STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

CASE 17-M-0815 - Proceeding on Motion of the Commission on Changes in Law that May Affect Rates

STAFF PROPOSAL TO ADDRESS THE ACCOUNTING AND RATEMAKING OF THE TAX CUTS AND JOBS ACT OF 2017

March 29, 2018

INTRODUCTION

On December 22, 2017, the Tax Cuts and Jobs Act of 2017 (Tax Act) was signed into law. The Tax Act includes substantial changes to the federal income tax structure and will result in a material reduction in the costs for New York's largest utilities.

The most immediate change, and one that has significant impact, is the reduction of the utilities' corporate federal income tax rate from 35% to 21%, which is not currently reflected in the utilities' rates. Utilities may also be impacted by other aspects of the legislation such as the treatment of bonus depreciation and net operating losses.

On December 29, 2017, the Commission issued an Order Instituting a Proceeding[1] to study the potential effects of the enactment of the Tax Act on the tax expenses and liabilities of New York State utilities. The Commission stated its intent was to protect ratepayers' interests, with the goal of ensuring that any federal income taxes currently built into rates and accumulated deferred income taxes which, under the Tax Act, would result in excess collection, are captured for ratepayer benefit.

The Order instructed Department of Public Service Staff (Staff) to conduct a technical conference to solicit information that would inform and assist in developing a subsequent Staff recommendation to the Commission. The technical conference was held on February 9, 2018 and was attended by representatives from electric, gas, steam and water utilities, as well as representatives from the telephone

[1] Case 17-M-0815, Proceeding on Motion of the Commission on Changes in Law that May Affect Rates, Order Instituting Proceeding (issued December 29, 2017) (Order).

industry, consumer groups, and other interested parties. The technical conference was intended to gain a common and comprehensive understanding of how the Tax Act will impact utilities in New York State. The forum included identification of the Tax Act changes that will impact the utilities, discussions regarding appropriate ratemaking and related accounting, how to quantify the net benefits, and discussion of the financial implications for the utilities.[2]

The Commission further required Staff to file recommendations addressing the accounting and ratemaking treatment of the Tax Act's changes. This Staff proposal contains recommendations associated with preservation of the net benefits, measurement of the net benefits, the ratemaking mechanism to return ongoing and deferred benefits to customers, accounting and ratemaking treatment of the major tax changes required by the Tax Act, and the interest rate to be applied to the deferred benefits until the benefits are passed back to customers.

The utilities and other interested parties are invited to comment on Staff's recommendations within 90 days, and in the interest of efficiency, the utilities are encouraged to collaborate on issues common to them, and separately address any concerns unique to their individual situation.

[2] In January 2018, prior to the scheduled technical conference, letters were sent by the Director of the Office of Accounting, Audits and Finance of the Department of Public Service to the major energy and water utilities, and telephone companies, seeking information from the utilities to identify and quantify the impact of the recently enacted federal Tax Act. The utilities were asked to respond to the questions contained in the letters to facilitate discussion at the technical conference.

STATUTORY AUTHORITY

Under Public Service Law (PSL) §§65(1), 79(1), 89-b(1), and 91(1), all gas, electric, steam, water and telecommunication utilities are required to provide safe and adequate service at just and reasonable prices. The Commission, under PSL §§66(1), 80(1), 89-c(1), and 94(2) has general supervision of all gas, electric, steam, water and telecommunication utilities. Further, under PSL §§66(4), 79(7), 89-c(3), and 95(2), the Commission has the authority to prescribe uniform methods of keeping accounts, records and books used by all gas, electric, steam, water and telecommunication utilities. Under the broad authority to establish rates granted by the PSL, the Commission has the authority to review utilities' existing rates to determine if they are just and reasonable under current conditions.

BACKGROUND

The Tax Act's impact on utility taxation is very similar to what occurred in 1986 with the enactment of the Tax Reform Act of 1986 (TRA-86). TRA-86 significantly altered the taxation of public utilities beginning in 1987. Aspects of TRA-86 that specifically and significantly affected public utilities included reducing the corporate tax rate from 46% to 34%, repealing investment tax credits, and extending lives for accelerated depreciation.

In response to TRA-86, the Commission instituted a proceeding, and similarly instructed Staff to develop proposed accounting and ratemaking procedures necessary to implement the requirements of TRA-86 as they affected the state's public utilities. Subsequently, in addressing the impacts of TRA-86, the Commission adopted a policy of using deferred accounting as

the mechanism for capturing the interim effects of TRA-86, pending disposition in utilities' next general rate proceeding, thereby preserving any net tax savings for ratepayers (together with carrying charges at the utilities' rate of return) without disrupting the utilities' rate plans or cash flows.[3]

In the Order, the Commission indicated the experience with TRA-86 was an instructive and a useful guide for constructively addressing the ramifications of the Tax Act. The Commission provided utilities notice of its intent through this proceeding to ensure that net benefits accruing from the Tax Act are preserved for ratepayers, either through deferral accounting or another method, from the first day the Tax Act was put into effect.[4] Staff's recommendations reflected in this proposal are designed to meet the Commission's stated intent.

SUMMARY

The Tax Act significantly revises federal income taxation of public utilities. Large investor owned utilities will realize immediate reductions in federal income tax expenses through a decrease in the corporate top marginal tax rate from

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[3] Case 29465, Tax Reform Act, Statement of Policy on Accounting and Ratemaking Procedures to Implement Requirements of the Tax Reform Act of 1986 (issued July 7, 1987).

[4] There are provisions in the Tax Act that take effect prior to January 1, 2018. For example, the availability of using bonus depreciation by utilities is terminated as of September 27, 2017. The determination of net benefits should take into account the impact of all tax law changes from the date each change is applicable.

35% to 21% beginning January 1, 2018.[5] The Tax Act also contains unfavorable provisions including the elimination of bonus depreciation for utilities effective September 27, 2017, and implementation of taxation of contributions in aid of construction (CIAC) for water utilities.[6]

For customers served by large investor-owned utilities, the result of these changes is anticipated to be a net reduction in the utilities' federal income tax expense, and thus the revenue requirements they are currently supporting in rates. Staff's initial estimate of the statewide reduction in federal income tax expense for the major electric, gas, steam and water utilities is over $750 million, or a decrease of approximately 3.2% of revenues, on an annual basis, when the new corporate tax rate is fully effective.[7] In addition, utilities currently have excess deferred tax balances totaling approximately $4.8 billion that were provided by ratepayers at the previous tax rate, and will not be needed to pay future taxes at the 21 percent tax rate. These excess deferred tax balances (explained in more detail below) generally exist because income taxes related to timing differences were charged

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[5] It is commonly said that the corporate tax rate is 35%, however the rate varies from 15% to 35%, depending on the amount of income subject to tax. The Tax Act adopted a flat 21% corporate tax rate for all levels of income.

[6] Prior to the implementation of the Tax Act, CIAC amounts were taxable for the energy and telephone utilities, with an exemption specifically provided to water utilities. The Tax Act removes the exemption and now CIACs for all utility industries are taxable.

[7] The Tax Act's corporate tax rate change to 21% is effective for taxable years beginning January 1, 2018. Utilities that are not calendar year taxpayers will be subjected to a blended tax rate until the start of their next fiscal year period.

to customers assuming the higher 35% tax rate. However, the impact of the Tax Act will vary among utility industries and individual companies.

The changes in the tax law will reduce costs of the large investor owned New York State utilities. Staff proposes that the net tax benefits resulting from the lower tax expense be preserved for ratepayers in their entirety until they are reflected in rates. As more fully described below, Staff recommends that the utilities continue to defer the net impact of the changes resulting from the Tax Act until such time that the benefits can be fully passed on to customers through a general rate case and/or sur-credit filing addressing the disposition of all impacts of the Tax Act.[8][9]

Staff's recommendations reflect what is known currently about the Tax Act impacts. Staff is cognizant that given the complexity of the tax law changes contained within the Tax Act, the fact the Internal Revenue Service (IRS) code is not yet available, and the likelihood that the IRS will need to provide subsequent clarification for specific changes reflected in the Tax Act, the utilities' quantification of the net benefits may not be precise, and are subject to change. Thus, deferral amounts may require further adjustments.

