

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

COMMISSIONERS:

Anne F. Mead, Chair¹
Harold A. Jerry, Jr.
Gail Garfield Schwartz

CASE 29465 - Proceeding on motion of the Commission as to the proposed accounting and ratemaking procedures to implement requirements of the Tax Reform Act of 1986 as they affect public utilities.

STATEMENT OF POLICY ON ACCOUNTING AND
RATEMAKING PROCEDURES TO IMPLEMENT
REQUIREMENTS OF THE TAX REFORM
ACT OF 1986

(Issued July 7, 1987)

Introduction

On November 14, 1986, we issued for comment a proposal by our staff for implementing the provisions of the Tax Reform Act of 1986 (TRA-86). The new tax law significantly alters the taxation of public utilities. In particular, the maximum federal income tax rate was reduced, for most utilities, from 46% to an effective rate of 40% in 1987 and to 34% beginning January 1, 1988. TRA-86 also repealed investment tax credits,

¹ Anne F. Mead served as Chairman of the Commission until June 17, 1987.

generally reduced deductions for accelerated depreciation and capitalized overheads, and subjected unbilled earned revenues and customer contributions for construction to new taxation.

Staff recommended that we implement TRA-86 by adopting the following guidelines:

1. Preserve the net savings of TRA-86 for ratepayers.
2. Use deferred accounting as the mechanism for preserving the benefits on an interim basis pending disposition of current and deferred savings in general rate proceedings, including second and third stage proceedings.
3. Use the tax benefits as an offset to costs approved for rate recovery and incurred subsequent to a utility's last rate case, or apply tax benefits against general cost increases if the utility can demonstrate such action will delay a rate filing, depending upon each utility's circumstances.

Staff also proposed specific accounting and ratemaking treatments for the major tax changes, covering the reduction in corporate tax rates, the treatment of excess accumulated deferred taxes, the new taxation of unbilled revenue and contributions in aid of construction, the repeal of tax deductions for capitalized overheads and the reserve for bad debts, and the alternative minimum tax. Finally, staff offered proposals on the measurement period for computing deferred tax savings and the accrual of interest on any net increases in utilities' cash flow.

Twenty-six parties responded to staff's proposal.¹ The utilities generally supported staff's proposal to preserve the tax savings through the deferred accounting procedure, as well as the other features of staff's proposal. Many respondents discussed technical issues raised by the proposal.

The Consumer Protection Board (CPB) filed a response in the form of a petition requesting temporary rate reductions of \$2.15 billion for the major utilities, to account for both the net effect of TRA-86 and its (CPB's) estimates of their then-current equity return requirements. By notice issued December 18, 1986, we invited comments by other parties on CPB's proposal. Our companion order in this proceeding resolves the issues raised by CPB's petition and the responses to it.

We will first discuss the threshold issue of the propriety of using deferred accounting to capture the benefits of TRA-86, and then address ourselves to staff's other proposals and the comments on them. We should point out at the outset that the policies set forth in this statement are subject to future amendment or clarification, because the Internal Revenue Service (IRS) has not issued final regulations implementing TRA-86.

I. Use Of Deferred Accounting to Capture TRA-86 Savings

The use of deferred accounting to distribute TRA-86 tax savings to utilities' ratepayers in future rate proceedings is

¹ A list of the parties is appended to this Statement of Policy.

proper. Under staff's approach, the incremental tax savings or expenses generated between January 1, 1987¹ and the date of utility's next-following general rate change would be deferred. The deferred amounts (as well as the continuing impact of TRA-86) would be reflected in the revenue requirement established in the general rate case in which the rate change is investigated. As staff noted in its proposal, we have routinely used deferred accounting to capture the effects of material transactions occurring between rate cases for future disposition.

This mechanism has the advantage of preserving interim TRA-86 benefits for ratepayers without disturbing existing cash flow and interest coverage targets or producing undesirable fluctuations in base rates. Moreover, this procedure will assure a fair and orderly review and disposition of the TRA-86 tax effects, which, after all, will affect the hundreds of large and small utilities we regulate.

As more fully discussed in our companion order, we do not find persuasive either the criticisms of the Department of Law or CPB, or the latter's recommendation for immediate, temporary rate reductions for affected utilities (with specific quantification for the 11 largest companies). These parties improperly assume that deferral accounting will not ultimately benefit ratepayers, and they fail to acknowledge the other

¹ For gas utilities with tax years ending September 30, the deferral would begin October 1, 1986.

considerations that affect utilities' revenue requirements. To be sure, in circumstances where we conclude that utilities' current rates will likely result in earned returns exceeding authorized returns and the prospects of near-term rate stability are good, we shall seek temporary rate reductions. Indeed, we have taken steps to reduce and stabilize for several years the rates of Con Edison (electric),¹ New York Telephone² and Rochester Telephone,³ and we have initiated proceedings to consider rate reductions for several other utilities.⁴ Other utilities have had general rate cases pending before us and we have been able to reflect prospective TRA-86 tax savings in our rate decisions, as staff recommended.⁵ We have found this approach -- use of deferred accounting of the tax effects for eventual disposition in a rate case, coupled with

¹ Case 29523 - Opinion and Order Approving Rate Decrease and Settlement Agreement and Determining Allocation of Rate Increase, Opinion No. 87-4, issued March 25, 1987.

² Case 28961 - Opinion and Order Extending Rate Case Moratorium, Opinion No. 85-17(D), issued May 11, 1987.

³ Case 29551 - Opinion and Order Approving Rate Decrease and Rate Moratorium, Opinion No. 87-12 (issued June 17, 1987).

⁴ See, e.g., Case 29585 - AT&T Communications of New York, Inc. - Order Instituting Proceeding and Establishing Temporary Rates, issued April 24, 1987; Case 29592 - Continental Telephone Company of New York, Inc. - Order Instituting Proceeding, issued May 13, 1987; and Case 29593 - ALLTEL New York, Inc. - Order Instituting Proceeding, issued May 13, 1987.

