STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. C980818A

On August 18, 1998, a Petition for Advisory Opinion was received from Niagara Mohawk Power Corporation, 300 Erie Boulevard West, Syracuse, New York 13202.

The issues raised by Petitioner, Niagara Mohawk Power Corporation, are:

1. Whether the amounts realized by Petitioner upon the divestiture of its fossil and hydro-electric generating facilities via auction, constitute "gross earnings" for purposes of section 186 of the Tax Law, that are subject to the franchise tax imposed under section 186 of the Tax Law.

2. If the proceeds from such sales are found to constitute "gross earnings" for purposes of section 186 of the Tax Law, whether only the amount of the auction proceeds received in excess of the original cost basis of the facilities is considered "gross earnings" within the meaning of section 186 of the Tax Law.

3. Whether the amounts realized by Petitioner upon the divestiture via auction, of its fossil and hydro-electric generating facilities constitute "gross income" for purposes of section 186-a of the Tax Law, that are subject to the gross receipts tax imposed under section 186-a of the Tax Law.

4. If the proceeds from such sales are found to constitute "gross income" for purposes of section 186-a of the Tax Law, whether only the amount of the auction proceeds received in excess of the original cost basis of the facilities, less expenses of sale, are considered "gross income" within the meaning of section 186-a of the Tax Law.

Petitioner submits the following facts as the basis for this Advisory Opinion.

Petitioner is an investor-owned public utility company incorporated in New York and it is primarily engaged in the generation, transmission, distribution and sale of electricity and the distribution of natural gas in New York. It has two sources from which to satisfy the demands for electricity by its customers: it either produces the electricity itself, in its nuclear, hydro or fossil-fuel plants, or it purchases electricity for resale from other power producers.

Petitioner is one of several utilities in New York State that are restructuring their corporate organizations and possibly selling off some of their business enterprises to unrelated third parties

in order to make their businesses more competitive and to bring down electric rates paid by customers.

Petitioner's proposed restructuring, described below, is in response to the Competitive Opportunities Proceeding instituted in 1994 by the New York Public Service Commission ("PSC") in Case No. 94-E-0952 ("Competitive Opportunities Proceeding"), which endorsed a fundamental restructuring of the electric utility industry in New York State based on competition in the generation and energy services sectors of that industry. The PSC enunciated its policy objectives in an order (Opinion No. 96-12), issued May 20, 1996 ("Generic Order"). The PSC's Generic Order, among other things, required all the electric utilities subject to the Competitive Opportunities Proceeding to file a restructuring plan by October 1, 1996, which plan was required to address, among other things, the structure of the utility, both in the short and long term, a schedule for the introduction of retail access and a rate plan to be effective for a significant portion of the transition to retail access.

On February 24, 1998, the PSC approved a rates and restructuring plan ("PowerChoice") for Petitioner aimed at reducing electricity rates for many of Petitioner's current customers and allowing the customers to choose their energy supplier.

Subsequently, on March 20, 1998, the PSC issued, to Petitioner, Opinion 98-8 (Case 94-E-0098 and Case 94-E-0099)(the "Order") which, *inter alia*, approved PowerChoice. The key elements of the Order include:

(i) approval of Petitioner's Master Restructuring Agreement ("MRA") (discussed *infra*),

(ii) a revenue reduction of $111.8 million (exclusive of reductions in the New York State Gross Receipts Tax) for all customer classes to be phased in over a three-year period beginning upon the consummation of the MRA,

(iii) a cap on prices to electric customers in years four and five of the five-year rate plan,

(iv) an allowance for Petitioner to recover stranded costs (including the costs associated with the MRA),

(v) permission by the PSC to establish a regulatory asset, reflecting the recoverable costs of the MRA which will be amortized over a maximum of ten years ("MRA Regulatory Asset") (discussed *infra*),

(vi) an agreement by Petitioner to divest its fossil and hydro-electric generating facilities within a defined time period and retain its nuclear generating facilities with a commitment to explore their divestiture at a later date,

(vii) an agreement by Petitioner to provide its retail electric customers with the option to choose their supplier of electricity by no later than December 1999, and

(viii) an agreement to allow Petitioner to form a holding company structure to separate its utility businesses from its unregulated businesses.