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[8] Although Staff is recommending the net tax benefits be preserved and utilities employ deferred accounting for such benefits, Staff recognizes that not all utilities and utility industries can or should conform to these recommendations. Specifically, additional flexibility is provided for some telephone companies, and small water and gas utilities. The tax changes generally do not affect municipal utilities since they do not pay federal income taxes.

[9] Staff proposes its recommendations be applicable to the utilities identified in Appendix A.

EXPLANATION OF MAJOR CHANGES IN THE TAX ACT

The following section contains detailed technical descriptions of the major tax changes as they apply to investor owned public utilities. Staff proposals for accounting and ratemaking purposes are provided for each change identified.

(1) Corporate Tax Rate Reduction

The Tax Act reduces the top marginal corporate tax rate from 35% to 21%. The 21% tax rate is effective as of January 1, 2018 for all utilities. Utilities that file taxes based on a fiscal year other than a calendar year will utilize a blended tax rate for the first tax year based on the respective number of months the old and new tax rates are effective. Accordingly, the full ongoing benefits of the Tax Act will not be realized for all utilities until the fourth quarter 2018.

The change in corporate tax rate will impact utilities' current tax expenses payable to the United States Treasury (Treasury) as well as deferred tax expenses (originating deferred taxes) which are recoverable in revenue requirements. Additionally, as discussed further below, the change in tax rate will also impact utilities accumulated deferred income tax balances.

Staff Proposal

The reduction in the corporate tax rate is the single largest contributing factor to lower overall income tax expenses for large investor owned utilities. Alone, the change in the tax rate leads to a decrease in the amount of current and deferred income tax expenses and reduces the utilities' revenue requirements.

For calendar year filers, the accounting treatment is to record income tax expense at the new statutory rate of 21%.

For non-calendar year filers, the impact is to record income tax expense at the appropriate blended tax rate, until the commencement of the next fiscal year when the statutory rate of 21% becomes applicable. Consistent with the Commission's stated goal, the current tax expense and originating deferred tax expense benefits the utilities will realize from the reduction in the corporate tax rate should be captured and preserved for customers. To preserve these benefits, Staff proposes that utilities be required to defer the revenue requirement impact of the change in the corporate tax rate on current and originating deferred income tax expenses until such time as the new tax rate is reflected in rates.[10]

(2) Excess Accumulated Deferred Income Taxes (Excess ADFIT)

Deferred income taxes result from normalization accounting for tax/book timing differences. The majority of deferred tax balances on utilities' balance sheets are associated with accelerated tax depreciation of plant investment. IRS rules generally require normalization of the tax benefits of accelerated tax depreciation of plant investment.

Under the normalization method of accounting, a utility calculates its ratemaking tax expense using depreciation that is no more accelerated than its ratemaking depreciation (typically, straight-line). In the early years of an asset's life, this results in ratemaking tax expense that is greater

[10] The revenue requirement impact resulting from lower than forecast deferred tax balances is addressed in the discussion of bonus tax depreciation elimination below.

than actual current tax expense payable to the Treasury. The difference between the higher ratemaking tax expense and the actual tax expense is added to a reserve known as accumulated deferred federal income tax reserve, or ADFIT. The difference between ratemaking tax expense and actual tax expense is not permanent and reverses in the later years of the asset's life when the ratemaking depreciation method provides larger depreciation deductions and lower tax expense than the accelerated method used in computing actual tax expense.

This accounting treatment prevents the immediate flow-through to utility ratepayers of the reduction in current taxes resulting from the use of accelerated depreciation. Instead, the reduction is treated as a deferred tax expense that is collected from current ratepayers through utility rates, and thus these funds are available to utilities as cost-free capital.[11] In the later years when the accelerated depreciation method provides lower depreciation tax deductions than the book method, the lower ratemaking tax expense is collected from ratepayers and the difference between actual tax expense and ratemaking tax expense is charged to ADFIT, reducing the utility's cost-free capital (and increasing the utility's rate base).

The Tax Act's reduction of the highest corporate tax rate from 35 percent to 21 percent results in excess ADFIT. The excess ADFIT reserve is the balance of the ADFIT reserve immediately before the tax rate reduction that exceeds the balance that would have been held in the reserve if the 21 percent tax rate had been in effect for prior periods.

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[11] Accumulated deferred income tax balances are reflected as an offset to rate base to recognize that the cost-free capital is used to finance utility operations.

The excess reserves are amounts that utilities collected from ratepayers to pay future taxes that, because of the reduction in corporate tax rates, will no longer have to be paid. These benefits should be preserved and passed back to ratepayers, since ratepayers were the source of these funds that are no longer needed to pay future taxes.

IRS regulations specify the way excess reserves can be passed back to ratepayers under a normalization method of accounting. In other words, there are prohibitions against a more rapid or immediate pass back of the excess deferred tax reserves related to accelerated depreciation. The regulations provide that the excess reserve may be reduced, with a corresponding reduction in the revenue requirement the utility collects from ratepayers, no more rapidly than the excess reserve would be reduced under the average rate assumption method (ARAM).[12] These prescribed methods effectively require that regulatory commissions pass back the excess reserves related to the use of accelerated depreciation over the remaining book lives of the property that gave rise to the excess. Accordingly, accelerated tax depreciation driven excess ADFIT balances are considered "protected" by IRS normalization regulations.

Utilities also have deferred tax balances on their balance sheets that are not protected by IRS regulation. These balances were caused by tax/book timing differences other than from the use of accelerated tax depreciation. Examples of unprotected assets/liabilities are site investigation and remediation costs, storm damage, and pension and other post-

[12] For taxpayers that do not have adequate data to apply the average rate assumption method, use of the reverse South Georgia method (RSGM) is the authorized alternative.

retirement benefits (OPEBs) costs. Unprotected excess ADFIT values resulting from the reduction in the tax rate should be preserved as well. Since these excess ADFIT values are not related to accelerated depreciation timing differences they can be amortized and passed back to customers without the above IRS restrictions. Thus, the Commission has more discretion in determining timing of the pass back to/recovery from ratepayers of unprotected balances.

Staff Proposal

For regulatory accounting and ratemaking purposes, utilities should revalue all ADFIT balances as of December 31, 2017 using the 21 percent tax rate. Excess ADFIT balances should be grossed up for tax effects and reclassified as regulatory liabilities or assets, as appropriate. To facilitate future ratemaking and related accounting, utilities should be required to separately identify protected and unprotected excess ADFIT balances. This accounting treatment is needed to assure that the excess ADFIT balances will be preserved which will allow ratepayers to receive the portion of the excess ADFIT they have contributed.

For income tax purposes, due to the IRS normalization rules, utilities will begin amortizing the excess protected ADFIT before the lower tax rate is reflected in current rates. Ordinarily, these reversals will affect the utilities earnings and increase the rate of return due to the difference between the old corporate tax rate of 35% and the reduced current income tax rate of 21%. In order to preserve these benefits for customers, the revenue requirement value of this differential should be deferred and accumulated (together with carrying

charges on the balance) until the reversal of the protected excess ADFIT is reflected in rates.

The amortization of the excess ADFIT for protected assets is subject to IRS normalization rules which require the use of the ARAM method. In order to avoid potential violations of the IRS normalization rules, the ARAM method should be followed.[13] The determination of the method to use can vary from utility to utility, and can be handled on a case-by-case basis. As noted above, the excess ADFIT related to unprotected assets/liabilities should be deferred as of December 31, 2017 and its amortization should not begin until the issue is addressed within the context of a utility's next general rate change or sur-credit filing.

