STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. C000229A

On February 29, 2000, a Petition for Advisory Opinion was received from The Brooklyn Union Gas Company, One Metro Tech Center, Brooklyn, New York 11201.

The issue raised by Petitioner, The Brooklyn Union Gas Company, is whether the distribution of its subsidiary entities to its parent corporation, made in accordance with a 1996 Agreement with the New York State Public Service Commission, is a "dividend" for purposes of the excess dividends tax imposed under section 186 of the Tax Law.

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

Petitioner is a New York corporation that is regulated by the New York State Public Service Commission ("PSC"). Petitioner is formed for or principally engaged in the business of supplying natural gas, within the meaning of section 186 of the Tax Law, and therefore is subject to the franchise tax and excess dividends tax imposed under section 186.

Petitioner owned interests in five corporations and one limited liability company (the "Interests"). Under Agreements entered into with the PSC, and in the overall context of federally - and PSC - mandated deregulation and restructuring of utilities, Petitioner transferred the Interests to KeySpan Energy Corporation, its parent company or to a wholly owned subsidiary of the parent effective December 31, 1999.

As with the deregulation of electric utilities in New York, the natural gas industry has experienced mandated restructurings of historical businesses, designed to achieve greater market competitiveness. The mandatory deregulation and restructuring of natural gas utilities actually predate New York's deregulation of the electric utilities, and began in 1978. The Federal Energy Regulatory Commission ("FERC") issued Order 636 on April 8, 1992 adopting a proposed rule that required significant alterations in the structure of interstate natural gas pipeline services in light of the changes in the natural gas industry brought about by the Natural Gas Policy Act of 1978 ("NGPA"), the FERC's open access transportation program and the Natural Gas Wellhead Decontrol Act of 1989 ("Decontrol Act"). Order 636 required pipeline (i.e., transmission) companies to eliminate their functions as sellers of the commodity of natural gas, and to unbundle such sales from transportation (i.e., gas transmission) services. As set forth in Order 636, FERC believed that "this rule, when fully implemented, will finalize the structural changes in [FERC's] regulation of the natural gas industry ... [and] will therefore reflect and finally complete the evolution to competition in the natural gas industry initiated by those changes so that all natural gas suppliers, including the pipeline as merchant, will compete for gas purchases on an equal footing... [T]his promotion of competition among gas suppliers will benefit all gas consumers and the nation by 'ensur[ing] an adequate and reliable supply of [clean and abundant] natural gas at the lowest reasonable price.'"

The PSC first responded to the FERC Order 636 with the PSC's Order in Case 93-G-0932 - Proceeding on Motion of the Commission to Address Issues Associated with the Restructuring of the Emerging Competitive Natural Gas Market, issued October 28, 1993 ("Case 93-G"). Case 93-G initiated proceedings with the gas utilities and other interested parties "to determine how best to implement changes in the services provided by the LDC [local distribution companies] segment of the industry so that the benefits of the increased competition fostered by the federal actions are fully realized by consumers". Case 93-G proposed various principles and sought answers to a number of specific questions, including matters relating to LDCs' commodity supplies of natural gas. The Staff Report that accompanied Case 93-G states that "[t]he time has come to sort through the implications of [Order 636] and determine the regulatory actions necessary to most effectively advance the best interests of New York's gas consumers". The Report set forth "eight recommendations which we are proposing the [PSC] consider and either endorse or modify, to restructure New York's gas distribution companies to most effectively meet New York's needs."

PSC Opinion No. 94-26, Opinion and Order Establishing Regulatory Policies and Guidelines for Natural Gas Distributors, ("Opinion No. 94-26"), issued December 24, 1994, furthered the implementation of New York's deregulation of the gas industry. As summarized in Opinion No. 94-26, "a restructuring of the interstate natural gas industry had been set in motion by [FERC] with the issuance of its Order 636". Opinion No. 94-26 then "sets forth the policy framework to guide the transition of New York's gas distribution industry in the post- Order 636 environment." Among the key issues under consideration by the PSC in this time frame was the extent to which LDCs (that is New York gas utilities which serve as local distribution companies) should, like the pipeline companies, be required to cease selling gas as a commodity, and limit their function to providing transportation (i.e., gas distribution) services. Related issues included the ability of LDCs to compete with independent marketers in the sale of natural gas in their same service territories, as well as the management of gas utilities' existing "upstream" sources of supply. Opinion No. 94-26 established policies and guidelines that "consistently reflect the view that LDCs should be strongly encouraged to compete actively, on their own behalf, for sales to customers in competitive energy markets while, at the same time, unbundling services so that marketers and others can compete for market share." Opinion No. 94-26 ordered gas utilities to submit proposals to implement the PSCs policies and guidelines. See also, Gas Restructuring Proceeding, Order on Reconsideration, ("Order on Reconsideration")issued August 11, 1995.