⁵ See, e.g., Cases 29327 et al. - Niagara Mohawk Power Corporation - Rates, Opinion No. 87-3, issued March 13, 1987. In that case, we used deferral accounting for the pre-rate year (January - March 1987) TRA-86 tax savings.

rate reduction proceedings where warranted -- to be best suited for preserving the savings for ratepayers without causing substantial future rate changes or needlessly disturbing utilities' financial quality indicators.

Accordingly, we adopt a policy of using deferred accounting as the mechanism for capturing the interim effects of TRA-86 in 1987 and 1988, pending disposition in utilities' next-following rate cases, including proceedings initiated by us, second and third stage proceedings, and any other general rate proceeding. We shall require each company that has not reflected, or been ordered to reflect, TRA-86 effects in its rates or in a rate filing to submit a proposed plan for doing so that would take effect no later than March, 1989.

II. Other Policy Issues

Six policy issues were raised in staff's proposal. We shall briefly describe each staff recommendation, discuss the comments of the parties, and state our policy on the issue. Our resolution of the ratemaking issues in this proceeding follows the accounting standards and ratemaking practices we have generally applied in assigning tax costs to current and future years. These principles have evolved in response to tax law changes in the past and they are not necessarily controlling with respect to future tax legislation.

Permanent vs. Temporary Tax Changes

Permanent changes in income tax costs are generally included in current tax expense, while temporary changes are normalized and spread over one or more future years. The reduction in the corporate tax rate (from 46% to 40% in 1987 and 34% in 1988) is an example of a permanent reduction that reduces current tax expense. On the other hand, the reduced TRA-86 deduction for accelerated depreciation is a temporary change, for the lower current depreciation deductions will be offset by higher deductions in future years. Staff's proposed treatment of the changes in tax rates and depreciation deductions was not disputed by the parties.

Timing

Tax laws often require certain revenues and/or expenses to be included in taxable income in one year even though they are not recovered in rates until a subsequent year. The deferral accounting procedure is used in these instances to conform the timing of tax and rate treatment. Staff's proposal to defer the impact of the newly-enacted taxation of unbilled revenues is an example of a timing difference, since the actual revenues are not realized until the year after the tax is payable. The deferred accounting procedure we normally apply to timing differences (and temporary differences described above) either increases or decreases cash flow and interest coverage, depending on the transaction.

Financial Impact

In the past, we have authorized deferred tax treatment to improve certain utilities' cash flow and interest coverage. The selection of the time period used for reversal of excess deferred taxes should take into account its impact on credit quality indicators of utilities with less favorable financial conditions.

Generally, our ratemaking approach will follow the foregoing principles. We recognize, however, that specific company circumstances may warrant departures.

A. Contributions in Aid of Construction

Under TRA-86, customer contributions in aid of construction (customer contributions or "CIACs") received after December 31, 1986 are taxable. Staff proposed that utilities normalize the tax effect of customer contributions pending recovery in future years through tax deductions for depreciation on the contributed property. With normalization, ratepayers would not pay directly the tax effect of the customer contributions; the utility would have to finance the resulting tax payment. The tax payment would be included in rate base and gradually decline as the tax deductions from depreciation are realized.¹

Staff stated that normalization is the least disruptive method of dealing with the taxation on customer contributions,

¹ Customer contributions generally are of an ongoing nature and so the financing of related tax payments are, in many respects, similar to other outlays required to complete construction.

because it results in the lowest payment to the federal government, causes little administrative difficulty, and has a minimal financial impact on major utilities. Staff recognized, however, that the financing option may not be feasible for many relatively small water companies that depend heavily on customer contributions for construction, because the sheer magnitude of the financing requirements would impede such financing.

Staff discussed an alternative under which customers and/or developers would pay both the contributed amount and the related income taxes. Staff conceded this method would be problematic, both because of the uncertain tax status of many small water companies (i.e., they might charge for income taxes when none are payable), and because of the administrative difficulty of tracking tax depreciation on contributed property and returning tax payments to individual customers. Staff also found this method would require a higher federal tax outlay than would the financing method.

Virtually all comments addressed water industry problems, particularly the question of who should pay the tax on customer contributions. The comments can be summarized under the following four headings.

1. Utility Financing

This option is the least-cost alternative, because the tax payable to the government is controlled by collections from customers and it requires the lowest customer payments. Moreover, as noted by New York-American Water Company, Inc., this method will

not discourage developers from extending mains, because it obviates advances needed to pay taxes. Small water companies, however, might receive contributions that are large in relation to their rate base; this option would not be feasible for many of those companies.

2. Gross-Up Method.

Under this approach, the contributor/developer would advance the contribution and also pay an amount sufficient to allow the utility to pay the tax on the contribution. The utilities would reimburse the contributor/developer for the tax payment as the property is depreciated on future tax returns. Since customer payments made to the utility for the taxes would themselves be taxable (thus triggering a tax on the tax), this option would be the most costly.¹

Wanakah Water Company, Inc. (Wanakah) and Country Knolls Water Works, Inc. (Country Knolls) support this method, because they fear that (1) they and other utilities might not be able to finance the additional amounts, and (2) in any event, the financing burdens under staff's approach might hamper their ability to provide adequate service.

¹ If a utility collects taxes on CIACs from customers, the revenues must be sufficient to pay (1) the tax on the principal amount of the contribution, and (2) an incremental amount to pay income taxes on revenues collected to pay the taxes (the tax on the tax). A utility in a 34% tax bracket would pay an effective tax rate of 52% on taxes collected from customers.

3. Present-Value Method.

Under this 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 under the utility financing method. The utility would finance a portion of the tax payment under the present-value method, but the interest and principal on the borrowings would be paid as the tax benefits are realized over the life of the property. The amount of funds advanced under this approach depends on the applicable corporate tax rate, the discount rate, and the timing of tax depreciation benefits.