(3) Repeal of Alternative Minimum Tax

Prior to the Tax Act, alternative minimum tax (AMT) was a separate method of determining tax liability designed to ensure that taxpayers, including corporations, do not completely avoid paying any income taxes. This was achieved through applying limitations on certain deductions, exemptions, losses and credits. A corporation's AMT for the tax year was the excess of the tentative minimum tax over the regular tax liability. The AMT was required to be paid in addition to the corporation's regular tax liability. For ratemaking purposes, the AMT paid was generally not recognized as a tax expense; rather AMT was deferred and added to rate base. As the AMT reversed, rate base was reduced.

[13] Unless adequate records were not maintained, in which case the IRS permits usage of RSGM.

Corporations are permitted a tax credit against their regular income tax liability for all or a portion of AMT paid in previous years. Any unused tax credits may be carried forward against a corporation's regular tax liability.

The Tax Act repeals the corporate AMT effective for tax years beginning after December 31, 2017. Any AMT credit carryovers to tax years after that date generally may be utilized to the extent of the taxpayer's regular tax liability (as reduced by certain other credits). In addition, for tax years beginning in 2018, 2019, and 2020, to the extent that AMT credit carryovers exceed regular tax liability (as reduced by certain other credits), 50% of the excess AMT credit carryovers are refundable (a proration rule with respect to short tax years). Any remaining AMT credits will be fully refundable in 2021.

Utilities could potentially be impacted if they have historic AMT carryforwards related to AMT since they would be able to claim a refund of 50% of the remaining credits in tax years 2019, 2020, and 2021. Potentially this means that ADFIT related to AMT will be reduced and fully eliminated by 2021. Historically, utilities have rarely ended up paying the alternative minimum tax.

Staff Proposal

Through the responses to a questionnaire in January, no utility has indicated to Staff that the repeal of the AMT and related provisions for carry forwards of the Tax Act will have an impact. Since the tax impact of AMT is typically not used in rate setting (other than the rate base impact) and it appears that New York utilities are not impacted by the change, Staff is not proposing any particular ratemaking or accounting treatment

recommendation for this change. Companies should provide comments proposing accounting and rate treatment of this provision, if it is likely to affect them.

(4) Elimination of Bonus Tax Depreciation

In order to stimulate the economy, Congress introduced the availability of bonus tax depreciation in 2001 through the Job Creation and Worker Assistance Act. Bonus tax depreciation is a tax incentive that allows companies to immediately deduct a large percentage (ranging from 30%-100%) of capital investments, thereby allowing businesses to recover capital investments more quickly for tax purposes, while also providing an interest-free cash flow benefit. IRS rules require that these tax benefits also be normalized comparable to accelerated tax depreciation. These cash flow benefits, reflected as deferred taxes on utility balance sheets have effectively financed a significant portion of utility investments. Since being introduced in 2001, Congress has approved numerous extensions of bonus tax depreciation. Most recently, prior to the enactment of the Tax Act, the Protecting Americans from Tax Hikes Act of 2015 extended bonus tax depreciation for property acquired and placed in service during 2015 through 2019, allowing 50% depreciation for property placed in service during 2015, 2016, and 2017, and a phase down to 40% depreciation in 2018, and 30% depreciation in 2019.

While the Tax Act now allows the expensing of 100% of the cost of qualified property placed in service after September 27, 2017, and before January 1, 2023, public utility property is not eligible for the full expensing provision. Bonus tax depreciation for utilities is eliminated effective September 27, 2017, and utilities will instead have to return to recording

depreciation using the modified accelerated cost recovery system (MACRS) for the full value of new investments. The effect of eliminating bonus depreciation will be to lower the previously forecast level of deferred taxes from new investments in revenue requirement. As a result, utilities will have a higher rate base as they will finance more of these planned plant investments than anticipated due to the loss of the free cash flow provided by bonus depreciation.

Staff Proposal

Effective September 27, 2017, utilities will cease to use bonus tax depreciation. Currently, utilities use both bonus tax and MACRS tax depreciation, but going forward only MACRS will be utilized. The use of MACRS for all investments will reduce the balance of deferred taxes as compared to bonus depreciation. The elimination of bonus tax depreciation has an adverse impact from a ratemaking perspective, and when compared to the revenue requirement used to set utilities' existing rates, creates not only a revenue requirement deficiency, but also impacts the expected cash flows of the utilities. When current rates were set, the use of bonus tax depreciation had the effect of increasing the projected deferred tax balance, which is reflected in rate base as a credit. With the Tax Act's elimination of bonus depreciation, the deferred tax balance projected and included in rate base is now too high and the overall rate base that was included in the revenue requirement too low. Therefore, with this change, and because rates have not yet been modified, utilities will be deprived of authorized levels of carrying charges on rate base, causing revenue requirement deficiencies.

Similarly, until the tax rate changes are reflected in a rate case, utilities will realize cash flow shortfalls due to the tax rate reduction impact on MACRS depreciation generated deferred taxes. Deferred taxes forecasted based on a tax rate of 35% will be realized based on a 21% tax rate effective January 1, 2018. Therefore, utilities will be deprived authorized levels of carrying charges on rate base, causing revenue requirement deficiencies.

For accounting and ratemaking purposes, utilities should determine the revenue requirement impact of the loss of bonus depreciation and MACRS tax rate reductions and reflect these values in calculation of the Tax Act net benefits. The impact from the elimination of bonus tax depreciation and reduced MACRS benefits are components that will offset the revenue requirement benefits stemming from the Tax Act. The overall net benefit that is determined for a utility should be addressed within the context of its next general rate change or sur-credit filing.

(5) Treatment of Net Operating Losses

For net operating losses (NOLs) arising after December 31, 2017, the Tax Act limits the utilities' ability to utilize carryforwards to 80% of taxable income. NOLs arising after 2017 can be carried forward indefinitely, but carryback will be generally prohibited.

Staff Proposal

For ratemaking purposes the impact of NOLs are generally deferred with the balance of the deferred FIT related to NOLs placed in rate base. NOLs occurring in tax years beginning before January 1, 2018 under the prior law, will not

have a taxable income limitation and will continue to have a 2-year carryback and 20-year carryforward period. Utilities with existing NOLs would have recognized a deferred tax asset at their effective tax rate. The deferred tax asset balance, at December 31, 2017, should be remeasured using a 21% corporate tax rate. When the NOL is utilized, the utility will recognize the 21% cash benefit. The ratemaking treatment to be applied to the determined 14% excess (35% minus 21%), should be similar to that applied to the other unprotected deferred tax balances. For accounting and ratemaking purposes, utilities should determine the revenue requirement impact of the change in treatment of NOLs and reflect the values in calculation of the Tax Act net benefits.

(6) Interest Deduction Limitation

The Tax Act caps corporate interest expense deductions at 30% of adjusted taxable income. However, the interest deduction limitation does not apply to regulated public utilities, accordingly, utilities will not be impacted.

Staff Proposal

Staff expects that all interest related to utility operations would remain tax deductible and flowed through in establishing revenue requirements. No accounting or ratemaking changes are required since interest expenses for regulated utilities is tax deductible without limitation.

(7) Contributions in Aid of Construction

Contributions in Aid of Construction (CIACs) are customer provisions of plant, money or services to a utility at no cost. CIACs are generally a cost-free source of capital to

the utility like debt or equity, thus, CIACs are recorded in a credit balance sheet account. Such contributions may come from developers, customers, governmental entities, or others to utility systems to fund plant associated with new utility services without burdening existing customers. Plant contributed to a utility increases the utility's plant in service balance, but does not increase rate base of utilities because CIACs are reflected as a credit offset to the plant value in rate base.

The TRA-86 made CIACs taxable for utilities. Thus, the utility had to make an up-front payment of taxes for the CIACs it received. In determining the proper ratemaking to be applied for the TRA-86 tax law change, the Commission considered three options as to cost responsibility of the tax on the CIACs. The options included: (1) utility financing method; (2) gross-up method; and (3) present-value method. The Commission also allowed each utility to select the method that achieves the greatest long-run advantages.

