STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

At a Session of the Public Service Commission held in the City of Albany on November 8, 2006

COMMISSIONERS PRESENT:

William M. Flynn, Chairman
Patricia L. Acampora
Maureen F. Harris
Robert E. Curry, Jr.
Cheryl A. Buley

CASE 04-M-1693 - Proceeding on Motion of the Commission as to the Accounting and Ratemaking Related to the Implementation of the Prescription Drug and Medicare Improvement Act of 2003.

CASE 91-M-0890 - In the Matter of the Development of a Statement of Policy Concerning the Accounting and Ratemaking Treatment For Pensions and Post-Retirement Benefits Other Than Pensions.

ORDER ADOPTING ACCOUNTING
FOR 2003 MEDICARE ACT EFFECTS

(Issued and Effective November 16, 2006)

BY THE COMMISSION:

BACKGROUND

In the First Medicare Order,[1] the accounting for impacts that arise out of the 2003 Medicare Act was considered.[2] That statute creates subsidies and tax benefits for employers that include prescription drug benefits in the retirement plans

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[1] Case 04-M-1693, supra, Order Clarifying Prior Policy Statement and Order, Instituting a Proceeding, and Soliciting Comments (issued February 2, 2005).

[2] Prescription Drug and Medicare Improvement Act of 2003 (Public Law No. 108-173.

they offer employees. It was decided that utility employers that furnish drug benefits to their retirees were required to apply the requirements of the OPEB Statement and Order,[3] when accounting for 2003 Medicare Act impacts. Comments, however, were solicited on the proper application of the OPEB Statement and Order.

2003 Medicare Act impacts were addressed further in the Second Medicare Order.[4] As discussed there, the ratemaking, accounting and cash flow implications related to the timing when 2003 Medicare Act costs are incurred, a subsidy payment under the Act is received, and a tax benefit provided for in the Act is realized, could create confusion. As a result, additional proceedings were conducted, leading to the promulgation of a Straw Proposal for performing the accounting necessary to properly reflect timing impacts.[5]

Parties were invited to submit comments on the issues raised by the Straw Proposal in filings submitted no later than August 21, 2006. Moreover, notice of the Straw Proposal was published in the State Register on July 5, 2006, in conformance with State Administrative Procedure Act (SAPA) §202(1). The comment period provided for under SAPA §202(1)(a) expired on August 21, 2006. The parties that responded to the notices are listed, with abbreviations, and their comments are summarized, below.

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[3] Case 91-M-0890, supra, Statement of Policy and Order Concerning the Accounting and Ratemaking Treatment for Pensions and Post-Retirement Benefits Other than Pensions (issued September 7, 1993).

[4] Case 04-M-1693, Order Denying Rehearing, Granting Clarification in Part and Providing For Further Proceedings (issued December 2, 2005).

[5] Case 04-M-1693, Notice Soliciting Comments on Straw Proposal (issued June 16, 2006).

POSITIONS OF THE PARTIES

Con Ed/O&R

According to Consolidated Edison Company of New York, Inc. (Con Edison) and Orange and Rockland Utilities, Inc. (O&R)(collectively, Con Ed/O&R), proposed rate plans for Con Edison steam service and O&R gas service provide for treatment of 2003 Medicare Act effects that differ from the approach taken in the Straw Proposal. The utilities note that they follow the OPEB Statement and Order, which requires them to defer variations in pension and OPEB costs from the levels assumed in base rates until rates are next re-set. Under that approach, Con Ed/O&R contends, they actuarially projected and reflected in rates the expected tax benefits they would receive under the 2003 Medicare Act. These projections, the utilities contend, have reduced rate plan forecasts of the revenues they must recover from ratepayers.

Under the Straw Proposal, Con Ed/O&R complain, a different approach is taken; an actuarial projection is not made and recognition of 2003 Medicare Act tax benefits in rates is instead delayed until the tax benefits are realized, which occurs at the time the cost subsidy is received. The Straw Proposal approach, the two utilities believe, is premised upon the assumption that reflecting the Act's tax benefit in rates based on actuarial projections, at a time substantially earlier than the time the tax benefit is realized, would likely cause utilities to seek financing to bridge the gap between the time when the tax benefit projection is reflected in rates and when the tax benefit is realized. But, the utilities note, a failure to project the tax benefit in rates at the earlier time conflicts with the terms of their Rate Plans, which do reflect that projection.