The New York State Builders Association, Inc. (Builders Association) favored this method over the gross-up method, suggesting that there was uncertainty over the taxability of the developers' contribution and the actual tax liability of the utility. The Builders Association also said it would be unfair for the utility to charge the developer for the tax when the utility will receive tax benefits from the contribution.

4. Other

Shorewood Water Corporation (Shorewood) recommended that the developer finance the utility tax payment related to the customer contribution with a non-contingent financial instrument. For example, Shorewood continued, the contributor/developer could advance monies to pay federal taxes. The utility would then issue

a note to the developer with a face amount equal to the CIAC, a repayment schedule coinciding with the tax life of the property, and an interest rate that is greater than the utility's nominal debt cost but lower than or equal to its incremental debt cost. This approach is designed to minimize payments to the IRS (through elimination of the tax on a tax) and to provide a source of financing to the utility.

Shorewood also urged that utilities be allowed the flexibility to choose the option that is best suited to their circumstances. Shorewood found staff's normalization proposal appropriate where contributions are small, but financially burdensome where significant growth is expected. Shorewood also believes the gross-up method may unreasonably stifle growth, prevent some companies from realizing the cost advantages of size, and distort natural growth patterns because of competition from municipal water utilities. In short, Shorewood recommended that we permit each utility to select the method that achieves the greatest long-run advantages.

5. Discussion

It is apparent that no single approach is optimal under all circumstances. The utility financing approach (staff's proposal) is the least costly, but it cannot be used by water utilities who lack ready access to external financing sources. This method also imposes financing costs on the general body of ratepayers and thus undermines the rationale for customer contributions, which is to insulate existing ratepayers from costs

related to expansion. These costs may be significant where contributions are a major source of capital.

The other options involve contributor/developer payments in some form for the tax liability. These options generally require higher tax payments than utility financing and create administrative problems that small water companies may be unable to resolve. Further, the amount to be billed contributors for taxes depends on their often uncertain overall tax status and the tax rates effective in the year the contribution is made; the same uncertainty exists for reimbursements through tax deductions when future tax benefits are realized. And this uncertainty is further complicated for Subchapter S and unincorporated utilities because the tax effects of water operations are flowed through to individual tax returns.

Despite the many uncertainties and complications inherent in these options, we conclude that generally applicable guidelines for the treatment of CIAC are necessary. A case-by-case approach would unduly burden staff with a multitude of specific proposals needing resolution, and a completely flexible approach, such as that recommended by Shorewood, would give the utilities too much leeway in determining contributor/developer payments for service.

Our guidelines are based on the likely characteristics of groups of utilities. Our specific objective is to minimize the overall cost of taxation on CIACs, while protecting the general body of ratepayers from the effect of CIAC transactions. We shall

provide for exceptions to the general guidelines only upon a showing of good cause.

a. Electric, gas and telephone utilities

The CIAC transactions for these utilities are relatively minor. Five of the 11 major utilities in the state report total contributions of only \$11 million annually, compared to total plant additions of \$1,265 million in 1986. The remaining six reported that the impact of CIAC taxation was immaterial.¹

Therefore, we shall adopt the utility financing approach for these utilities. Although this approach spreads the financing cost over the general body of ratepayers, it minimizes the overall payments to the federal government and the amounts involved are immaterial.

b. Major water utilities

The major (Class A) water utilities routinely receive CIACs in the normal course of business. Although these companies generally have access to external financing sources, a financing program for CIAC taxes will have a discernable effect on the companies and their ratepayers. For these water utilities, we shall adopt the present-value method, under which the contributor/developer is required to pay the principal amount and

¹ The five companies quantifying taxes on contributions are Niagara Mohawk Power Corporation, Long Island Lighting Company, Rochester Gas and Electric Corporation, Central Hudson Gas & Electric Corporation and National Fuel Gas Distribution Company, Inc. Those stating the amount was immaterial are New York State Electric & Gas Corporation, Orange & Rockland Utilities, Inc., Consolidated Edison Company of New York, Inc., The Brooklyn Union Gas Company, New York Telephone Company, and Rochester Telephone Corporation.

the additional tax on the tax component of the principal amount, less the present value of future tax benefits. Under this option, the utilities must also finance a portion of the tax payment, but these companies generally have access to external financing sources. Moreover, the impact on ratepayers will be minimized because the future tax benefits will provide the return on the capital raised by the utility to finance the initial tax liability.¹ We shall direct our Office of Accounting and Finance to establish accounting procedures to implement this approach.

We also encourage these utilities, subject to our prior approval, to pursue variations of this option, including a scheme under which the contributor/developer finances the tax payment through debt instruments, or pays the financing charges directly. We caution, however, that the IRS has not yet determined whether these payments are "loans" or a tax avoidance scheme.

In response to the Builders Association's concerns, we shall adopt a true-up mechanism to ensure that receipts for taxes not paid do not enhance earnings. On the other hand, contributor/developers should not be excused from paying the amounts because of a temporary change in a utility's tax status. Accordingly, the utility should segregate any funds collected from contributor/developers that are not subsequently paid to the

¹ Under the present-value approach, the utility finances the present value of future tax benefits. As the tax benefits are realized at their higher nominal value, the utility recovers the principal needed to repay the loan and interest on the unpaid balance.

government and propose an annual disposition of the excess.¹ Again, our Office of Accounting and Finance will develop technical accounting procedures for these situations.

The present-value approach will require utilities to develop a formula for computing the credit against contributor/developer tax payments. We will use the following elements in computing the credit:

- 1) Tax rate - Utilities should use the normal incremental tax rate effective for the year the contribution is received. Any excess (or deficiency) over actual taxes paid should be reserved for future disposition.
- 2) Discount rate - Utilities should use the current unadjusted rate on customer deposits.
- 3) Period - Utilities should use the depreciation lives for water plant prescribed by current tax laws (20 years).

The tax status of refundable advances is similar to contributions, except that utilities realize a tax deduction upon repayment of the advance. In these cases, the utilities should increase the amount of the advance to compensate for carrying charges on borrowings to pay income taxes until the advance is repaid.