Under the utility financing method used by many electric and gas utilities, customers did not pay the FIT effect of the CIAC at once, the utility financed the resulting tax payment. The tax payment was included in rate base and gradually declined as the tax deductions from depreciation were realized. The utility financing method was determined to be the least cost alternative.

The gross-up method would require the contributor/developer to advance the contribution, and also pay an amount sufficient to allow the utility to pay the tax on the contribution. The utility would reimburse the contributor/developer for the tax portion of the contribution as the property was depreciated on future tax returns. This method

was determined to be the most costly, as it resulted in higher upfront tax expense caused by taxes due on the value of the contributed taxes.

Under the present-value method, a utility would apply the gross-up method to the amount of funds the contributor/developer would have to advance after reducing the basic contribution (principal plus taxes) by the present value of future tax benefits from depreciation. The payment from the contributor/developer would generally be lower than the amount required under the gross-up method but higher than the utility financing method.

In developing its guidelines on the most appropriate method to employ, the Commission looked to minimize the overall cost of taxation on CIACs, while protecting the general body of ratepayers from the effect of the CIAC transactions. In the TRA-86 Policy Statement, the Commission adopted the utility financing approach for electric, gas and telephone companies, and the present-value method for major (Class A) water utilities. For the small water utilities (other than Class A), it was determined a different approach was needed, as those companies are often financially weak, have uncertain tax situations, and have limited administrative capacity to account for the tax consequences of contributions. For the small water utilities, the Commission's established guidelines included using the present-value method or some variation of customer-contributed financing, or the gross-up method in the situation where external financing sources were not available.

In 1996, the "Small Business Job Protection Act" repealed taxes on CIACs for water utilities. However, the recent Tax Act makes CIACs taxable for water utilities.

Staff Proposal

The TRA-86 Order adopted the utility-finance method for electric, gas and telephone companies primarily because it is the least cost alternative, since it avoids the incremental cost of the tax-on-the-tax, and because it will not discourage developers, since it obviates additional amounts of advances needed to pay taxes. For major water companies (Class A), the TRA-86 Order adopted using the present-value method, since financing CIAC taxes could have a discernable effect on water companies and their customers. The present-value method adds to the overall costs of a project due to the tax-on-the-tax impact. For this reason, Staff recommends a departure from the TRA-86 Order for major water companies, and believe that major water companies should now use the utility-finance method, similar to the other industries. Or, alternatively, if the major water company can show that the utility-finance method would have a significant adverse effect on its finances or customers, when compared to the present value method, the company can use the present value method.

For smaller water companies (Class B, C and D), Staff recommends the present-value method be used, while also allowing for the possibility of using the gross-up method, but only in situations where external financing sources are not available. Under the gross-up method, the contributor/developer will pay upfront an amount to allow the utility to pay the tax on the contribution and the utility will return the excess tax payment to the contributor/developer as the property is depreciated on future tax returns.

The discount rate recommended to be used under the present-value method in the TRA-86 Order was the other

unadjusted customer capital rate, which is often used as a proxy for short-term borrowing. Since the calculation under the present-value method is taken over the life of long-lived assets, Staff recommends using the pre-tax rate of return, which is more appropriate for long-term financing.[14] For companies that have had a rate case within the last four years, they may use the pre-tax rate of return approved in their most recent rate order, updated for any changes in federal or state tax rates. For companies that have not had a rate case in more than four years, they should use the pre-tax rate of return published in the Tier 2 Application Worksheet (an Excel file), on the "Clean Energy Standard" page of the Commission's website,[15] as a proxy for the pre-tax rate of return. This proxy-rate return is a more contemporaneous and reasonable rate that takes into consideration regulatory-lag and is readily available.

RATEMAKING APPROACHES AND OPTIONS

The Commission stated in the Order instituting this proceeding its intent to ensure that the net benefits accruing from the Tax Act are preserved for ratepayers. These net benefits include the revenue requirement impact of the change in the corporate federal income tax rate from 35% to 21%, the excess accumulated deferred income taxes related to change in the corporate federal income tax rate, and the impact of the

[14] See Appendix B for an example of the present-value calculation.

[15] The Tier 2 Application Worksheet can be found at the following link: http://www3.dps.ny.gov/W/PSCWeb.nsf/All/56C58A580D2CF2E185257FD4006B90CE?OpenDocument.

elimination of bonus depreciation.[16] The materiality of the Tax Act revisions warrant immediate Commission action to preserve the net benefits for ratepayers of the largest utilities. Initially, Staff recommends the use of deferred accounting, with carrying charges accruing on the accumulated balances, as an interim procedure to preserve the benefits of the Tax Act, until the deferred net tax benefits and the ongoing effects of the tax law changes can be incorporated in each utility's next rate filing. The Commission routinely uses deferred accounting treatment to address material events or transactions that occur between rate proceedings and therefore this methodology is consistent with past Commission practice.

While Staff believes deferred accounting will achieve the goal of preserving the benefits for customers, Staff does not propose allowing this interim method to be used indefinitely because it would unjustly delay the return of the benefits to ratepayers and the deferred regulatory liability balances could become too large. Accordingly, the determination of the appropriate ratemaking mechanism, and the timing of implementation of such mechanism, in order to pass back the ongoing benefits and return the deferred net benefits to customers need to be addressed.

The options for providing the net tax benefits to customers include either (1) implementing a sur-credit to reflect the benefits under the Tax Act; or (2) requiring utilities that do not have filed rate cases for consideration during 2018, to file for a rate change, which would, in effect reopen existing rate plans to incorporate the changes. Staff

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[16] There are other changes stemming from the Tax Act, but Staff does not anticipate those changes to produce material savings.

favors the first option, determining that it will minimize disruptions in existing rate plans, and provide customers with the significant tax savings generated by the changes contained in the Tax Act as soon as possible. The options are further analyzed below.

<u>Option One - Implementation of a Sur-Credit</u>

The first option for flowing the benefits back to customers is through the authorization of a sur-credit (refund), which would serve as an offset on customer bills. This type of mechanism could be specifically required for the utilities which have not reflected the Tax Act changes in a recently approved rate plan. This sur-credit would reflect both the immediate and ongoing effects of the Tax Act changes, as well as a proposed plan for pass back or amortization of all deferred benefits, including the identified excess ADFIT balances.[17] All necessary tariff and tariff statements to implement such a sur-credit mechanism would be filed on a temporary basis pending further action by the Commission to make them permanent. Staff would review the filings, determine the utilities' compliance and bring its findings to the Commission.

Staff sees multiple advantages of adopting the sur-credit application approach. First, and foremost, a sur-credit can be implemented in a relatively short time period, which allows for a timely pass back of the significant benefits to

[17] Since the revised IRS tax regulations are not yet published, the full ramifications of the tax law changes are not known now and may not be known at the time utilities quantify and reflect the net benefits in the submittal of the proposed sur-credit filings. There will likely be some additional deferrals that result and potentially alternate treatment of determined benefits, once the regulations are known.

customers. Second, this approach can be implemented with administrative efficiency, as a utility's base rates will not require an immediate change, and the sur-credit can be terminated when appropriate. In addition, this approach allows for the utilities' existing rate plans to operate and continue as intended without reopening them.

However, Staff also acknowledges there may be drawbacks to the implementation of a sur-credit approach. Staff is aware that the tax savings are material to operations, and question whether the implementation of this type of mechanism is appropriate for all circumstances. Staff is also aware of competing concerns; specifically, that an excessive delay of refunds unfairly deprives the customer of benefits, and that immediate refunds of a material amount could potentially significantly impact the company's cash flow, and in turn, credit metrics. The negative impact of a credit downgrade could in turn lead to a higher cost of capital, thereby increasing rates for an extended period of time. Although Staff acknowledges these concerns, the advantages associated with the implementation of a sur-credit outweigh the alternative. The Commission should, however, allow for flexibility if a utility can demonstrate that pass back of the net benefits through implementation of a sur-credit is not in the customers long term interest.