Con Ed/O&R are concerned that modifying the 2003 Medicare Act accounting embedded in the proposed steam and gas

Rate Plans might force recalculation of the overall rates provided for in those proposals. They also contend that the amount they would need to finance during the period between the actuarial projections of the tax benefits in rates and the realization of those benefits would be less than anticipated in the Straw Proposal. The financing requirements, they contend, would be further offset by the savings customers obtain from the crediting to them of the projected tax benefits earlier than their time of realization. Con Ed/O&R also maintain that projecting the tax benefits in rates reduces the amount of the unfunded OPEB balance, upon which the companies must accrue interest. The two utilities conclude that 2003 Medicare Act tax benefit timing is best addressed by their approach of making actuarial projections instead of the Straw Proposal's approach of awaiting the time when the tax benefits are realized.

In a supplemental filing dated September 15, 2006, however, Con Ed/O&R announce they see advantages to the Straw Proposal approach of recognizing the tax benefits in rates at the time the benefits are realized instead of actuarially projecting them earlier. They believe that the Straw Proposal approach advances inter-generational equity.

While Con Ed/O&R now favor the Straw Proposal approach, they maintain that a transition from the accounting described in the proposed steam and gas rate plans is needed. As a result, they would defer application of the Straw Proposal approach under these particular circumstances until the time when rates for the services governed by the affected rate plans are next set. Consequently, they ask that the proposed Con Edison Steam and O&R Gas Rate Plans be approved even though they deviate from the Straw Proposal accounting, which would be applied when the rates for those services are revised. The accounting could commence immediately, however, for Con Edison's gas service and O&R's electric service, where existing rate plans do not inherently conflict with the Straw Proposal.[6]

NYSEG

According to New York State Electric & Gas Corporation (NYSEG), neither its electric nor its gas operations are subject to the OPEB Statement and Order. The utility reports that its Gas Rate Plan, which extends through December 31, 2008, explicitly provides for a waiver from the OPEB Statement and Policy, and so it will account for 2003 Medicare Act expenses in accordance with that waiver rather than with the accounting protocols prescribed in these proceedings.[7]

NYSEG also contends that its electric operations have been exempt from the OPEB Statement and Order since July 31, 1997.[8] In support of this contention, it references a filing it made in response to the Second Medicare Order. The utility notes, however, that it has concluded that the 2003 Medicare Act effects fall into the category of mandatory regulatory, legislative, accounting and tax changes it must implement under its existing electric Rate Plan.[9] As a result, it states, it has been using credits created under the 2003 Medicare Act to offset costs incurred in 2004 and 2005 that otherwise would have been

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[6] Con Ed/O&R claim that the existing Con Edison Electric Rate Plan also conflicts with the Straw Proposal, and that the Rate Plan should supercede any conflicting accounting that may be adopted here.

[7] Case 01-G-1668, New York State Electric & Gas Corporation, Order Establishing Rates (issued November 20, 2002).

[8] Case 96-E-0891, New York State Electric & Gas Corporation's Plans For Electric Rates and Restructuring, Order Adopting Terms of Settlement Subject to Modifications and Conditions (issued January 27, 1998) and Opinion No. 98-6 (issued March 5, 1998).

[9] Case 01-E-0359, New York State Electric & Gas Corporation, Order Adopting Provisions of Joint Proposal With Modifications (issued February 27, 2002).

deferred for later recovery, thereby reducing the burden on future ratepayers. It nonetheless concludes, however, that the Straw Proposal does not apply to its electric operations because it is a feature of the OPEB Statement and Order, which is inapplicable to its electric operations.

RG&E

Rochester Gas & Electric Corporation (RG&E) reports that its electric and gas operations are subject to the requirements of the OPEB Statement and Order. It therefore believes it will be subject to the decision on the Straw Proposal, and it does not oppose that accounting so long as it is applied in the same manner to all utilities operating under the OPEB Statement and Order.

National Grid

Niagara Mohawk Power Corporation d/b/a National Grid (National Grid) states that it generally supports the accounting protocols prescribed in the Staff Proposal. It agrees that the return of the 2003 Medicare Act tax benefit to ratepayers should not be actuarially projected in rates and should occur no sooner than when the tax benefit is realized in the year in which the cash subsidy is received. It propounds, however, what it describes as one minor modification to the Straw Proposal accounting protocols.

