STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

At a session of the Public Service Commission held in the City of Albany on January 12, 2005

COMMISSIONERS PRESENT:

William M. Flynn, Chairman
Thomas J. Dunleavy
Leonard A. Weiss
Neal N. Galvin

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 CLARIFYING PRIOR POLICY STATEMENT AND ORDER, INSTITUTING A PROCEEDING, AND SOLICITING COMMENTS

(Issued and Effective February 2, 2005)

BY THE COMMISSION:

BACKGROUND

Under the Prescription Drug and Medicare Improvement Act of 2003 (Public Law (P.L.) No. 108-173)(2003 Medicare Act), enacted on December 8, 2003, employers that include prescription drug benefits in the retirement plan benefits they offer retired employees will receive from the federal government, beginning in 2006, subsidy payments offsetting the cost of the prescription drugs. Under the Act, those payments will not be recognized as taxable income to the employers or in calculating the income tax deduction available to employers for prescription drug benefit expenses. The currently-effective accounting protocols for pension and post-retirement benefit expenses other than pensions (OPEB), as established in the OPEB Statement and Order,[1] require New York utility employers to defer the subsidy payments and tax benefits arising out of the 2003 Medicare Act, beginning in 2004.

It appears that some utilities may not be fully aware that all of the OPEB Statement and Order requirements adhere to their accounting for the 2003 Medicare Act impacts. Some utilities may not have recognized the extent to which that Statement and Order is applicable, and requires them to defer all cost effects arising in 2004 out of the Act's subsidy payments and tax benefits, instead of accounting for at least some of the benefits accruing in 2004 as income to shareholders. Clarification is needed to ensure that utilities are fully aware of the provisions of the OPEB Statement and Order as they apply to the 2003 Medicare Act.

Notwithstanding that clarification, implementation of the 2003 Medicare Act may continue to present accounting and ratemaking issues. A new proceeding is commenced to address those issues.

DISCUSSION AND CONCLUSION

Clarification of the OPEB Statement and Order is appropriate, given the potential accounting and ratemaking impacts arising out of the 2003 Medicare Act. It is therefore clarified that the accounting and ratemaking treatment of the expenses and benefits New York utilities experience as a result of the 2003 Medicare Act, including its provisions on

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[1] 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).

prescription drug benefits for retirees, fall within the scope of the OPEB Statement and Order.

The 2003 Medicare Act

The prescription drug benefits created in the 2003 Medicare Act are intended to expand the breadth of the prescription drug insurance coverage available to retirees. In conformance with that goal, one of the purposes of the Act is to encourage employers to retain existing prescription drug benefits for their medicare-eligible retirees or to add that coverage to their retiree benefit plans. The 2003 Medicare Act achieves that result by establishing a subsidy payment program that, beginning in 2006, will fund 28% of an employer’s per capita retiree drug prescription costs between $250 and $5,000 if the employer offers its retirees prescription drug benefits that are at least as valuable, on an actuarially-equivalent basis, as the 2003 Medicare Act prescription drug benefits.[2] The amount of the subsidy payment is indexed for inflation for years after 2006.

Notwithstanding that subsidy payment incentive, it is expected that retiree participation in the prescription drug benefit plans utility employers offer will decline. The 2003 Medicare Act affords retirees the choice of participating in a utility employer’s health care plan, or instead taking prescription drug benefits from a competing prescription drug plan under Medicare Part D. At least some retirees will likely opt to participate in Medicare Part D, leaving utilities with lower enrollments in their retiree prescription drug plans than was previously anticipated.

[2] Prescription Drug and Medicare Improvement Act of 2003, P.L. No. 108-173, §1860D-22.

The 2003 Medicare Act also extends tax benefits to eligible employers. Under existing provisions of the Internal Revenue Code (IRC), employers may take an income tax deduction for the expense they incur in providing retiree health benefits, including the cost of prescription drug benefits. The 2003 Medicare Act, however, excludes its subsidy payments from the definition of taxable income otherwise applicable to these employers, and from the calculation of the income tax deduction available to the employers for retirement benefit expense.[3] For example, an employer that pays $2 million in retiree prescription drug costs in 2006, while receiving a federal subsidy payment of $500,000, may nonetheless claim a $2 million tax deduction, and is not required to include the $500,000 payment in taxable income.

The subsidy payments utility employers will receive under the 2003 Medicare Act and the decline in participation in their prescription drug plans they will experience as a result of the Act will reduce the overall costs of providing prescription drug benefits to retirees. The tax benefit they receive under the Act will also contribute to lower overall retiree benefit costs, which will eventually result in lower allowances for those costs in utility rates.