Option Two - Utility Rate Filings

The Commission could require utilities to make a rate filing to incorporate the tax reform changes. The advantages to this approach include the synchronization of rates with the tax changes, protection against shareholder windfall of the net benefits, and it could provide a more comprehensive evaluation of the benefits and tailor the pass-back of savings more

thoroughly to specific utility needs. However, Staff has identified some disadvantages as well, the primary concern being the amount of time needed to work through a rate change filing leading to an unnecessary postponement of ratepayers realizing the benefits. Because of the more extensive rate process, utilities would incur incremental costs to prepare the required rate filing, which would reduce and be an offset to the net benefits that will go back to customers. Consumer interest groups would have to participate in numerous lengthy proceedings. Additionally, this option would likely result in a disruption of existing rate plans, and could lead to utilities requesting recovery of other expenses. This result would be in direct conflict of the predetermined goal to minimize reopening existing rate plans. Moreover, for the utilities that are currently in the course of a rate proceeding, requiring separate filings to address the tax changes is not a practical approach, given that the tax reform changes could be incorporated into the present rate proceeding.

Staff Proposal

As noted, initially Staff recommends the use of deferred accounting, together with carrying charges on the accumulated balances, as an interim procedure to preserve the benefits of the Tax Act, until the net tax benefits and the ongoing effects of the tax law changes can be incorporated in each utility’s next rate filing. This approach preserves the net benefits for customers and allows for an orderly transition to appropriate rate adjustments.

In order to both incorporate the ongoing net tax benefits into utilities’ rates, and to begin to return the deferred regulatory liabilities, in a timely manner, Staff recommends utilities that have not had an opportunity to

incorporate the Tax Act changes in a recently approved rate plan, be required to file for a tariff rate change, specifically for the implementation of a sur-credit, to be effective October 1, 2018. This sur-credit would reflect both the immediate and ongoing effects of the Tax Act changes (*e.g.* impact on current federal tax expense of the change in corporate tax rate from 35% to 21%, elimination of bonus depreciation), as well as a proposed plan for pass back or amortization of all deferred benefits, including the pass back of the identified excess accumulated deferred income tax balances.

For any company that has a pending rate filing before the Commission as of October 1, 2018, the immediate and ongoing effects of the Tax Act changes are required to be incorporated into the pending case and the associated revenue requirement(s). This would include reflection of a proposed plan for pass back or amortization of all deferred benefits, including the pass back of the identified excess ADFIT balances.[18]

The Staff preferred approach is that all net benefits will be returned to customers through the sur-credit that is implemented, and in conjunction with the next base rate change. However, flexibility should be afforded when a utility credibly demonstrates that pass back of the full net benefits is not in the customers long term interest (*e.g.* the cost of a credit downgrade will have significant impact on future rates). It is incumbent upon a utility to demonstrate its case, and provide the cost benefit analysis of any alternative proposed treatment

[18] For those affected companies, the implementation of a sur-credit to be effective October 1, 2018 would not be required. However, the expectation is that a comprehensive resolution that addresses the net benefits resulting from the Tax Act would be addressed in the pending rate case.

of the benefits. The utility will need to show how customers are better off under its proposal.

RATEMAKING ISSUES

Measuring the Net Benefit Impact of the Tax Changes

Until such time that a utility's rates are changed to reflect the impacts of the tax changes of the Tax Act, the net benefits realized by a company must be determined and deferred, together with carrying charges. In order to properly quantify the net benefits, a measurement methodology must be established to compute income tax expense under both the new and old tax laws. There are two methodologies that could be used to measure the net benefit impact of the tax changes. The first option would measure the impact based on the rate year revenue requirement projections that were used to establish utilities' existing rates. A second option would use the actual operating results of the utility. As described in more detail below, the most appropriate measurement method is the use of the rate year revenue requirement projections that were used to establish current rates.

Option One - Rate Year Revenue Requirement Forecasts

Under this measurement method the amount to be preserved for the benefit of ratepayers would be measured based on the rate year revenue requirement forecasts used to establish existing rates. This methodology would capture the difference in the rates customers are currently paying versus rates that would result if the changes in tax law were known at the time rates were set. As most utilities are currently operating under multi-year rate plans, the use of rate year revenue requirement

forecasts would measure the interim benefits in a manner that is consistent with the rate plans the Commission has adopted.[19]

A possible drawback to using rate case forecasts of income taxes is the impact it could have on utility earnings; since rate year forecasts of income taxes are based on projected amounts and not actual results, there could be a positive or negative impact on a utility's earnings, depending on a company's actual operating results. Using rate year revenue requirement forecasts is the most appropriate method to measure the impact of the tax reform changes. This is a fair approach since it measures savings relative to allowances for income taxes in the ratemaking determinations. For utilities whose rate plan has expired, Staff proposes using the last Commission-approved rate year revenue requirement forecast in that rate plan be used to measure the impact.

Option Two - Actual Operating Results

Under this measurement method, the net benefit impact would be calculated by comparing a utility's actual operating results under the Tax Act to the income tax expense and related deferred tax effects that would result under the old tax law, with the difference being deferred for future disposition by the Commission. The Commission adopted this methodology to measure the impact of the tax changes resulting from TRA-86. It favored this approach because it was most representative of the actual

[19] In calculating the interim benefits that customers are entitled to, the full revenue requirement effect of the tax changes should be considered, including the gross ups for revenue taxes and uncollectibles.

effect of the tax changes.[20] This approach would result in no impact on a utility's operating income and thus is earnings neutral.

However, Staff recognizes that the regulatory approach is materially different today, having evolved significantly over the last 30 years. At the time TRA-86 was implemented, utilities routinely filed one-year litigated rate cases, with the multi-year rate plan concept just emerging and not fully endorsed. Under those circumstances, the time that passed between rate cases was relatively short; thus, the departure between actual results and forecasts would have been expected to be minor.

Under today's regulatory approach, most of the major utilities operate under multi-year rate plans which contain specific provisions addressing the impacts of changes in law. These rate plan provisions generally contemplate the measurement of the impact of changes in law relative to rate case forecasts. Therefore, using a methodology that employs actual operating results would be a departure from the provisions negotiated in rate plans and thus would disturb the balance of interests negotiated in the rate agreements. If the changes due to the Tax Act were calculated based on actual results, and the utility was underearning, ratepayers would not realize the full difference between the tax allowance included in rates. Conversely, if the utility was overearning, then ratepayers would realize more than the difference between the tax allowances in rates and what taxes would have been under the new

[20] Case 29465, Tax Reform Act, Statement of Policy on Accounting and Ratemaking Procedures to Implement Requirements of the Tax Reform Act of 1986 (issued July 7, 1987), pages 34-35.

tax system. In other words, use of actual results implicitly captures the tax impacts of all variances from forecasts.

Carrying Charge Rate on Deferred Net Benefits

The Commission routinely allows accrued carrying costs on deferred balances until the deferred amount is admitted to rate base or are recovered from or returned to ratepayers. There are several different carrying charge rate options that could be used: (1) the utility's pre-tax rate of return; (2) the Commission's prescribed other customer capital rate; or (3) the rate applied to deferred items as specified in a utility's rate plan. Generally, the timing of the recovery/refund of the deferred amount is of paramount importance when determining which rate is the most appropriate to use for carrying charges on a deferred balance, since that affects the amount of time that the underlying deferred item is financed by or for the utility. For example, in instances when the timing of the recovery/refund of the deferred amount is expected to be long term in nature the Commission typically uses a long-term rate such as the pre-tax rate of return.

In an effort not to disrupt the terms of a utility's rate agreement, Staff proposes the carrying costs to be applied to the deferred balances be calculated using the rate that is applied to other deferred items specified in its particular rate plan. If a utility's rate plan does not specify a carrying charge rate, Staff proposes the carrying costs be calculated

using the utility's Commission-approved pre-tax rate of return.[21] The time period expected to fully return the realized tax benefits to customers is not expected to be a short-term episode, it will be, at a minimum, a full year if not longer. Use of the Commission approved pre-tax rate of return not only is supported by the longer-term duration of the pass back of benefits, but also is consistent with the rate base treatment of tax deferrals in ratemaking.

