

electricity service area of the purchaser; (4) sold to a municipal utility if the requirements of (1), (2) or (3) of this paragraph are satisfied by the purchaser (treating the purchaser as the issuing municipal utility); or (5) used to fuel the transportation of the prepaid gas supply on a pipeline. Thus, for example, the sale of gas or electricity by the issuing municipal utility directly to customers of another municipal utility is not a qualifying use.

Some commentators recommended that the final regulations define "retail customer" as a customer that is not purchasing for resale. The final regulations provide that a retail customer is a customer that purchases natural gas or electricity, as applicable, other than for resale. The final regulations also clarify that the consumption of natural gas by a nongovernmental person to produce electricity for sale is not a qualifying use of natural gas under the 90 percent use test.

Some commentators requested clarification of which "contiguous" areas may be treated as part of a municipal utility's service area. One commentator suggested that contiguous areas should not be considered part of the service area. To provide clarity, and in light of the expansion of the service area definition to include any area recognized as the service area under state or Federal law, the final regulations eliminate contiguous areas from the definition of service area.

Some commentators suggested that the definition of service area should be expanded to include any area "in which" (rather than "throughout which") the municipal utility provided service during the five-year period. To ensure that the gas or electricity is consumed by customers in an area recognized as the service area of a municipal utility under state or Federal law, or throughout which the municipal utility provided service during the five-year period, the final regulations do not adopt this comment.

2. Prepayments for Electricity

Some commentators suggested that the natural gas exception should be expanded to include prepayments for electricity. These commentators stated that the restructuring of the electric power industry has affected municipal electric utilities in a manner that is similar to the effect that deregulation of the natural gas industry had on municipal gas utilities. These commentators stated that restructuring has threatened the ability of municipal electric utilities to obtain a secure supply of electric power on

commercially reasonable terms, and that electric power prepayment transactions are necessary to obtain a guaranteed supply of electric power on favorable terms in light of restructuring.

The final regulations add an exception to the definition of investment-type property for certain electricity prepayments that are made by or for one or more municipal utilities (for example, if a joint action agency acquires electricity for one or more municipal electric utilities). The exception applies only if at least 90 percent of the prepaid electricity financed by the issue is used for a qualifying use. For this purpose, electricity is used for a qualifying use if it is to be: (1) Furnished to retail electric customers of the issuing municipal utility who are located in the electricity service area of the issuing municipal utility; or (2) sold to a municipal utility and furnished to retail electric customers of the purchaser who are located in the electricity service area of the purchaser.

3. Remedial Actions

The preamble to the proposed regulations states that issuers may apply principles similar to the rules of § 1.141-12 to cure a violation of the use requirement. Commentators requested clarification regarding which remedies under § 1.141-12 are available for this purpose. The final regulations provide that issuers may apply principles similar to the rules of § 1.141-12 to cure a violation of the 90 percent use requirement, and that the "redemption or defeasance" remedy in § 1.141-12(d) and the "alternative use of disposition proceeds" remedy in § 1.141-12(e) are available for this purpose.

Some commentators requested clarification of the amount of nonqualified bonds that must be redeemed or defeased under the "redemption or defeasance" remedy. Under the final regulations, the amount of nonqualified bonds is determined in the same manner as for output contracts taken into account under the private business tests, including the principles of § 1.141-7(d), treating nonqualified sales of gas or electricity as satisfying the benefits and burdens test under § 1.141-7(c)(1). Commentators also suggested that the definition of "nonqualified bonds" under § 1.141-12 may require excessive amounts of bonds to be retired. The IRS and Treasury Department are considering this comment in connection with possible amendments to § 1.141-12.

4. Commodity Swap Contracts

The proposed regulations provide that a transaction will not fail to qualify for the natural gas exception by reason of any commodity swap contract that may be entered into between the issuer and an unrelated party (other than the gas supplier), or between the gas supplier and an unrelated party (other than the issuer), so long as each swap contract is an independent contract. For this purpose, the proposed regulations provide that a swap contract is an independent contract if the obligation of each party to perform under the swap contract is not dependent on performance by any person (other than the other party to the swap contract) under another contract (for example, a gas supply contract or another swap contract). Notice 2002-52 (2002-30 I.R.B. 187), provides that a natural gas commodity swap contract will not fail to be an independent contract solely because the swap contract may terminate in the event of a failure of a gas supplier to deliver gas for which the swap contract is a hedge.

Commentators generally agreed with the provision on swap contracts in the proposed regulations, as modified by Notice 2002-52. The final regulations retain the provision on commodity swap contracts for natural gas prepayments, as modified by Notice 2002-52, and expand it to apply to electricity prepayments.

E. De Minimis Prepayments

The proposed regulations add an exception for prepayments made within 90 days of the date of delivery of all the property or services to which the prepayment relates. Commentators recommended that the exception apply based on reasonable expectations. The final regulations adopt this comment. This change to a reasonable expectations standard is intended to permit a prepayment to qualify for the de minimis exception even if an unexpected event beyond the control of the issuer causes delivery of the property or services to be delayed beyond the 90-day period. The reasonable expectations standard does not, however, apply to any change to the terms of the prepayment other than an unexpected delay in delivery.

II. Private Loans

The existing regulations, at § 1.141-5(c)(2)(ii), provide rules for determining whether a prepayment for property or services is treated as a loan for purposes of the private loan financing test. The existing regulations for private loans are similar to the existing regulations in