According to National Grid, the regulatory liability established and then released, for the purpose of returning to ratepayers the tax benefit realized from the operation of the 2003 Medicare Act, should be recorded in a revenue or amortization expense account and should not be entered into a deferred tax expense account. The Straw Proposal suggested an entry into a deferred tax account was the appropriate choice.

National Grid claims that while the regulatory liability arises from a change in tax law, the benefits that result are not necessarily best recorded as a tax expense. The company believes its approach properly recognizes the permanent tax rate difference related to the subsidy in the same year that it accrues the subsidy as a reduction to book expense. It provides proposed sample book entries that would implement its modification to the Straw Proposal.

DISCUSSION AND CONCLUSION

The points Con Ed/O&R and NYSEG raise regarding rate plans are being addressed in other proceedings, and so need not be considered here. National Grid's proposed modification to the accounting entries identified in the Straw Proposal appears sound. With that modification, the requirements of the Straw Proposal are adopted, as the 2006 Accounting and Ratemaking Protocols In Connection With the Medicare Act of 2003 (attached hereto), binding on utilities that account for 2003 Medicare Act effects under the OPEB Statement and Order.

Con Ed/O&R suggested that the proposed Con Edison Steam Rate Plan and O&R Gas Rate Plan should provide for a transition to the 2003 Medicare Act's accounting adopted here. That approach has been reflected in the recent adoption of those Rate Plans.[10] Both provide for 2003 Medicare Act tax benefit accounting that deviates from the accounting adopted here, but do not require that the accounting continue beyond the next time there is a change in rates. As a result, the Rate Plan

[10] Case 05-S-1376, Consolidated Edison Company of New York, Inc., Order Determining Revenue Requirement and Rate Design (issued September 22, 2006), p. 9; Case 05-G-1494, Orange and Rockland Utilities, Inc., Order Establishing Rates and Terms of a Three-Year Rate Plan (issued October 20, 2006), p. 31.

accounting may be viewed as a transition mechanism, as Con Ed/O&R propose.[11]

As to NYSEG, the recent Rate Order decision on its electric rates addresses its contention that its electric operations are outside the scope of the OPEB Statement and Order. As that Rate Order provides, a separate proceeding is needed to fully examine NYSEG's OPEB accounting practices from 1999 to date. That proceeding will decide the extent to which NYSEG's electric rate operations have been subject to the OPEB Statement and Order, and will establish the OPEB accounting that NYSEG must follow in the future. Included among those determinations will be resolution of the impact of the accounting protocols adopted here, which are a subset of the requirements of the OPEB Statement and Order.[12]

Niagara Mohawk proposes to modify the accounting entries provided for in the Straw Proposal, to record the deferral of the tax benefits in a revenue or amortization expense account instead of in a deferred tax expense account. This modification is appropriate. The entries made to defer the tax benefits for eventual inclusion in rates are a regulatory deferral and should be recorded as such, instead of as deferred tax entries, as would occur under the Straw Proposal.

With that modification, the remainder of the requirements promulgated in the Straw Proposal are satisfactory. New York utilities subject to the OPEB Statement and Order are therefore directed to account for 2003 Medicare Act effects in

[11] Con Edison's contentions regarding its Electric Rate Plan, which is currently in effect, will be addressed to the extent necessary during the ongoing implementation of that Rate Plan. Case 04-E-0572, Consolidated Edison Company of New York, Inc., Order Adopting Three-Year Rate Plan (issued March 24, 2005).

[12] Case 05-E-1222, New York State Electric & Gas Corporation, Order Adopting Recommended Decision With Modifications (issued August 23, 2006), pp. 75-77.

conformance with the attached 2006 Accounting and Ratemaking Protocols in connection with the Medicare Act of 2003, which implement the Staff Straw Proposal as modified above.

The Commission orders:

1. The utilities subject to the Statement of Policy and Order Concerning the Accounting and Ratemaking Treatment for Pensions and Post-Retirement Benefits Other Than Pensions issued September 7, 1993 in Case 91-M-0890 are directed to account for impacts related to the Prescription Drug and Medicare Improvement Act of 2003 in accordance with the discussion in the body of this Order.