¹ A change in tax rates or tax status in the future may alter the amount or recovery pattern of tax benefits. In such cases the utility should also prepare adjustments for the shortfall or excess.

c. Small water utilities

The treatment of tax payments on CIAC is not easily resolved for small (other than Class A) water companies. These companies are often financially weak, have uncertain tax situations, and have limited administrative capacity to account for the tax consequences of contributions. Many of these companies depend exclusively on customer contributions for construction funds, so tax considerations are important. Under such conditions, the gross-up method appears to be the only sound approach.

We shall adopt the following guidelines for small water companies:

- 1) The present-value method or some variation of customer-contributed financing should generally be used. Subchapter S corporations and unincorporated companies should use the incremental tax rates for taxable corporations in their tax bracket.
- 2) The gross-up method should be used only where external financing sources are not available.
- 3) Utilities using the gross-up method must keep records of collections for contributions and taxes by customer and provide for a repayment schedule as tax benefits are recovered. Any utility collections for taxes on CIACs that are not paid to the government must be preserved for disposition to payers. Subchapter S and unincorporated companies should compute their tax status as if they were stand-alone corporations for purposes of compliance with this provision.

d. General

Our future treatment of taxes on CIACs will depend in large measure on forthcoming regulations and other rulings issued by the Treasury Department and the IRS. These rulings may affect

the economics of one or more of the options or create new opportunities for cost savings. Therefore, our resolution of the issues is subject to further review as these rulings are issued, or as other developments arise.

Finally, the taxation of CIACs introduces a fundamental question about the propriety of the use of customer contributions to finance plant additions. The new tax adds a significant, up-front cost that may exceed 50% of the amount required for construction itself. This burden will fall especially hard on customers of small water companies that depend exclusively on customer funds for plant additions, either through surcharges or other general tariff provisions.¹ Accordingly, we stand ready to consider reasonable alternatives to customer contributions for plant expansion by both water companies and other utilities in general.

B. Interest on Interim Deferred Tax Savings (or Costs)

Staff proposed to include a return allowance on the net effect of cash inflows (or outflows) generated by TRA-86 during the interim period the funds are retained (or foregone) prior to inclusion in rates. Staff did not specify the interest rate, but its apparent intent was to employ the overall rate of return.

¹ Some such companies might be in lower tax brackets or tax loss positions, which would, of course, reduce exposure to the taxation.

Brooklyn Union proposed a rate based on the interest rate applicable to over- and under-collections stemming from Gas Adjustment Clause charges. This rate is currently 8.5%, which is well below the overall rate of return for all major utilities. Brooklyn Union sought to apply the interest charge only to the change in income taxes payable, not the other favorable cash flow enhancements.

Con Edison argued that consistency and reasonableness in the treatment of funds held in deferred accounts require that any tax savings it defers should not accumulate interest prior to their inclusion in rates. Con Edison claimed that it is neither earning a return nor accumulating interest on most deferred expenses, and that this treatment is consistent with our practice of not allowing carrying charges on authorized deferred expenses prior to their inclusion in rates.

We conclude that the carrying charges should be based upon a utility's overall rate of return, because this approach is fair to utilities and ratepayers and consistent with our treatment of tax deferrals for ratemaking purposes. Brooklyn Union's proposal would make sense if the TRA-86 benefits/costs were of short duration. But the new law also results in drastic reductions in cash flow from investment tax credits, accelerated depreciation, unbilled revenues, and other sources that will affect the companies over a longer period of time. On the other hand, the companies retain interim benefits from lower deferred taxes and lower tax rates, benefits which have shorter term

implications but may last as long as two years. In order to achieve consistency, and considering the fact that the equity component is net of potential tax savings, we find that the overall rate of return is reasonable.

Contrary to Con Edison's contention, we have allowed a return on deferred costs where the return allowances have a substantial impact on earnings. For example, we ordered continuation of AFC with respect to the costs of the abandoned Sterling and New Haven projects until rate recovery commenced.¹ The cash flow effects of TRA-86 are themselves significant, and a carrying charge is proper under the deferral accounting procedure we have adopted.

The base for computing carrying charges should include:

1. The change in current tax expense (old law vs. TRA-86);
2. The change in deferred tax expense (old law vs. TRA-86); and
3. The change in investment tax credits realized (old law versus TRA-86) in the fiscal year ended in 1986.²

¹ Case 27794 - Sterling Loss Proceeding, Opinion No. 82-1 (issued January 12, 1982); Case 27811, New Haven Loss Proceeding, Opinion No. 84-25 (issued September 19, 1984).

² This treatment is provided to compensate utilities for cash flow losses due to the elimination of investment credits for 1986 fiscal years. Current utility rates were predicated on the availability of those benefits but the IRS eliminated them on a retroactive basis. As explained below, we have not provided for a return for fiscal years ended in 1986 because those years are closed.

The carrying charges should commence when the benefits of TRA-86 are realized..

Finally, we reject Brooklyn Union's proposal to apply the interest charge only to the change in Federal income taxes payable (the difference between higher taxes payable under the old tax law versus TRA-86). This proposal ignores the cash flow impacts of changes in deferred taxes. In addition, Brooklyn Union used a method based on the cumulative difference in current taxes payable. Our approach is based on the use of monthly average balances, which more precisely measures changes in cash flow.

C. Reserve for Bad Debts

TRA-86 limits tax deductions for bad debts to actual bad debt write-offs; the balance in any existing tax reserves for bad debts is to be included in taxable income ratably over a four-year phase-in period. Staff proposed to flow through the tax on bad debts by increasing current income tax expense over the same four-year period prescribed by TRA-86. The revenue requirement effect of staff's proposal, which amounts to an increase of about \$16 million annually on a statewide basis, is relatively insignificant.

CPB opposed staff's proposal and recommended deferral of the tax effects of eliminating bad debt reserves, which would require the utilities to finance the higher tax payments. CPB offered no further support for its proposal.