Staff proposes the deferred balance on which to apply the carrying costs include the revenue requirement impact of the following items: the change in the corporate federal income tax rate; any required amortization of the excess accumulated deferred income taxes; and, the carrying cost impacts of the elimination of bonus depreciation and the tax rate reduction impact on use of MACRS.

Change in Law Provisions

Most utilities are currently operating under multi-year rate plans which include provisions that address the manner in which utilities are to account for any changes in law. Generally, these provisions indicate that if the change in tax law results in an amount that exceeds a defined materiality threshold, the utility will defer an amount that reflects the full impact of the change on its books until either its next

[21] Each utility's Commission approved pre-tax rate of return will need to be adjusted to reflect the impact on the rate due to the new 21% income tax rate. For any utility that will be required to use the pre-tax rate of return, the revised rate would be applicable in calculating the appropriate carrying charges.

general rate proceeding or until the Commission decides on the disposition of the regulatory asset/liability.[22]

Considering the expected materiality of the net benefits the utilities will realize from the Tax Act; most utilities should already be deferring the savings associated with the tax changes in the Tax Act for the benefit of customers.[23] For utilities without a "change in law" provision, due to either the respective rate plan not including the provision or the rates having been set based on a litigated proceeding, Staff notes that the Commission in its December 29, 2017 Order put utilities on notice that the net benefits must be preserved for ratepayers and, therefore, proposes these utilities preserve for ratepayers the net benefits associated with the changes in tax law consistent with the outcome of this proceeding.

FINANCIAL CONSIDERATIONS/IMPLICATIONS

From a credit perspective, the Tax Act is seen as a credit positive for nearly every sector of the U.S. economy.

[22] See Cases 17-E-0238 and 17-G-0239, Niagara Mohawk Power Corporation d/b/a National Grid - Electric and Gas Rates, Order Adopting Terms of Joint Proposal and Establishing Electric and Gas Rate Plans (issued March 15, 2018),Joint Proposal, Section 10.1.9, Externally Imposed Costs; and Cases 16-E-0060 and 16-G-0061, Consolidated Edison Company of New York – Gas and Electric Rates, Order Approving Electric and Gas Rate Plans (issued January 25, 2017), Joint Proposal, Section P.2, Miscellaneous Provisions (Legislative, Regulatory and Related Actions).

[23] Staff is not proposing here to modify the utility specific rate plan provisions that address accounting treatment for changes in law. However, the Commission could make the determination to modify the utility rate plan provisions in this generic proceeding by prescribing implementation of a specific tax treatment.

However, for utilities the cash flow ramifications that result from some of the Tax Act's provisions are largely viewed negatively by the major ratings agencies (S&P Global, Moody's Investors Service and Fitch Ratings). Principally it is negative for U.S. regulated utilities because, once the impacts are reflected in rates, the lower 21% statutory tax rate reduces the amount of cash collected from customers, while the loss of bonus depreciation and lower incremental deferred taxes (21% versus 35% historically) reduce the amount of "tax equity" available to finance rate base.

According to S&P Global Ratings (S&P), taxes, like accounting and ratemaking matters, are extremely complex and thus it will require some time for both utilities and their regulators to fully understand all the implications of the Tax Act. In its analysis dated January 24, 2018, S&P suggests that overall utility credit quality will be marginally and negatively impacted, but that for most companies the magnitude will be mild enough for them to offset the effect to preserve ratings, if so desired.[24] According to S&P, "the impacts of tax reform hinge on a utility's strategy and rapport with regulators, particularly with respect to rate-setting and return of deferred taxes back to ratepayers."[25] Further,

> [w]hile special treatment allowing for deductibility of interest expense is viewed as positive, it is offset by the loss of cash flow from bonus depreciation, which S&P expects could shave as much as 3% off typical funds from operations (FFO) to debt ratios. Those tighter

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[24] U.S. Tax Reform: For Utilities' Credit Quality, Challenges Abound, S&P Global Ratings Direct, January 24, 2018

[25] Ibid.

> margins could put some utility issuers closer to their credit action trigger.[26]

Moody’s Investors Service (Moody’s) also has noted that most utilities are currently well positioned in their credit profiles to offset the effect of the Tax Act. Rather than waiting for more clarity, however, it revised its ratings outlook to “negative” from “stable” for 24 utilities it says, “were already prone to potential ratings action.” In its January 19, 2018 analysis, among the 24 regulated utilities identified by Moody’s are New York-based Consolidated Edison Company of New York, Inc., Orange and Rockland Utilities, Inc., Brooklyn Union Gas Company and KeySpan Gas East Corporation.[27] Then, on February 15, 2018, Moody’s also revised Niagara Mohawk Power Corporation’s outlook to negative following that company’s submission of a Joint Proposal.[28] In its analysis, Moody’s found that the Tax Act would reduce a given utility’s ratio of cash flow from operations pre-working capital to debt by roughly 150 to 250 basis points, assuming no corrective action is taken. Moody’s believes that most companies will actively manage their cash flow to debt ratios by issuing more equity and/or obtaining relief through regulatory channels.

Fitch’s preliminary analysis concurs with those of S&P and Moody’s. Like the others, it notes in its January 24, 2018

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[26] Ibid.

[27] Rating Action: Moody’s changes outlooks on 25 US regulated utilities primarily impacted by tax reform, Moody’s Investors Service, January 19, 2018.

[28] Rating Action: Moody’s changes outlook for Niagara Mohawk Power Corporation to negative, Moody’s Investors Service, February 15, 2018.

analysis that "absent mitigating strategies on the regulatory front, this is expected to lead to weaker credit metrics and negative rating actions for issuers with limited headroom to absorb the leverage creep."[29] Unlike the others, however, Fitch does acknowledge a longer-term credit positive of the Tax Act, noting "the reduction in federal income taxes lowers cost of service to customers, providing utilities headroom to increase rates for capital investments."[30]

Given the potential of very significant cash flow ramifications, Staff expects some utilities may propose a ratemaking treatment that departs from these recommendations. Accordingly, should any utility propose ratemaking treatment that departs from these recommendations, Staff expects those utilities to include in their comments, detailed cash flow implications that align with the Staff's recommendations. Should the utility wish to depart from Staff's recommended approach, and provide an alternative method for fully passing back the savings to ratepayers, it should also provide detailed cash flow support for their alternative approach. Such analyses together should thoroughly demonstrate the ramifications of passing back all deferred benefits on their various credit metrics and to indicate utility management's plans and strategy for mitigating these impacts, presuming an argument can be made for doing so in a cost-effective manner.

Staff is of the view that the unique financial and regulatory circumstances of each utility may warrant differing

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[29] Tax Reform Impact on the U.S. Utilities, Power & Gas Sector; Tax Reform Creates Near-Term Credit Pressure for Regulated Utilities and Holding Companies, Fitch Ratings, January 24, 2018.

[30] Ibid.

treatment for utilities. Accordingly, Staff anticipates and encourages the individual utility comments, and subsequent filings relating to the ultimate disposition of the deferrals, to take those circumstances into account when presenting any desired regulatory response.

SPECIAL CONSIDERATIONS

Telephone Companies

The telecommunications industry has been undergoing a transformation over the last several decades. Markets, technologies, infrastructure and networks have evolved continuously. The Commission's goal of creating effective, facilities-based competition in the telecommunications market in lieu of traditional regulation of the incumbent local exchange carriers (ILECs) has largely been realized.

The last regulatory plans approved by the Commission for the state's two largest ILECs - Verizon of New York, Inc. (Verizon)[31] and Frontier Telecommunications of Rochester, Inc. (Frontier Rochester)[32] were significant steps to move those companies off traditional rate of return regulation. And in recognition of the existence of sufficient competition, in April

[31] Case 92-C-0665, New York Telephone Company – Performance-Based Incentive Regulatory Plan, Opinion No. 95-13, (issued August 16, 1995); and Case 00-C-1945, Proceeding to Consider Cost Recovery by Verizon and to Investigate the Future Regulatory Framework, Order Instituting Verizon Incentive Plan (issued February 27, 2002).