As previously stated, the PSC approved the MRA which allowed Petitioner to terminate, restructure or amend 27 of its power purchase agreements ("PPAs") with 14 independent power producers ("IPPs"). Seventeen PPAs were terminated.[1] All of the IPPs which had their PPAs with Petitioner terminated, restated, or amended, qualify as QFs. In exchange for terminating, restructuring or amending the PPAs, on June 30, 1998, the IPPs received from Petitioner approximately $3.9 billion in cash, 42.9 million shares of Petitioner's common stock (representing approximately 23 percent of Petitioner's outstanding shares following issuance), and financial instruments structured as indexed swap contracts. Petitioner will be permitted to recover its MRA related costs for book purposes over a ten-year period by establishing the MRA Regulatory Asset which will be amortized ratably.[2] Petitioner's rates as contemplated under PowerChoice are designed to permit recovery of the MRA Regulatory Asset over this ten-year period.

The provision in the Order requiring Petitioner to divest all of its fossil and hydro-electric generating facilities (the "Facilities") contemplates that the divestiture will occur within a defined

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[1] As part of the Public Utility Regulatory Policies Act of 1978, Pub. L. 95-617, 92 Stat, 3117 ("PURPA"), Petitioner was required to offer to purchase electricity from qualifying small power producers and qualifying cogenerators (collectively "QFs"). Pursuant to PURPA, the Federal Energy Regulatory Commission ("FERC") promulgated regulations which mandated that a utility purchase electricity from a QF at a rate up to the utility's full forecasted avoided cost. Avoided cost is the additional cost that the utility would have incurred had it instead generated the purchased electricity itself or obtained it from another source. Specific implementation of the QF rules under PURPA was delegated in New York to the PSC. In 1981, the PSC passed the "Six-Cent Law" establishing six cents per kilowatt as the floor on avoided costs for projects less than 80 megawatt in size. PURPA and the Six-Cent Law, in combination with other factors, attracted large numbers of QFs to New York State. Since PURPA and the Six-Cent Law passed, Petitioner has been required to purchase electricity from QFs in quantities in excess of its demand and at prices in excess of that available to Petitioner by internal generation or for purchase in the wholesale market. In order to mitigate the escalating costs of the PPAs, Petitioner entered into negotiations with the QFs to terminate, amend or restate the PPAs. These negotiations led to the MRA. On June 30, 1998, the MRA was consummated and Petitioner terminated 17 of its PPA with QFs.

[2] A regulatory asset is created by a regulatory directive to defer an otherwise current expenditure until such time as the asset is to be charged off per the directive. Such charge off generally coincides with the rate-recovery period allowed the PSC.

time period via auction or, absent acceptable bids, via a spin-off or another form of legal separation, and contemplates Petitioner's commitment to explore divestiture of its nuclear generating facilities at a late date. Pursuant to the Order, Petitioner has commenced the process of divesting all of its Facilities, via auction, to one or more potential purchasers. The Facilities represent 4,217 megawatts of electricity capacity and have a book value of approximately $1.1 billion.

Petitioner states that it is presently and will continue to be subject to tax pursuant to sections 186 and 186-a of Article 9 of the Tax Law.

Discussion

Section 186 of the Tax Law imposes a franchise tax upon every corporation, joint-stock company or association formed for or principally engaged in the business of supplying gas, when delivered through mains or pipes, or electricity, "for the privilege of exercising its corporate franchise or carrying on its business in such corporate or organized capacity in this state". The tax is three-quarters of one percent on the taxpayer's gross earnings from all sources within New York State, and four and one-half percent on the amount of dividends paid during each year ending on the thirty-first day of December in excess of four percent on the actual amount of paid-in capital employed in New York State by the taxpayer.