Brooklyn Union observed that it received permission to defer current timing differences resulting from the book versus tax deduction for bad debts in a prior rate case¹ and proposed to continue this practice. The company recommended that we consider deferral of all temporary income tax differences, as currently defined in the Financial Accounting Standards Board's (FASB) Exposure Draft on the proposed Accounting for Income Taxes, issued in September 1986.

1. Prior Years' Deductions

The new tax law limits the deduction for bad debts to actual write-offs; thus utilities will have to repay the government for more generous allowances permitted under the prior law. Because we established the ratemaking treatment for bad debt tax deductions under the prior law on a case-by-case basis, we shall require as well that the funding for the higher tax payments under TRA-86 conform to the particular circumstances of each utility.

Some companies, like Brooklyn Union and Con Edison, have established reserves for the higher tax deductions allowed in the past. These reserves provide a cushion to offset the payback of bad debt deductions required by TRA-86. Other utilities, however, have passed through the prior deductions in either lower customer rates or higher corporate earnings.

¹ Case 28380 - Brooklyn Union Gas Company - Gas Rates, Opinion No. 83-21, issued October 19, 1983.

We shall maintain the same accounting for the payback of excess deductions as the company used when it claimed these deductions in the past. Utilities with existing reserves should maintain those reserves to absorb the impact of higher taxes. All other utilities should fund the higher taxes through increases in current tax expense, consistent with the treatment used in the past when these deductions were realized. The utilities in the latter group may claim the increase in current tax expense in revenue requirements; however, recoupment of these outlays will depend on a demonstration that ratepayers have received the tax benefits of bad debt accruals in the past.

CPB's proposal for normalization fails to address the disposition of the deferred amounts. In addition, it makes little sense to start a normalization program where, as here, the government is not only limiting deductions prospectively, but also requiring a payback of prior deductions. In retrospect, a generic normalization policy would have been sound, had we known the temporary nature of the liberal deductions allowed in the past. However, unless that option was used in the past, as in the case of Brooklyn Union and Con Edison, the lower bad debt deductions should be recovered through increases in current income tax expense.

2. Future years

The use of actual bad debt write-offs for tax purposes generally will result in book/tax differences beginning in 1987. In the past, these amounts have usually been reflected in current

tax allowances for ratemaking purposes. The better course now is to normalize such book/tax differences to provide a matching of the expenses and their tax deductibility, consistent with generally accepted accounting principles.¹

Brooklyn Union's attempt to broaden the deferred tax procedure to include the more comprehensive approach proposed by the Financial Accounting Standards Board is premature, since the FASB has not issued its final standards. The regulatory approach to these guidelines should be determined in a subsequent proceeding.

D. Excess Deferred Income Taxes - Other Than Tax Depreciation

The reduction in the maximum corporate tax rate effectively forgives a substantial portion of the deferred taxes collected from customers, but not yet paid to the Treasury, resulting in an excess deferred tax balance.² There are a number of deferred tax reserves, unrelated to depreciation, which we authorized either for cash flow purposes or to maintain our policy

¹ For utilities using a "flow-through" method prior to 1987, any write-offs in 1987 and subsequent years that are applicable to pre-1987 accruals should be excluded from the normalization.

² The new tax law requires that the excess deferrals related to accelerated depreciation be amortized over the remaining lives of the property which generated the deferred taxes, according to a prescribed formula; this treatment is not in dispute. For flow-through companies, no normalization of tax depreciation was required by IRS for tax systems employed before ACRS. Thus, for example, deferred taxes attributable to the ADR system do not appear to be controlled by the new tax law. We shall require continuation of these deferrals until further study is completed.

of deferring temporary tax benefits (in some cases, the tax effect creates a cost, i.e., decommissioning expenses). These net discretionary reserves may be returned to customers over a short period of time.

Staff suggested that the excess (or shortfall) in these reserves be returned (or recovered) over the same time period as provided for the related assets or liabilities. Staff's proposal would maintain existing credit quality measurements, such as cash flow and interest coverage, and would provide a cushion against possible future increases in tax rates, which would require rate increases not only to pay the higher tax rates but also to restore depleted reserves. Ratepayers would continue to receive the benefit of rate base deductions.

Staff estimated a statewide revenue requirement impact of net excess deferred tax reserves of about \$350 million, with the benefit falling mostly on two utilities. LILCO has about \$175 million of excess tax reserves because tax normalization has been used for many years to maintain minimal cash flows. New York Telephone, the largest utility in the state, has about \$100 million of excess reserves.

CPB objected to staff's proposal and recommended instead that any excess in deferred income taxes, other than accumulated tax depreciation, be flowed through to customers within two years, absent a serious cash flow problem. For utilities with such problems, CPB would accelerate the flow through of excess deferred

taxes when the large construction project causing financial distress is completed or abandoned.

Under TRA-86, we have ample discretion to determine the time period for disposition of excess tax reserves, other than those relating to accelerated depreciation. Therefore, we conclude that the excess deferred tax reserves should be returned to ratepayers as soon as practicable consistent with our existing policy, which spreads the impact of unusual one-time costs or credits over a controlled period in order to avoid abrupt rate fluctuations. We also recognize that in some cases the financial considerations that led us to authorize normalization militate against immediate refunds of the excess deferred tax amounts. Accordingly, we will determine the disposition of the excess tax reserves on a case-by-case basis. These excess reserves should be segregated in separate sub-accounts. Of course, during the retention period, ratepayers will be compensated by rate base deductions.

E. Unbilled Revenues

The Act requires utilities to include unbilled revenues in taxable income for the year in which the underlying utility services are rendered to customers. The companies most affected by this change are the electric, gas and water utilities that bill 30 to 60 days (or longer) in arrears. Telephone companies charge in advance for a significant portion of their services and are not similarly affected by this change. Staff estimated that the

statewide impact of this change would be an increase in taxes payable of about \$230 million, which, under the new law, can be spread ratably over a period not exceeding four years.