[32] Cases 93-C-0103, Rochester Telephone Corporation - Restructuring Plan, and 93-C-0033, Rochester Telephone Corporation - Multiyear Rate Stability Agreement, Opinion No. 94-25, (issued November 10, 1994). The Agreement was modified and extended in Opinion 00-04 (issued March 30, 2000).

2006, the Commission approved full residential pricing flexibility for Verizon and Frontier Rochester in its Competition III proceeding.[33]

The transition to a competitive market has been slower, however, for the 38 remaining ILECs regulated by the Commission, that are considerably smaller and largely provide service in the more rural areas of the state. Nevertheless, in recognition that competitive pressure did exist in varying degrees for these companies, the Commission issued an order in March 2008 establishing a framework for these ILECs to obtain additional pricing flexibility if certain criteria were met.[34] That framework continues today and has provided streamlined rate relief for many of these 38 ILECs.

The Commission subsequently adopted a Joint Proposal that established a State Universal Fund (SUSF) for a term of four years, beginning January 1, 2013.[35] The SUSF was adopted to provide continued support to those eligible ILECs that could demonstrate a need, to ensure the continued availability of

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[33] Case 05 C-0616 – Proceeding on Motion of the Commission to Examine Issues Related to the Transition to Intermodal Competition in the Provision of Telecommunications Services, Statement of Policy on Further Steps Toward Competition in the Intermodal Telecommunications Market and Order Allowing Rate Filings (issued April 11, 2006).

[34] Case 07-C-0349, In the Matter of Examining a Framework For Regulatory Relief, Order Adopting Framework (issued March 4, 2008).

[35] Case 09-M-0527, Proceeding to Examine Issues Related to a Universal Service Fund, (SUSF) Order Adopting Phase II Joint Proposal, (issued August 17, 2012).

basic local residential service in their service areas.[36] In a September 2017 order, the Commission extended the SUSF an additional four years; the SUSF is scheduled to expire on December 31, 2020.[37]

The SUSF is funded by all 40 of the State's wireline telecommunications carriers, and those carriers are allowed to recover their contribution via a surcharge on customer bills. Thirty-one of the 38 smaller ILECs are eligible to withdraw funds from the SUSF if, after a traditional rate case, the Commission determines there is a need for such support.[38] Currently 12 companies are authorized to receive SUSF support.

Staff Proposal

Staff has closely examined the information provided by the ILECs in response to the January 2018 letter sent to the telephone companies noted above. In addition, Staff analyzed data contained in the Annual Reports filed by the ILECs in recent years, any rate increase requests filed by ILECs in

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[36] The SUSF was preceded by the Transition Fund, established in recognition of universal service and the upward pressure on local service rates created by the phase-out of the New York Intrastate Access Pool. Case 02-C-0595, New York Intrastate Access Settlement Pool, Inc., Order Adopting Comprehensive Plan (issued December 23, 2003).

[37] Case 15-M-0742, Proceeding on Motion of the Commission to Review the State Universal Service Fund, Order Adopting Joint Proposal (issued September 16, 2016).

[38] The smaller ILECs that agreed not to withdraw from the SUSF are the six Frontier subsidiaries (Frontier Communications of Ausable Valley, Inc., Citizens Telecommunications Co. of New York, Inc., Frontier Communications of New York, Inc., Ogden Telephone Company, Frontier Communications of Seneca-Gorham, Inc., Frontier Communications of Sylvan Lake, Inc.) and Windstream New York Inc. (Windstream).

recent years, and additional information received from the New York State Telephone Association (NYSTA)[39] and the smaller ILECs on March 1, 2018 that identified the unique situation faced by the ILECs as compared to other utilities regulated by the Commission.

Based on the analysis, Staff recommends Verizon and Frontier Rochester be exempt from the rate and deferral actions recommended here. These companies were effectively removed from rate of return regulation long ago, as noted above, are not receiving SUSF support, and have reported large intrastate financial losses for many years. The other seven telephone companies (Frontier affiliates and Windstream) that have agreed to not request SUSF support should also be exempt.

The situation is not as straightforward for the remaining 31 ILECs regulated by the Commission, who are eligible to request and receive SUSF support, as these companies remain subject to rate of return ratemaking. For the 12 companies currently receiving SUSF support, the level of SUSF support was determined using the federal income tax rate of 34%, which was the rate assumed to be in effect at the time of the

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[39] All the ILECs except Verizon and the Frontier companies are NYSTA members. On its website, NYSTA states that it "represents New York's Telecommunications Industry along with the equipment and service companies that assist them. NYSTA provides its members with a strong and respected voice in the state capital, numerous venues for membership interaction, plus communications and educational programs that increase the knowledge of issues critical to individual and collective success.

authorization for these companies.[40] Staff's analysis indicates that the level of SUSF support for eight of those companies should be reduced to reflect the lower federal income tax rates resulting from the Tax Act.[41] To implement these reductions, Staff recommends that the monthly SUSF payments for these companies be adjusted, effective October 1, 2018, for the difference between what each company's monthly drawdown is as calculated at the 34% tax rate set in rates, versus the drawdown using the 21% rate under the Tax Act. In addition to adjusting

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[40] It is commonly said that the corporate tax rate prior to the changes in the Tax Act was 35%, however the old tax law had graduated tax rates that varied from 15% to 35%, depending on the amount of income subject to tax. The 12 companies currently receiving SUSF support have underlying revenue requirements that were computed using a federal income tax rate of 34%.

[41] Those eight companies are Chazy and Westport Telephone Corporation; Edwards Telephone Company, Inc.; Germantown Telephone Company Inc. d/b/a GTel Teleconnections; Newport Telephone Company, Inc.; Oriskany Falls Telephone Corporation; Pattersonville Telephone Company; Township Telephone Company, Inc. and Vernon Telephone Company, Inc. With respect to the four other SUSF recipients, Staff finds that the rate relief granted for two companies (Deposit Telephone Company, Inc. and Port Byron Telephone Company) was limited to significantly less than the Staff adjusted revenue requirement reflected in the Commission Order because the companies had limited the amount requested to $500,000 to qualify as a mini rate case. The change in tax rate would not have altered the amount granted by the Commission. Additionally, the final two SUSF recipients (Crown Point Telephone Corporation and Oneida County Rural Telephone Company) began drawing from the Transition Fund and are currently collecting from the SUSF under the grandfathering provisions of the Joint Proposal that created the SUSF. Given that the rate cases for those two grandfathered companies were decided almost ten years ago, and neither has filed a more recent full rate case to receive additional SUSF support, Staff does not propose any adjustment to their rate relief levels.

the monthly draw for each of these companies beginning October 1, 2018, Staff recommends that these companies propose how they will reimburse the SUSF for the overpayment of SUSF support from January 1, 2018 to September 30, 2018, inclusive of carrying charges.

The remaining ILECs that are not currently receiving SUSF support should be exempt, like Verizon and Frontier Rochester, from the rate and deferral actions recommended herein. If an ILEC not currently receiving SUSF support should request such support in the future, the necessary rate case review will fully reflect the Tax Act.

Water Utilities

There are approximately 115 rate regulated water utilities under the Commission's jurisdiction. There are four separate classes categorized by the amount of annual revenues. Class A water utilities are the largest and have annual revenues in excess of $1,000,000, Class B have annual revenues between $700,000 and $1,000,000, Class C have annual revenues between $400,000 and $700,000, and Class D would encompass the smallest water utilities with annual revenues of less than $400,000. Considering each of the classes have their own unique set of circumstances, Staff is recommending different accounting and ratemaking treatment to accommodate each class.