In response to the PSC directives in Case 93-G, Petitioner made a specific proposal in its compliance filing, Case 95-G-1046, to restructure its gas sales service rates, introduce aggregated transportation service, and incorporate other gas service modifications. Petitioner's compliance filing along with other utilities' compliance filings were addressed in the PSC's Order Concerning Compliance Filings, issued and effective March 28, 1996 ("March 28 Order"). In the March 28

Order, the PSC stated that in its Order on Reconsideration, they "lifted the restriction against a subsidiary marketer operating in its LDC parent's home service territory. The order requires formulation of safeguards which would include a requirement of fully separated operations and a prohibition on direct transactions between the LDC and the affiliate ...." The PSC concluded that the modifications of the utility filings that they required are a major step in bringing the benefits of gas competition to New York consumers, and that they "will continue to unbundle LDC services and provide utility companies, non-utility gas suppliers and customers the tools they need to provide service in a safe, reliable and efficient manner."

In Petitioner's Case 95-G-0761, the PSC staff entered into a "Stipulation and Agreement Resolving Corporate Structure Issues and Establishing a Multi-Year Rate Plan" on June 25, 1996, that was approved by the PSC in September 1996 ("1996 Petitioner's Agreement"). The PSC staff believed "that the holding company structure ... will provide [Petitioner] the flexibility it needs to compete effectively in the ever increasing competitive energy marketplace and that the conditions in this Agreement will protect customers from potential harm that might result from the new corporate structure. A holding company structure, as set forth in this Agreement, will enable [Petitioner] to maximize its ability to realize, without undue delay, the opportunities associated with competition to the benefit of [Petitioner's] customers, shareholders and the general public." The 1996 Petitioner's Agreement sets forth the framework for the restructuring of Petitioner into a holding company form to be effectuated pursuant to a share-for-share exchange after which Petitioner will become a subsidiary of KeySpan Energy Corporation. Simultaneously therewith, the current unregulated subsidiaries of Petitioner will be transferred to and become direct or indirect subsidiaries of KeySpan Energy Corporation. Between the time that the 1996 Petitioner's Agreement is approved and the reorganization date, Petitioner will be permitted to make investments in Non-Utility activities up to the percentage limits and in the lines of business applicable to KeySpan Energy Corporation in the 1996 Petitioner's Agreement. In addition to the customer protections inherent in a holding company structure as compared to a utility/subsidiary structure, the agreement provides that Petitioner has agreed to implement a number of customer protections relating to: (1) affiliate transactions and cost allocations; (2) personnel allocations and transfers; (3) access to books and records; (4) maintenance of the financial integrity of Petitioner; (5) diversion of management attention and potential conflicts of interest; (6) anti-competitive concerns, and (7) maintenance of superior customer service.

Petitioner and Long Island Lighting Company ("LILCO") agreed to merge in the Settlement Agreement approved by the PSC on December 10, 1997, Case No. 97-M-0567 ("1997 Settlement Agreement"). As set forth in the 1997 Settlement Agreement, "[Petitioner] effected the KeySpan Reorganization on September 30, 1997, and that [Petitioner] is now a subsidiary of KeySpan. The current Non-Utility subsidiaries of [Petitioner] are being transferred to and will be direct or indirect subsidiaries of KeySpan, other than certain subsidiaries (listed in Appendix 'D' attached hereto and made a part of this Agreement), the transfer of which [Petitioner] believes, would result in adverse tax consequences."