Staff recommended that the utilities defer recognition of the higher taxes, an approach that increases working capital (rate base) requirements so that the higher expense does not increase rates currently. Con Edison opposed staff's normalization proposal and urged that we treat the increased taxes related to unbilled revenues as immediate offsets to the lower tax rate. The company argued that taxation of unbilled revenues is nothing more than an increase in taxes payable designed to offset the reduction in federal revenues due to the lower corporate tax rates. Con Edison also claimed that the law would increase current tax payments by \$80 million over a four-year period. Con Edison also objected to financial recognition of unbilled amounts as "revenue" since actual realization is dependent on future events, such as meter reading and billing for service. Thus, Con Edison urges that we reject the accrual of unbilled revenues for financial and ratemaking purposes, and instead allow the tax on these revenues as a current expense.

LILCO, on the other hand, proposed to record unbilled revenue in a manner consistent with the tax treatment. It said that this treatment matches revenues and expenses in accordance with generally accepted accounting principles.

CPB stated that it might be beneficial to reflect the full impact of the change in recording unbilled revenues in 1986

(even though TRA-86 prescribes a four-year phase-in) to maximize the use of investment tax credits for utilities with substantial carryovers.

In similar cases involving tax timing differences, we have required a "matching" procedure to defer the effect of the higher taxes until such time as the underlying revenues are realized. Therefore, we shall adopt staff's proposal and require the utilities to finance the higher taxes.

With respect to Con Edison's claim that the collection of unbilled revenues is uncertain, and thus precludes recording of the amounts on financial statements, we note that this position attaches an overly strict standard to the financial recognition of these assets. The accrual of unbilled revenues is proper under generally accepted accounting principles where service has been rendered and the amount owed can be reasonably estimated. Further, most utilities record at least a portion of unbilled revenues on financial statements without objection. We will, however, review this issue and other cash flow factors in a separate proceeding we shall initiate on the ratemaking treatment for unbilled revenues. Until that review is completed, we shall require deferral accounting for unbilled revenues.

CPB's proposal to include all unbilled revenues in 1986 taxable income in order to accelerate recovery of investment credit carryovers would have negative consequences. First, it would increase 1986 income taxes above normal levels for affected utilities because of IRS limitations on the amount of credits that

may be taken against taxes in one year. The greater credits realized would only partially benefit ratepayers because the law requires a sharing of the benefits with stockholders, and we would have to provide for recovery of the higher tax payments. Moreover, the increase in cash flow provided by the credits would be offset by negative cash flow consequences of higher taxes on unbilled revenues. Therefore, we reject CPB's proposal.

Finally, we note that the staff proposal to defer the tax on unbilled revenues was directed primarily toward electric utilities that do not fully record these revenues. Most gas, telephone, and water utilities accrue for unbilled revenues; thus, they should also record related expenses, including income taxes. These utilities should offset the tax on unbilled revenues against the reserves set up for this expense. Further, the tax savings resulting from recording the tax reserves at the former 46% rate as compared to actual payments at the lower current tax rate should be preserved for ratepayers in accordance with the overall objective of this proceeding.

F. Alternative Minimum Tax

TRA-86 imposes a more severe alternative minimum tax (AMT) than the prior law. For the near term, the tax affects mainly utilities with heavy construction programs, or rate moderation plans, since one-half of the allowance for funds used during construction (AFC), or its post-operational equivalent, is now taxable. The entities subject to the AMT are entitled to credits against future normal tax liabilities.

The conditions under which the AMT will apply in New York will probably be temporary since cash income will replace AFC as the major plants under construction are included in rate base. Since utilities will realize tax credits in the future in exchange for higher immediate AMT payments, staff proposed to defer the AMT. This treatment requires affected utilities to finance the additional payment, and avoids increasing current income tax expense. Staff viewed its proposal as consistent with our customary deferral practice with respect to temporary income tax levies and credits.

Four utility respondents either objected to the staff proposal or requested modifications and clarifications. RG&E proposed a modification that would allow current recovery of the AMT in the event that circumstances indicated that an extended period of time would pass before a company returned to normal tax status. Niagara Mohawk proposed that utilities with no pending rate case that use deferred accounting to preserve the benefits of TRA-86 for ratepayers be permitted to offset the AMT directly against tax savings from the lower tax rate on an interim basis. Under Niagara Mohawk's approach, once the impact of TRA-86 is included in rates, staff's approach would apply.

Shorewood Water Corporation argued that the AMT should be allowed in current rates because the tax is assessed on utilities that are in the poorest financial condition and are least able to finance the cost.

LILCO expressed concern that, while the staff proposal would reduce overall federal income tax expense for ratemaking purposes, TRA-86 could have a severe impact on its cash flow and, consequently, its financial condition. LILCO stated that the AMT provision would increase its taxes payable by \$30 million despite carryover losses and investment tax credits. LILCO did not explicitly object to the staff deferral proposal for the AMT, but recommended a clarification that would permit inclusion of the AMT in current rates "if and when the utility will not receive a credit for the AMT payment in future years."

We recognize that staff's AMT proposal will add to external financing pressure for utilities in the greatest need for cash flow relief. But it is unwise to subordinate staff's basically sound ratemaking approach to a less desirable alternative without a specific demonstration of need. Thus, we shall adopt staff's deferral approach for the AMT. Utilities, however, may request waivers from the general accounting and ratemaking guidelines for company-specific factors, such as severe financial stress.

As RG&E suggests, future conditions may require a change from deferral to current expensing of the AMT; the need for any such change, however, would occur gradually and allow ample time for reaction. Such conditions are not present now and we will not adopt RG&E's proposal for a blanket exception to the deferred accounting guidelines for AMT.

The modification proposed by Niagara Mohawk for utilities with no pending rate case is largely moot, since all the major companies affected by the AMT have filed rate cases.