2. This proceeding is continued.

By the Commission,

(SIGNED) JACLYN A. BRILLING
Secretary

PUBLIC SERVICE COMMISSION
OFFICE OF ACCOUTING AND FINANCE

Cases 04-M-1693 & 91-M-0890

2006 Accounting and Ratemaking Protocols
In Connection With the Medicare Act of 2003

(November 2006)

In an Order Denying Rehearing, Granting Clarification in Part and Providing for Further Proceedings ("the Order") issued December 2, 2005 in Cases 04-M-1693 and 91-M-0890, the Public Service Commission ("the Commission") established procedures for developing accounting protocols that would address timing issues attending receipt of subsidy payments and recognition of tax effects related to the Prescription Drug and Medicare Improvement Act of 2003 ("2003 Medicare Act" or "the Act"). The protocols were needed to coordinate 2003 Medicare Act impacts with existing accounting and ratemaking procedures for New York regulated utility expenses related to post-retirement benefit expenses other than pensions (OPEB). The Order directed Department of Public Service Staff ("Staff") to prepare a Straw proposal on the needed accounting and ratemaking protocols.

In conformance with the Order, a Straw Proposal, prepared by Office of Accounting and Finance ("A&F") Staff, was issued for comment on June 16, 2006. After consideration of the comments received, the Commission adopts these 2006 Accounting and Ratemaking Protocols In Connection With the Medicare Act of 2003.

INTRODUCTION AND BACKGROUND

On December 8, 2003, the 2003 Medicare Act was signed into law, expanding Medicare by adding a voluntary prescription drug benefit under a new Medicare Part D. A key aspect of the Act is the employer subsidy. To encourage employers to continue current prescription drug coverage for retirees, the federal government will pay an employer that provides a qualified retiree prescription drug plan a tax-free subsidy equal to 28% of qualifying enrollees' allowable annual prescription drug costs between $250 and $5,000 (i.e., up to $1,330). These amounts will be adjusted annually based on the change in Medicare Part D costs.

In May 2004, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) 106-2, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*, which provides guidance on the accounting and disclosure requirements related to the 2003 Medicare Act. Under FAS 106-2, employers will treat the reduction in the accumulated postretirement benefit obligation (APBO) attributable to the subsidy as an actuarial gain to the extent they can assign this reduction to past service. Because of the reduction to the APBO, the interest cost component of FAS 106 cost will be lower in the future. Current period service cost will reflect the impact of this subsidy on future costs.

Employers receive a tax deduction when they pay or fund retiree prescription benefits. The subsidy when received is non-taxable income and does not reduce the employer’s tax deduction for this cost. For example, an employer that pays $5,000 in prescription drug costs in 2006 and receives a $1,000 subsidy related to those costs will retain the $5,000 tax deduction and receive the $1,000 subsidy tax-free. The FSP acknowledges that to account for this under FASB No. 109, *Accounting for Income Taxes* (FAS 109), an employer should establish a deferred tax asset based on the assumed future tax deduction without reflecting the subsidy. In effect, the subsidy is treated as a permanent difference under FAS 109, and employers should measure deferred tax assets as if the APBO did not reflect any subsidy.

For example, the employer's carrying amount of accrued postretirement benefit liability on its books is assumed to be $1,000 before the adoption of the FSP. Assuming an income tax rate of 35%, the employer had recorded a deferred tax asset of $350. It is determined that the adoption of the FSP will result in the subsidy producing an actuarial gain of $200. The accrued postretirement benefit liability will be reduced to $800 ($1,000 minus $200); however no change will be made to the deferred tax asset, because the $350 still represents the future tax benefit to the employer. In periods after the adoption of the FSP, it will be necessary to identify the portion of subsequent net periodic benefit cost that reflects the subsidy and add that effect back to the accrued postretirement benefit cost for purposes of calculating the tax basis of the OPEB liability on which the deferred tax asset will be measured.

DISCUSSION

Ratemaking & Financial Impacts of Subsidy and Tax Benefit

The subsidy provided under the 2003 Medicare Act will cause reductions in the utilities' rate allowance for OPEBs in three direct ways. First, upon implementation of the Act and its associated accounting there will be an actuarial gain that results from the reduction in the APBO. This recognizes that in the future years when payments for benefits already earned are made there will be subsidy amounts received by utilities at that time to offset a portion of the payment. This lowered obligation reduces the need for funding, and is reflected in the net periodic cost accruals prospectively through the amortization of the actuarial gain. Second, service costs reflected in the net periodic cost accrual prospectively will be lower to reflect this offset to future benefit costs provided by the subsidy. Third, the non-taxable status of the subsidy will provide a tax benefit to utilities thus reducing the overall cost of providing these benefits.

