement that the qualified user purchase equipment, goods, or services from the service provider; and a requirement that the qualified user pay liquidated damages for cancellation of the contract. In contrast, a requirement effective on cancellation that the qualified user reimburse the service provider for ordinary and necessary expenses or a restriction on the qualified user against hiring key personnel of the service provider is generally not a contract termination penalty. Another contract between the service provider and the qualified user, such as a loan or guarantee by the service provider, is treated as creating a contract termination penalty if that contract contains terms that are not customary or arm's-length that could operate to prevent the qualified user from terminating the contract (for example, provisions under which the contract terminates if the management contract is terminated or that place substantial restrictions on the selection of a substitute service provider).

.05 *Periodic fixed fee* means a stated dollar amount for services rendered for a specified period of time. For example, a stated dollar amount per month is a periodic fixed fee. 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 objective external standards. Capitation fees and per-unit fees are not periodic fixed fees.

.06 *Per-unit fee* means a fee based on a unit of service provided specified in the contract or otherwise specifically determined by an independent third party, such as the administrator of the Medicare program, or the qualified user. For example, a stated dollar amount for each specified medical procedure performed, car parked, or passenger mile is a per-unit fee. Separate billing arrangements between physicians and hospitals generally are treated as per-unit fee arrangements.

.07 *Qualified user* means any state or local governmental unit as defined in §1.103-1 or any instrumentality thereof. The term also includes a section 501(c)(3) organization if the financed property is not used in an unrelated trade or business under §513(a) of the 1986 Code . The term does not include the United States or any agency or instrumentality thereof.

.08 *Renewal option* means a provision under which the service provider has a legally enforceable right to renew the contract. Thus, for example, a provision under which a contract is automatically renewed for one-year periods absent cancellation by either party is not a renewal option (even if it is expected to be renewed).

.09 *Service provider* means any person other than a qualified user that provides services under a contract to, or for the benefit of, a qualified user.

SECTION 4. SCOPE

This revenue procedure applies when, under a management contract, a service provider provides management or other services involving property financed with proceeds of an issue of state or local bonds subject to §141 or §145(a)(2)(B) of the 1986 Code .

SECTION 5. OPERATING GUIDELINES FOR MANAGEMENT CONTRACTS

.01 *In general*. If the requirements of section 5 of this revenue procedure are satisfied, the management contract does not itself result in private business use. In addition, the use of financed property, pursuant to a management contract meeting the requirements of section 5 of this revenue procedure, is not private business use if that use is functionally related and subordinate to that management contract and that use is not, in substance, a separate contractual agreement (for example, a separate lease of a portion of the financed property). Thus, for example, exclusive use of storage areas by the manager for equipment that is necessary for it to perform activities required under a management contract that meets the requirements of section 5 of this revenue procedure, is not private business use.

.02 *General compensation requirements*.

(1) *In general*. 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 facility. Reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties is not by itself treated as compensation.

(2) *Arrangements that generally are not treated as net profits arrangements*. For purposes of §1.141-3(b)(4)(i) and this revenue procedure, compensation based on:

(a) A percentage of gross revenues (or adjusted gross revenues) of a facility or a percentage of expenses from a facility, but not both;

(b) A capitation fee; or

(c) A per-unit fee

is generally not considered to be based on a share of net profits.

(3) *Productivity reward*. For purposes of §1.141-3(b)(4)(i) and this revenue procedure, 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.

(4) *Revision of compensation arrangements*. In general, if the compensation arrangements of a management contract are materially revised, the requirements for compensation arrangements under section 5 of this revenue procedure are retested as of the date of the material revision, and the management contract is treated as one that was newly entered into as of the date of the material revision.

.03 *Permissible Arrangements*. The management contract must be described in

(1) *95 percent periodic fixed fee arrangements*. At least 95 percent of the compensation for services for each annual period during the term of the contract is based on a periodic fixed fee. The term of the contract, including all renewal options, must not exceed the lesser of 80 percent of the reasonably expected useful life of the financed property and 15 years. For purposes of this section 5.03(1) , a fee does not fail to qualify as a periodic fixed fee as a result of a one-time incentive award during the term of the contract under which compensation automatically increases when a gross revenue or expense target (but not both) is reached if that award is equal to a single, stated dollar amount.

(2) *80 percent periodic fixed fee arrangements*. At least 80 percent of the compensation for services for each annual period during the term of the contract is based on a periodic fixed fee. The term of the contract, including all renewal options, must not exceed the lesser of 80 percent of the reasonably expected useful life of the financed property and 10 years. For purposes of this section 5.03(2) , a fee does not fail to qualify as a periodic fixed fee as a result of a one-time incentive award during the term of the contract under which compensation automatically increases when a gross revenue or expense target (but not both) is reached if that award is equal to a single, stated dollar amount.

(3) *Special rule for public utility property*. If all of the financed property subject to the contract is a facility or system of facilities consisting of predominantly public utility property (as defined in §168(i)(10) of the 1986 Code), then "20 years" is substituted--

(a) For "15 years" in applying section 5.03(1) of this revenue procedure; and

(b) For "10 years" in applying section 5.03(2) of this revenue procedure.

(4) *50 percent periodic fixed fee arrangements*. Either at least 50 percent of the compensation for services for each annual period during the term of the contract is based on a periodic fixed fee or all of the compensation for services is based on a capitation fee or a combination of a capitation fee and a periodic fixed fee. The term of the contract, including all renewal options, must not exceed 5 years. The contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the third year of the contract term.

(5) *Per-unit fee arrangements in certain 3-year contracts*. All of the compensation for services is based on a per-unit fee or a combination of a per-unit fee and a periodic fixed fee. The term of the contract, including all renewal options, must not exceed 3 years. The contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the second year of the contract term.

(6) *Percentage of revenue or expense fee arrangements in certain 2-year contracts*. All the compensation for services is based on a percentage of fees charged or a combination of a per-unit fee and a percentage of revenue or expense fee. During the start-up period, however, compensation may be based on a percentage of either gross revenues, adjusted gross revenues, or expenses of a facility. The term of the contract, including renewal options, must not exceed 2 years. The contract must be terminable by the qualified user on reasonable notice, without penalty or cause, at the end of the first year of the contract term. This section 5.03(6) applies only to:

(a) Contracts under which the service provider primarily provides services to third parties (for example, radiology services to patients); and

(b) Management contracts involving a facility during an initial start-up period for which there have been insufficient operations to establish a reasonable estimate of the amount of the annual gross revenues and expenses (for example, a contract for general management services for the first year of operations).

.04 *No Circumstances Substantially Limiting Exercise of Rights*.

(1) *In general*. 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 the facts and circumstances.

(2) *Safe harbor*. 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 provider 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).

SECTION 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 93-19 , 1993-1 C.B. 526, is made obsolete on the effective date of this revenue procedure.

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective for any management contract entered into, materially modified, or extended (other than pursuant to a renewal option) on or after May 16, 1997. In addition, an issuer may apply this revenue procedure to any management contract entered into prior to May 16, 1997.

HG/slg