When section 186 of the Tax Law was enacted in 1896, it provided for a franchise tax measured by "gross earnings from all sources within this state". In 1907, the Legislature amended section 186 by providing a statutory definition of gross earnings. Gross earnings is defined as "all receipts from the employment of capital without any deduction."

The definition of gross earnings was added to address a 1906 New York State Appellate Division decision holding that in order to arrive at taxable "gross earnings", the cost of raw materials used in producing the utility service was to be deducted from the company's gross receipts. (See People ex rel Brooklyn Union Gas Co. v Morgan, 114 App Div 266, affd 195 NY 616).

In 1969, the New York State Court of Appeals stated that "the 1907 amendment [of section 186] did not contemplate a substitution of 'capital' or 'gross receipts' for 'gross earnings' as the basis for taxation. It merely sought to include that portion of capital which the Brooklyn Union Gas Co. case [supra] required to be deducted from 'gross earnings' to arrive at the proper basis. This is only that portion of 'gross earnings' which represents the 'employment of capital' to manufacture, distribute and sell various public utility services." (Matter of Consolidated Edison Co. of NY v State Tax Commission, 24 NY2d 114, 119). In the Con Ed case, the court determined that the proceeds received by the company for property damage and insurance claims and from the sale of capital assets no longer employed in its business, consisting of real property, scrap and used machinery, are amounts realized from the destruction or confiscation of capital, not from the employment of capital.

Section 186-a of the Tax Law imposes an excise tax on the furnishing of utility services that is equal to three and one-quarter percent from October 1, 1998 through December 31, 1999 (three and one-half percent prior to October 1, 1998 and two and one-half percent on and after January 1, 2000) of the gross income of a utility that is subject to the supervision of the PSC or the gross operating income of every other utility doing business in New York State. For purposes of section 186-a, a "utility" includes a person subject to the supervision of the PSC and every person (whether or not such person is subject to such supervision) who sells or furnishes gas or electricity, by means of mains, pipes, or wires; regardless of whether such activities are the main business of such person or are only incidental thereto. The word "person" is defined in section 186-a.2(b) of the Tax Law and includes corporations, companies, associations, joint-stock companies or associations, partnerships and LLCs.

Gross income, as defined in section 186-a.2(c) of the Tax Law, consists of the following elements:

1. receipts from any sale made or service rendered for ultimate consumption or use by the purchaser in New York State;

2. profits from the sale of securities;

3. profits from the sale of real property;

4. profits from the sale of personal property (other than inventory);

5. receipts from interest, dividends, and royalties, derived from sources within New York State; and

6. profits from any transaction (except sales for resale and rentals) within New York State whatsoever.

Accordingly, under section 186-a of the Tax Law, a utility subject to the supervision of the PSC includes in gross income the profits from the sale of real property and the profits from the sale of personal property, other than inventory. For purposes of section 186-a, the basis for computing the profit from the sale of real or personal property, other than inventory, is the original cost of the property, without the deduction for depreciation attributable to such property. If the sale of the real or personal property results in a loss, rather than a profit, such loss may not be deducted from the taxpayer's other gross income.

In Long Island Lighting Company, Adv Op Comm T&F, May 19, 1995, TSB-A-95(9)C,("LILCO-I") it was determined that in the sale-leaseback transactions presented, the profit, rather than the entire proceeds, on the sale of equipment (machinery and equipment used in the production, transmission and distribution of electricity and natural gas, such as an undivided

interest in one of LILCO's electricity generating plants, or certain diesel generators manufactured by Colt Industries, together with associated spare parts, accessories and related equipment and structures) was required to be included in gross income for purposes of section 186-a of the Tax Law. When determining whether there was a profit or loss on the sale of the equipment, for purposes of section 186-a, depreciation attributable to the equipment was not deducted from the original cost. The profit was determined by subtracting from the receipts from the sale of the equipment, the original cost of the equipment along with the expenses incurred in making the sale. If the sale of such equipment resulted in a loss, the loss could not be deducted from LILCO's other gross income.