The Commission's OPEB Statement of Policy ("SOP") requires that actuarial gains and losses be amortized into OPEB expense over a ten year period and be reflected in rates.[1] The amortization of the Act's subsidy-related actuarial gain and lower service costs, when reflected in rates, should not cause New York utilities to experience a need for financing. Such a financing requirement would arise only if the combination of these two effects results in a utility experiencing an annual credit for its net periodic cost accrual for OPEB's, and then seeing this credit reflected in rates. Based on review of the utilities' OPEB expense accrual levels, this possibility does not seem realistic.

However, reflecting the tax benefit in rates coincident with recognition of the subsidy in the OPEB expense accrual is likely to give rise to a need for financing. This occurs because rates will be reduced, at the revenue requirement amount, in the year the subsidy-related tax benefit is reflected in earnings, while recognizing the deferred

[1] Case 91-M-0890, Statement of Policy and Order Concerning the Accounting and Ratemaking Treatment for Pensions and Post-Retirement Benefits Other Than Pensions (issued September 7, 1993).

tax credit in earnings yields no immediate cash flow benefits. The cash inflow for this tax benefit is realized in later years when the benefit payments are made and the non-taxable subsidy is received. In contrast, no financing requirement would arise if the tax benefits are not reflected in rates until the subsidy is received and the tax benefit is realized.

Model Illustrating The Accounting and Ratemaking

In order to avoid creating a financing requirement as a result of the inclusion of the subsidy-related tax benefit in rates, accounting and rate making for the 2003 Medicare Act are based on reflecting the tax benefits in rates after the benefits are realized at the time the subsidy is received. The following model provides a demonstration of this accounting and rate making.

The model assumes that the utility's actual retiree drug benefits costs are equal to the amount reflected in setting rates, and that there is a $100 benefit cost, which generates a $28 subsidy payment. The non-taxable status of the subsidy produces a $15 ($28 x 35% / 65%) tax benefit so that the net cost of these benefits is $57 ($100-$28-$15=$57).

The model provides for a rate allowance of $72 in year one. The $15 subsidy related tax benefit is not reflected in year one rates, but instead is deferred for ultimate return to ratepayers once the utility actually receives the tax benefit.

In year one, the $72 rate allowance consists of $100 in drug benefit costs net of the related $28 subsidy included in the OPEB expense accrual. However, the utility is still required to account for the subsidy-related deferred tax expense credit of $10 pursuant to SFAS 109.

The SOP deferral accounting in year one requires that a $15 expense debit (and a regulatory liability of $15) be recorded to offset the revenue requirement effect of the subsidy related deferred tax expense credit of $10 recorded in year one. This is needed so the tax benefit is deferred for ratepayer benefit to offset drug benefit costs. There is no cash outflow in year one and accordingly no financing requirement is created. The utility has $15 of deferred tax assets that are matched by a regulatory liability of $15; both are non-cash transactions.

In year two, the drug benefit payments are made, the subsidy is received and the utility realizes the $10 cash inflow from the tax benefit. The subsidy related deferred tax asset has been converted into $10 of cash in year two. This is represented by a $10 credit balance in the internal reserve.

In year three,[2] the $15 tax benefit is returned to ratepayers through a lower revenue requirement. This amount is provided through the $5 reduction in the FIT liability and the $10 of cash held by the utility.

CONCLUSION

Due to the unique nature of Medicare and the potential for future federal budgetary pressures affecting both Medicare payments and tax code provisions, there could be major changes to the benefits and structure of Medicare programs. Such changes could have a significant impact on OPEB costs. For this reason, a conservative approach to ratemaking for the subsidy-related tax benefit is preferred. As a result, the income tax benefit will not be reflected in rates until the subsidy is received and the tax benefit is realized by the utility. Thus, the tax savings would be deferred for ultimate return to ratepayers once the utility obtains the tax benefit. This cautious approach should not cause utilities to experience greater cash needs or cause financing requirements to arise. Also, ratepayers will not be disadvantaged since, as shown in the accounting model above, the tax benefits received will bear interest by inclusion in the Internal Reserve until they are reflected in rates. According, these 2006 Accounting and Ratemaking Protocols In Connection With the Medicare Act of 2003 are adopted.

[2] A third year was added to allow for the display individually of the financial implications of the receipt of the tax subsidy (year 2) from the return to customers of the tax subsidy benefit (year three).