On November 3, 1998, the PSC issued its Policy Statement Concerning the Future of the Natural Gas Industry in New York State and Order Terminating Capacity Assignment, Case 93-G ("1998 Policy Statement"). The PSC states "The most effective way to establish a competitive market in gas supply is for local distribution companies to cease selling gas. Without separation of the monopoly gas distribution function and the competitive merchant function the LDCs would likely remain dominant providers. The elimination of regulated LDC merchants would also address "level playing field" issues between LDCs and marketers. Thus, separation of the LDC distribution function from the competitive merchant function would maximize competition and customer benefits. Additionally, the regulation of a competitive function should be unnecessary." The PSC further states that "We envision a process comprising three basic elements which should be pursued in parallel. The first consists of discussions with each LDC on an individualized plan that would effectuate our vision. ... The second element consists of collaboration among staff, LDCs, marketers, pipelines, and other stakeholders on a number of key generic issues. ... The third element addresses coordination of issues that are also faced by electric utilities. This includes provider of last resort issues, as well as a plan to allow competition in other areas, such as metering, billing, and information services. These issues should be addressed in conjunction with the electric restructuring proceedings." The PSC thus intends that LDCs - traditional local gas companies – will no longer sell gas to customers. Instead, LDCs should limit their regulated business to transportation (i.e., gas distribution) services, delivering the gas that will be sold to customers by unregulated, competitive gas marketers. The 1998 Policy statement directs gas utilities to file individual proposals to address the details of this competition-driven mandate.

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.

In People ex rel Adams Electric Light Co v Graves, 272 NY 77,79, the Court of Appeals stated that under the franchise tax imposed by section 186, "[a] dividend implies a division or distribution of corporate profits."

Petitioner is one of several gas utilities in New York State that are reorganizing their corporate structure to eliminate their functions as sellers of natural gas and to unbundle such sales from transportation services as required by FERC Order 636 and PSC Opinion No., 94-26. This gas utilities restructuring is similar to the electric utilities restructuring where the electric utilities were required 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 electric utilities restructuring, the Commissioner of Taxation and Finance has issued Advisory Opinions to Central Hudson Gas & Electric Corporation, Adv Op Comm T&F, July 29, 1998, TSB-A-98(12)C, New York State Electric & Gas Corporation, Adv Op Comm T&F, July 29, 1998, TSB-A-98(11)C, Niagara Mohawk Power Corporation, Adv Op Comm T&F, January 26, 1999, TSB-A-99(3)C and Rochester Gas and Electric Corporation, Adv Op Comm T&F, January 27, 1999, TSB-A-99(8)C. In each of those opinions, it was held that a distribution, to the newly organized holding company, of all of the common stock of certain subsidiaries of the petitioner implementing the petitioner's electric utility restructuring agreement that was confirmed by a PSC order, does not represent a distribution of the profits of the petitioner. Accordingly, these restructuring distributions were not treated as dividends subject to the excess dividends tax under section 186 of the Tax Law.

In this case, Petitioner's transfer of the Interests, effective December 31, 1999, that were affected by the1997 Settlement Agreement, to KeySpan Energy Corporation, its parent company, or to a wholly owned subsidiary of the parent, is part of a series of transactions entered into by Petitioner pursuant to the 1996 Petitioner's Agreement with the PSC which is in response to FERC Order 636 and PSC Opinion No. 94-26 requiring gas utilities to cease selling gas as a commodity and limit their function to providing transportation service, which would achieve the goal of FERC to foster competition in the natural gas industry benefitting all gas consumers and the nation by ensuring an adequate and reliable supply of gas at the lowest reasonable price. This transfer of Petitioner's Interests does not represent a distribution of the profits of Petitioner. Accordingly, like Central Hudson, supra, NYS Gas & Electric, supra, Niagara Mohawk, supra and Rochester Gas and Electric, supra, the transfer of the Interests will not be treated as dividends subject to the excess dividends tax under section 186 of the Tax Law.

Note: For taxable years ending after January 1, 2000, section 186 of the Tax Law is repealed, and taxpayers formerly taxable under section 186 are now subject to the franchise tax imposed under Article 9-A of the Tax Law (L 2000, ch 63).

DATED: July 11, 2000

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

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