Petitioner is one of several utilities in New York State being compelled by the PSC to reorganize their corporate structure and possibly sell off some of their business to unrelated third parties pursuant to the PSC's Competitive Opportunities Proceeding and the PSC's policy objectives set forth in the Generic Order (Opinion No. 96-12). With respect to such mandated restructuring, the Commissioner of Taxation and Finance has issued an advisory opinion to Central Hudson Gas & Electric Corporation, Adv Op Comm T&F, July 29, 1998, TSB-A-98(12)C. (See also, Long Island Lighting Company, Adv Op Comm T&F, February 27, 1998, TSB-A-98(3)C ("LILCO-II") and New York State Electric & Gas Corporation, Adv Op Comm T&F, July 29, 1998, TSB-A-98(11)C.) The Central Hudson advisory opinion reached several conclusions, including the conclusion that the sale of electric generation assets pursuant to the auction process, implementing the petitioner's restructuring agreement that was confirmed by a PSC order, does not represent the employment of capital, and that the consideration received by the petitioner for the generation assets does not constitute "gross earnings" taxable under section 186 of the Tax Law. For purposes of section 186-a of the Tax Law, the petitioner would realize "gross income" to the extent that a profit is generated from the sale of the generation assets at auction. Following LILCO-I, supra, the profit, if any, would equal the amount that the consideration received by petitioner as a result of the auction process exceeds the original cost of the generation assets, without deduction for depreciation. Expenses of the sale are allowed to be deducted. It is appropriate in this situation to consider the distribution of the assets as one transaction or sale. Accordingly, the profit would be determined based on the sale of the aggregate of all the assets, not the sale of each asset separately. If the sale of the generation assets results in a loss, rather than a profit, such loss may not be deducted from petitioner's other gross income.

Conclusions

Issue 1. The sale of the Facilities pursuant to the auction process is part of a series of transactions being entered into by Petitioner as mandated by the PSC pursuant to the Competitive Opportunities Proceeding and the PSC's policy objectives set forth in its Generic Order (Opinion No. 96-12), and implemented under the restructuring plan described in PowerChoice and approved in the Order (PSC Opinion No. 98-8). Through this series of transactions, Petitioner is to divest itself of all of its fossil and hydro-electric generating facilities (the "Facilities") via auction. Like Con Ed, supra, and Central Hudson, supra, Petitioner does not employ its capital within the meaning of section 186 of

the Tax Law for the purpose of being forced to restructure its organization and auction its assets. Therefore, the amounts received by Petitioner for the Facilities as a result of the auction process are not receipts from the employment of capital, and do not constitute "gross earnings". Accordingly, the amounts received from such divestiture of the Facilities via auction pursuant to the Order are not taxable under the gross earnings tax imposed by section 186 of the Tax Law.

Issue 2. Since the amount received from the auction of the Facilities does not create gross earnings, this issue is moot.

Issue 3. For purposes of section 186-a of the Tax Law, following Central Hudson, supra, Petitioner will realize "gross income" to the extent that a profit is generated from the divestiture of all of the Facilities via auction as mandated by the Order.

Issue 4. For purposes of Issue 3, following LILCO-I, supra, and Central Hudson, supra, the profit from the divestiture of the Facilities via auction that constitutes gross income under section 186-a of the Tax Law would equal the amount that the consideration received by Petitioner as a result of the auction process exceeds the original cost of the Facilities, without deduction for depreciation. Expenses of the sale are allowed to be deducted. It is appropriate in this situation to consider the divestiture of the Facilities as one transaction or sale. Accordingly, the profit for the taxable year would be determined based on the sale of the aggregate of the Facilities during the taxable year, not the sale of each generating facility separately. If the sale of the Facilities results in a loss, rather than a profit, such loss may not be deducted from Petitioner's other gross income.

DATED: January 27, 1999

/s/
John W. Bartlett
Deputy Director
Technical Services Bureau

NOTE: The opinions expressed in Advisory Opinions are limited to the facts set forth therein.