Finally, Congress enacted an "environmental tax" (superfund legislation) at about the same time as the passage of TRA-86. The tax is imposed on alternative minimum taxable income (AMTI), effective January 1, 1987. Since this relatively minor tax is a new income-based tax, we will allow the utilities to include it in the deferral treatment accorded AMT.

III. Miscellaneous

In this section we will provide utilities with guidance on specific accounting practices consistent with our current understanding of the requirements of TRA-86. As noted above, we may revise or supplement our policies as regulations and rulings are issued by the Treasury Department and the Internal Revenue Service.

A. Capitalization Rules

The new law repeals tax deductions for most indirect costs allocated to construction, including pensions, payroll taxes and interest incurred during construction. Staff noted that the repeal generally conforms the tax treatment of these capitalized overheads with our accounting for regulated utilities. For companies that flow through these deductions, the change will cause upward pressure on rates; companies that already normalize these deductions will see less noticeable effects.

RG&E and Niagara Mohawk pointed out that the amount of interest capitalized for book purposes would not be the same as the amount of interest capitalized for tax purposes. The new law requires capitalization of construction period interest applicable to the following types of property:

1. Property with a class life of 20 years or more under the new depreciation rules; or
2. Property estimated to have a construction period of more than two years; or
3. Property estimated to have a construction period of more than one year and costing more than \$1 million.

It appears that, under TRA-86, the IRS has imputed an artificial capital structure in which all eligible construction projects are presumed to be financed by debt. Therefore, the capitalization of all interest for tax purposes will most likely exceed the interest we assign to construction under AFC allocation procedures, which also includes an equity component.¹ The additional interest capitalized for tax purposes will increase current income tax expense.

Under our assumptions for accounting and ratemaking, construction period capital costs are generally allocated consistent with the corporate capital structure. Ratepayers should receive the benefit of the interest deduction on rate base (including non-interest bearing construction) for which they

¹ Telephone companies are less affected because of favored tax treatment permitted for the construction of central office equipment.

provide a current return. Therefore, we conclude that utilities should normalize the income tax expense for the additional interest required to be capitalized for tax purposes. Our intent is to align the interest expense deduction for tax purposes with the interest expense for financial accounting and ratemaking purposes. This result is achieved by deferring the difference between interest capitalized on the tax return and the debt component of AFC times the AFC base (excluding grandfathered projects). The resulting deferred tax (predominantly a rate base addition) should be amortized over the life of the plant once it is placed into service.

B. Measurement Period

Under staff's proposal, the amount of TRA-86 tax savings preserved for future disposition would be measured by the difference between taxes calculated using the prior law tax and TRA-86. Utilities would compute current and deferred income tax expense on the basis of TRA-86 using actual monthly financial results. The monthly results must then be converted to an equivalent amount of income tax expense under the prior law. The difference is then preserved for, or owed by, ratepayers and recorded in Miscellaneous Adjustments of Income Taxes - Operating. These entries should also include adjustments for increases or decreases in rate base, including working capital, caused by cash flow changes. Staff urged that the impact of major plant additions be excluded from the computation.

Long Island Water recommended that staff's proposal be modified to reflect weather normalized sales. Although staff's proposal discussed different measurements, we have selected historical data as the most representative of the actual effect of the tax changes. This approach also offers simplicity of application and will minimize disputes.

Several utilities sought to modify staff's monthly deferral computation. AT&T, which has no plans for a general rate filing to be effective before December 31, 1988, sought an annual computation and said Staff's approach would impose unnecessary costs. We believe that any incremental costs would be more than justified by the benefit of more accurate monthly financial statements. Of course, the utilities may use estimates and make year-end adjustments, where appropriate.

NYSEG, Brooklyn Union, Rochester Telephone and ALLTEL recommended that consideration be given to the carrying costs necessary to pay the increased tax liability commencing in 1986, resulting from lost investment tax credits. The carrying costs for credits lost in 1986, however, have already been reflected in income statements for that year and we find that special treatment is unnecessary.

Central Hudson recommended that the impact of major plant additions be included in the deferral calculation to obtain more accurate results. The company may have misinterpreted staff's proposal, for it recognized that many provisions of TRA-86 would not apply to Nine Mile 2 and Shoreham because of grandfather

provisions.¹ The intent is not to ignore the impact of TRA-86 on these plants, but, rather, to segregate the effect so that we may review the overall impacts of these plants in isolation.

Central Hudson also said it was unclear whether staff intended that the interim deferred amounts for the period prior to the rate year in its pending rate case (i.e., the seven months ending July 31, 1987) be reflected in rates set in that rate proceeding. According to the company, it would be impractical to reflect all of the deferred amounts; for example, the deferred amounts for June and July 1987 would not be calculated by the time of our decision in the case, and the deferred amounts would be subject to the retroactive application of certain year-end adjustments. Central Hudson recommended that the deferred amounts be carried over to a future rate year or used to eliminate other deferred expenses.

The disposition of interim TRA-86 deferred benefits up to the time of the rate decision should be addressed in the pending rate case. Just as reasonable estimates are computed for the various cost-of-service elements, we believe a reasonable estimate can be made for the deferred TRA-86 benefits. Any material difference between the estimated and actual deferral should be captured in the company's next rate filing.

Niagara Mohawk argued that a deferral mechanism was unnecessary for the first three months of 1987 because the tax rate does not change until July 1, 1987. The new tax law,

¹ Under TRA-86, Nine Mile 2 and Shoreham are grandfathered, provided they go into service before January 1, 1991.

however, clearly requires blended rates for calendar year taxpayers, such as Niagara Mohawk (40% for 1987), and the company's proposal is, therefore, rejected.

Finally, we reiterate that our policy is to preserve all TRA-86 benefits for eventual disposition to ratepayers, including interim period benefits for the gross-up effect, revenue taxes, and other impacts. Proposals for disposition of interim period and ongoing tax changes should include the coincidental benefits.