The OPEB Statement and Order

Under the OPEB Statement and Order, a utility must account for all OPEB expenses by deferring any difference between the amount of the OPEB costs it experiences and the OPEB expense it is allowed to recover in its rates.[4] Requiring deferral protects both utilities and their customers from

[3] Prescription Drug and Medicare Improvement Act of 2003, P.L. No. 108-173, §1202, amending the IRC to add a new §139A.

[4] OPEB Statement and Order, pp. 18-20; Att. A, pp. 16-20.

inaccurate actuarial and healthcare cost assumptions; makes it possible to accurately recover properly-calculated costs in rates, instead of relying on estimates in making rates; and, creates a mechanism for capturing cost reductions.[5] For those utilities subject to the Statement and Order's requirements,[6] the deferrals are, depending on the circumstances, returned to or recovered from ratepayers, unless we direct a different ratemaking result.

The OPEB Statement and Order requires New York utilities offering retirement benefits other than pensions to meet the requirements of Financial Accounting Standard Board (FASB) Statements. In particular, the utilities must meet the requirements of Statement of Financial Accounting Standards (SFAS) No. 106, Employers Accounting for Post-Retirement Benefits other than Pensions, which governs the accounting entries the utilities subject to the Statement and Order must make to record OPEB effects.[7] Following enactment of the 2003 Medicare Act, FASB gave guidance on the implementation of SFAS No. 106, when it issued FASB Staff Position No. 106-2 (FSP No. 106-2).[8] There, it described the accounting employers who sponsor post-retirement plans that include a prescription drug benefit must follow in recognizing the effects of the Act. In

[5] OPEB Statement and Order, p. 5.

[6] As discussed in the OPEB Statement and Order, Att. A, p. 1, utilities may obtain an exemption from the Statement and Orders requirements; the utilities currently partially or fully exempt from those requirements are listed at Appendix A.

[7] OPEB Statement and Order, pp. 8-11.

[8] FASB Staff Position No. 106-2, Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvements and Modernization Act of 2003.

addition, FSP No. 106-2 offers guidance on accounting for the tax benefits that arise under the Act.[9]

As we decided in the OPEB Statement and Order upon adopting SFAS No. 106, it “provides a superior method for quantifying and apportioning OPEB costs among current and future customers.”[10] Since FSP No. 106-2 describes the accounting required at this time, under the authority of FSAS No. 106, to recognize the 2003 Medicare Act effects, FSP No. 106-2 falls within the ambit of the OPEB Statement and Order’s accounting provisions implementing FSAS No. 106, and utilities are required to make accounting entries related to the Act in conformance with FSP No. 106-2. This ensures that those entries will accurately reflect the retirement benefit costs and expenses the utilities experience, as the impacts of the 2003 Medicare Act are realized.

Moreover, in conformance with SFAS No. 106, the accounting prescribed in the OPEB Statement and Order was intended to capture the effects of changes to retirement plan benefits that occurred after the Statement and Order was promulgated. As it provides, employers were expected to review and revise OPEB expense levels "often for assumption changes, plan amendments and for the effects of implementing [the OPEB Statement and Order]."[11] The 2003 Medicare Act impacts are the types of changes in benefit expense assumptions and modifications to benefit plan requirements that fall within the ambit of the revisions that were expected.

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[9] FSP No. 106-2, p. 6.

[10] OPEB Statement and Order, p. 11.

[11] OPEB Statement and Order, p. 19.

The OPEB Statement and Order also noted that, in the event a national healthcare program were implemented, rate allowances could differ considerably from actual costs, and it was expected those differences would be captured through the deferral accounting mechanism.[12] Like a national healthcare program, the 2003 Medicare Act has the type of effect on pension and OPEB expense that the deferrals required under the OPEB Statement and Order were intended to capture. The Act's effects therefore fall with the ambit of the Statement and Order's requirements.

<u>Application of the OPEB Statement and Order to the 2003 Medicare Act</u>

Based on a review of recent filings made with the Securities and Exchange Commission filings, New York's combination electric and gas utilities, and its two largest gas utilities, taken together, will realize an approximately $52 million annual reduction in OPEB costs, exclusive of tax savings, during calendar year 2004 attributable to the 2003 Medicare Act. The value of the income tax benefits, including those arising out of the exclusion of the subsidy payments from the definition of taxable income, is significant, but cannot be quantified at this time.

The rates of the utilities that operate under the OPEB Statement and Order currently do not reflect the 2003 Medicare Act savings and benefits.[13] Those utilities must recognize both cost savings and tax benefits arising out of the Act in their

[12] OPEB Statement and Order, pp. 18-20.