Staff Proposal

Based on the analysis, Staff estimates the federal income tax savings to be material for Class A and B water companies. To be specific, the estimated revenue requirement impact of the tax savings are approximately 4% of annual revenues. As a result, Staff recommendations that apply to other major investor owned utilities should equally apply to

Class A and B water utilities. Specifically, deferred accounting should be employed to capture and preserve the net tax benefits for ratepayers, and any utility that has no current pending rate proceeding as of October 1, 2018, a sur-credit tariff filing should be made with an effective date of October 1, 2018 to begin the pass back of the deferred and current tax savings to rate payers. For any water utility that has a pending rate proceeding, the effects of the Tax Act changes should be incorporated into the pending case and the associated revenue requirement(s).[42][43]

With respect to Class C and D water utilities, Staff's initial review and analysis indicates the net tax benefits are not material in nature, and any tax benefits that may result would likely be less than the cost associated with requiring the utilities to prepare and submit a rate or sur-credit filing. It is also possible that some of these companies could experience a

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[42] In May 2017, the Commission commenced a proceeding, 17-W-0232, to quantify the impact of the elimination of the Qualifying New York Manufactures credit (QNYM). For companies this is applicable to, the QNYM credit had essentially eliminated New York State income taxes from 2014 through 2017. An amendment to this law reinstated state income taxes for water companies beginning in 2018. It is expected that the amended law will result in a deferred asset, with amounts being owed by customers to the companies. Staff recommends that impacts of the Tax Act, and the net tax benefits that result, be addressed in the ongoing QNYM proceeding for the applicable companies.

[43] Fishers Island Water Works Corporation is the single water company that falls into the Class B category, and currently has a rate proceeding pending before the Commission. It is anticipated the net tax benefits will be addressed in that proceeding. See Case 17-W-0472, Fishers Island Water Works Rates (commenced August 4, 2017).

tax increase with the implementation of the Tax Act changes if their effective tax rate prior to the change was a rate less than 21%.[44] As a result, Staff recommends that Class C and D water companies be exempted from deferral accounting requirements. However, the ongoing effects of the Tax Act changes should be included in the small water companies' future rate filings.

Small Gas Utilities

In addition to the gas utilities identified in Appendix A, there are five small gas companies that fall under the Commission's jurisdiction.[45] There are four separate classes of gas utilities, categorized by the amount of annual operating revenues from gas operations. Class A gas utilities are the largest and have annual operating revenues in excess of $2,500,000.[46] Class B gas utilities have annual operating revenues between $1,000,000 and $2,500,000; Class C have annual operating revenues between $150,000 and $1,000,000, and Class D would encompass the smallest gas utilities with annual operating revenues of less than $150,000.

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[44] Companies in the situation where tax expenses increase as a result of the Tax Act are free to file a full rate case petition with the Commission for relief.

[45] The five are Chautauqua Utilities, Inc; NEA Cross of NY, Inc; Valley Energy, Inc; Fillmore Gas Company, Inc.; and Reserve Gas Company, Inc.

[46] Class A gas companies encompass the major investor owned gas utilities. Staff recommendations contained herein would apply to all of the Class A companies.

Staff Proposal

Staff's initial review and analysis of the gas companies from Classes B, C and D indicate there would be minimal, if any net tax benefits, and rather the likely possibility that most, if not all, of these companies could experience a tax increase with the implementation of the Tax Act changes if their effective tax rate prior to the change was a rate less than 21%. Additionally, if there were to be any realized benefits, requiring these utilities to prepare and submit a rate or sur-credit filing would be administratively burdensome to their operations, and likely require reliance on outside expertise, the costs of which could be in excess of any benefits. As a result, Staff recommends that for these identified gas companies, they be exempted from deferral accounting requirements.[47] However, the ongoing effects of the Tax Act changes should be included in the gas companies' future rate filings.

CONCLUSION

In summary, the Tax Act changes are significant and will result in material reductions in the annual costs for New York's largest utilities. These utilities' existing rates and underlying revenue requirements currently provide excessive allowances for federal income taxes, and, absent Commission action could result in material windfalls for shareholders. Staff recommends the Commission capture via deferral accounting the full net benefits of the Tax Act for ratepayers and require

[47] Similar to the affected water utilities, gas companies in the situation where tax expenses increase as a result of the Tax Act are free to file a full rate case petition with the Commission for relief.

that the net benefits be returned to ratepayers as soon as practicable.

The Staff proposal on implementing the effects of the Tax Act changes to ensure net benefits are preserved and passed back to ratepayers should be issued to all interested parties and, consistent with the Order, any and all comments should be filed within 90 days of the issuance date. Comments by the affected utilities should include a detailed computation of: the ongoing net benefit from the tax changes; the expected net benefits to be deferred for customers from the effective date of each tax law change to the date in which new rates or the sur-credit will be implemented; and, the cash flow implications following the Staff recommendations. The eight telephone companies for which Staff recommends an adjustment be made to the SUSF, should similarly provide their calculations of the change in SUSF necessary to reflect the lower federal income tax rates resulting from the Tax Act, both for an ongoing adjustment effective October 1, 2018 and a return of overpayments of SUSF from January 1, 2018 to September 30, 2018. All interested persons are invited and encouraged to file comments.

Attachments

THE POLICY RECOMMENDATIONS WOULD APPLY TO THE FOLLOWING UTILITY COMPANIES:

Electric/Gas/Steam Companies:

1. **Central Hudson Gas & Electric Corporation**
2. **Consolidated Edison Company of New York, Inc.**
3. **Corning Natural Gas Corporation**
4. **KeySpan Gas East Corporation d/b/a National Grid**
5. **National Fuel Gas Distribution Corporation**
6. **New York State Electric & Gas Corporation**
7. **Niagara Mohawk Power Corporation d/b/a National Grid**
8. **Orange and Rockland Utilities, Inc.**
9. **Rochester Gas & Electric Corporation**
10. **St. Lawrence Gas Company, Inc.**
11. **The Brooklyn Union Gas Company d/b/a National Grid NY**

Water Companies:

1. **Fishers Island Water Works Corporation**
2. **Heritage Hills Water Works Corporation**
3. **New York American Water Company, Inc.**
4. **Saratoga Water Services, Inc.**
5. **Suez Water New York, Inc.**
6. **Suez Water Owego-Nichols, Inc.**
7. **Suez Water Westchester, Inc.**

Telephone Companies:

1. **Chazy & Westport Telephone Corporation**
2. **Edwards Telephone Company, Inc / TDS Telecom**
3. **Germantown Telephone Co., Inc., d/b/a Gtel Teleconnections**
4. **Newport Telephone Company, Inc.**
5. **Oriskany Falls Telephone Corporation**
6. **Pattersonville Telephone Company**
7. **Township Telephone Company, Inc.**
8. **Vernon Telephone Company, Inc.**

Example of CIAC Calculation - Using the Present Value Method

Contribution Calculation - Present Value Method

Cost of Project	$1,000
Present Value of Future Tax Benefits (FIT&SIT)	(110)
Net Cost (See Calculation Below)	890
Gross-up for Income Taxes**	1.35
Contributions	$1,205
Contributions	$1,205
Federal and State Income Taxes	315
Net Amount	890
Present Value of FutureTax Benefitss	110
Cost of Project	$1,000

** 1/(1-26.1%) =1.354 assuming a 6.5% SIT rate and 21% FIT rate

Depreciation on $1,000 Investment

Year	Tax Depreciation	Fit&SIT 26.1%	Present Value 8.15%
1	$ 40	$ 10	$ 10
2	40	10	9
3	40	10	8
4	40	10	8
5	40	10	7
6	40	10	7
7	40	10	6
8	40	10	6
9	40	10	5
10	40	10	5
11	40	10	4
12	40	10	4
13	40	10	4
14	40	10	3
15	40	10	3
16	40	10	3
17	40	10	3
18	40	10	3
19	40	10	2
20	40	10	2
21	40	10	2
22	40	10	2
23	40	10	2
24	40	10	2
25	40	10	1
Total	$ 1,000	$ 261	$ 110

6.5% NYS Rate + (1-6.5% NYS Rate)*21% FIT Rate = 26.1% Effective