[13] The rate plans of the utilities that are exempt from the OPEB Statement and Order may include provisions on the distribution of revenue and recovery of expenses that are applicable to the 2003 Medicare Act payments and benefits; those rate plan provisions will be effectuated according to their terms.

deferral accounting mechanisms, instead of flowing these benefits through to earnings and then to shareholders.

Consistent with SFAS No. 106, FSP No. 106-2 requires employers to reflect the forecasted future impacts on employer prescription drug expenses and retiree prescription drug plan benefit coverage resulting from the 2003 Medicare Act in current measures of expense, beginning with the 2004 annual period. In arriving at that expense, employers calculate the Accumulated Post-retirement Benefit Obligation (APBO).[14] Under SFAS No. 106, as implemented in conformance with the guidance found in FSP No. 106-2, the reductions in utility retiree health care expense accompanying the 2003 Medicare Act must be recognized in the APBO, for the effects accruing in calendar year 2004 and thereafter. As required by the OPEB Statement and Order, the impacts are then recognized and deferred.

Among the effects of the 2003 Medicare Act are the subsidy payments utility employers will receive as an offset to the costs of their prescription drug plans, which will reduce the expense they incur in providing that benefit. Recognition of the subsidy payments will concomitantly reduce the APBO, as the present value of the subsidy payments to be received in the future are incorporated into the APBO calculation. Utility employers shall treat this initial reduction to the APBO as an actuarial gain, deferred and amortized in the same manner as any other actuarial gain.[15]

Moreover, any other reductions to the annual expense utility employers experience in the future in providing

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[14] The APBO is the actuarial present value of the future benefits credited to employee services rendered to a particular date.

[15] The OPEB Statement and Order calls for a 10-year amortization of this type of gain, or loss, on a vintage year basis.

prescription drug benefits to retirees, as a result of the 2003 Medicare Act, also must be recognized in the APBO. These declines in the APBO will translate into future reductions in the interest costs accrued on pension plan benefit obligations. Amounts attributable to those effects also must be deferred.

As to the tax benefits utilities will realize under the 2003 Medicare Act, they are derived from and related to the OPEB savings. As discussed in FSP No. 106-2, SFAS No. 109 accounting for those tax benefits continues.[16] Consequently, the effect of the tax benefits utilities will experience as a result of excluding the subsidy payments from both recognition as taxable income and the calculation of the benefit expense deduction must be deferred under the OPEB Statement and Order.

Therefore, the OPEB Statement and Order shall be interpreted as requiring the accounting entries described above. As a result, the revenue requirement effects of the 2003 Medicare Act, including any tax benefits, shall be deferred for calendar year 2004 and each subsequent year thereafter.

Further Proceedings

With the OPEB Statement and Order deferrals in place, the proper ratemaking for the effects of the 2003 Medicare Act can be addressed to the extent necessary. Under the ratemaking prescribed in the OPEB Statement and Order, the deferrals will be preserved and will be recognized in rates at an appropriate time. Utilities should be permitted to comment on whether that approach to ratemaking is properly applicable to the 2003 Medicare Act benefits and impacts.

[16] SFAS No. 109, Accounting for Income Taxes, is a FASB Statement issued in 1992 that applied the same income tax reporting requirements to regulated firms as to unregulated firms; it prohibits net-of-tax reporting by regulated firms and requires the creation of a deferred tax liability for taxes that are to be paid in the future.

Other ratemaking and accounting issues also may arise out of the provisions of the 2003 Medicare Act. Accordingly, a proceeding is instituted to consider the accounting and ratemaking changes to the OPEB Statement and Order that might be needed to accommodate the 2003 Medicare Act.

The Commission orders:

1. 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, is clarified to the extent discussed in the body of this Order.

2. A proceeding is instituted to consider the accounting and ratemaking issues raised by the Prescription Drug and Medicare Improvement Act of 2003, as discussed in the body of this Order.

3. Parties are invited to submit comments on the issues raised in Ordering Clause No. 2 by submitting an original and five copies, no later than Monday, April 11, 2005, to Jaclyn A. Brilling, Secretary, Public Service Commission, 3 Empire State Plaza, Albany, NY 12223-1350. The Secretary is authorized, in her sole discretion, to extend this deadline.

3. These proceedings are continued.

By the Commission,

(SIGNED)

JACLYN A. BRILLING
Secretary

Utility Operations Outside the Scope of the OPEB Policy Statement and Order

(As of January 12, 2005)

The Brooklyn Union Gas Company d/b/a KeySpan Energy Delivery New York

Citizens Telecommunications Company of New York, Inc.

Consolidated Edison Company of New York, Inc. (Electric Department Only)

Frontier Telephone of Rochester, Inc.

New York State Electric & Gas Corporation (Electric Department Only)

Verizon New York Inc.