C. Qualified Progress Expenditures

Staff noted that investment tax credits claimed with respect to Qualified Progress Expenditures incurred before January 1, 1986 are not affected by the investment credit repeal or the phased-in 35% reduction. NYSEG correctly pointed out that later information indicates that these credits will be subject to the restrictions. Companies affected by this change, particularly LILCO and NYSEG, should account for these restrictions accordingly.

D. Exemptions from Deferral Treatment

Many water utilities do not have the accounting records or the capability to conform to our deferral mechanism. Therefore, we shall restrict the deferral accounting requirement for the 13 water companies classified as Class A, B, or C under

the recent revisions of the Uniform System of Accounts.¹ Our policy will effectively exclude from deferral accounting all water utilities with annual operating revenues of less than \$400,000, rather than the \$100,000 cutoff staff initially proposed. The ongoing effects of TRA-86 should be included in the small companies' future rate filings.

We shall not require telecommunications other common carriers (OCCs) and resellers to use deferral accounting, because we do not actively regulate their rates.

Penelec sought an exemption from the deferral proposal. It stated that we have followed the Pennsylvania Public Utility Commission's rate decisions in six consecutive rate proceedings, dating back to 1972, and noted that its New York operations constitute about 1% of its total operations. Penelec has proposed to reduce base rates for 1987 and 1988 TRA benefits in a pending Pennsylvania rate case and will pass along these benefits to its New York customers shortly after the case is resolved. We find Penelec's proposal reasonable, and we will grant the exemption.

Finally, we include in Appendix B other TRA-86 effects on utilities. These features did not generate significant controversy in the parties' comments.

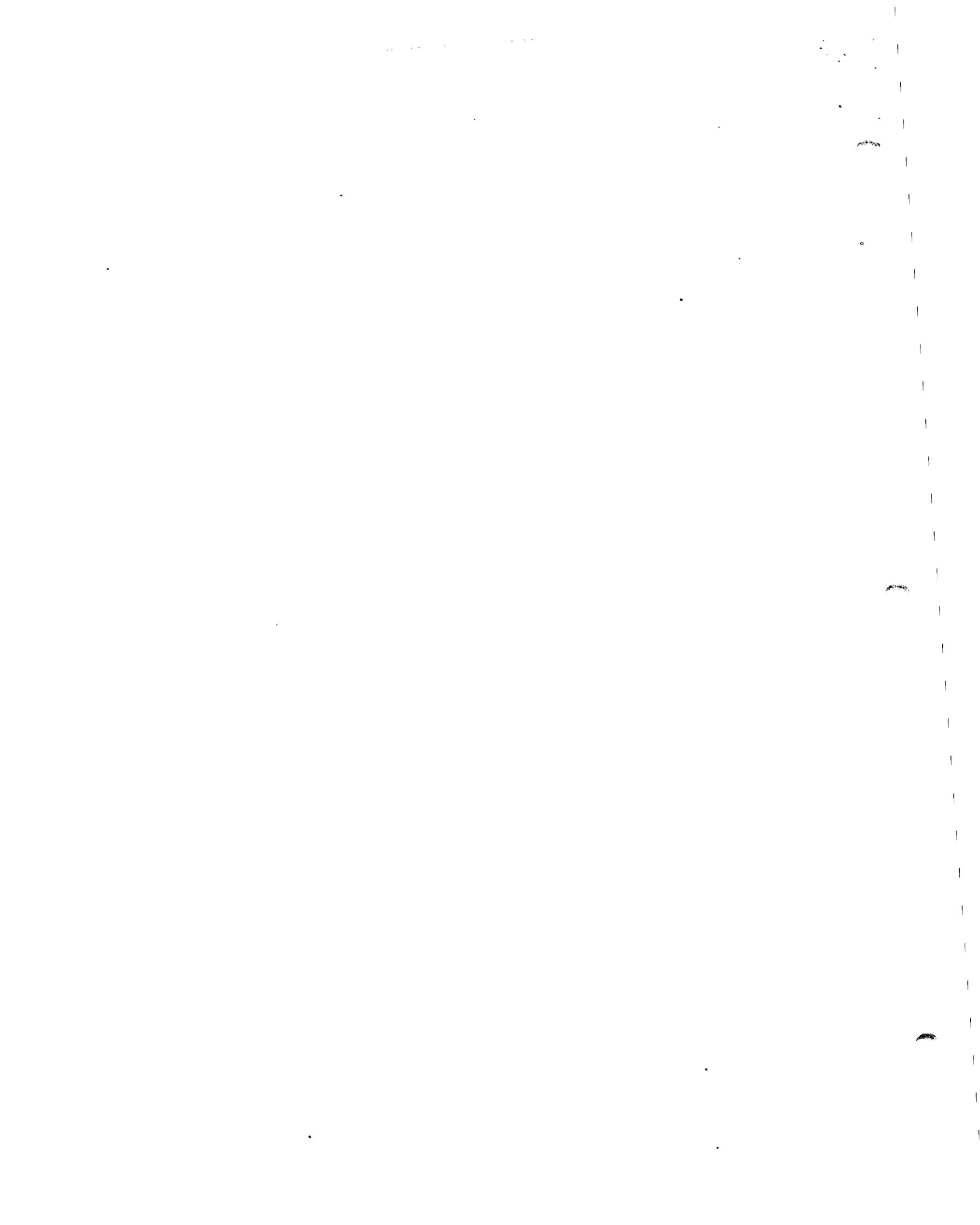
¹ These companies are: Jamaica Water Supply Co.; Spring Valley Water Co., Inc.; Long Island Water Corp.; New Rochelle Water Co.; New York Water Service Corp.; New York-American Water Co., Inc.; Citizens Water Supply of Newton; Sea Cliff Water Co.; Wanakah Water Co.; Country Knolls Water Works, Inc.; Owego Water Works; Shorewood Water Corp.; and Sterling Forest Water Corp.

CONCLUSION

On the basis of our review of the parties' comments and our further consideration of staff's recommendations, we shall adopt the foregoing procedures and policies for implementing TRA-86. Utilities shall conform their practices to these procedures and policies.

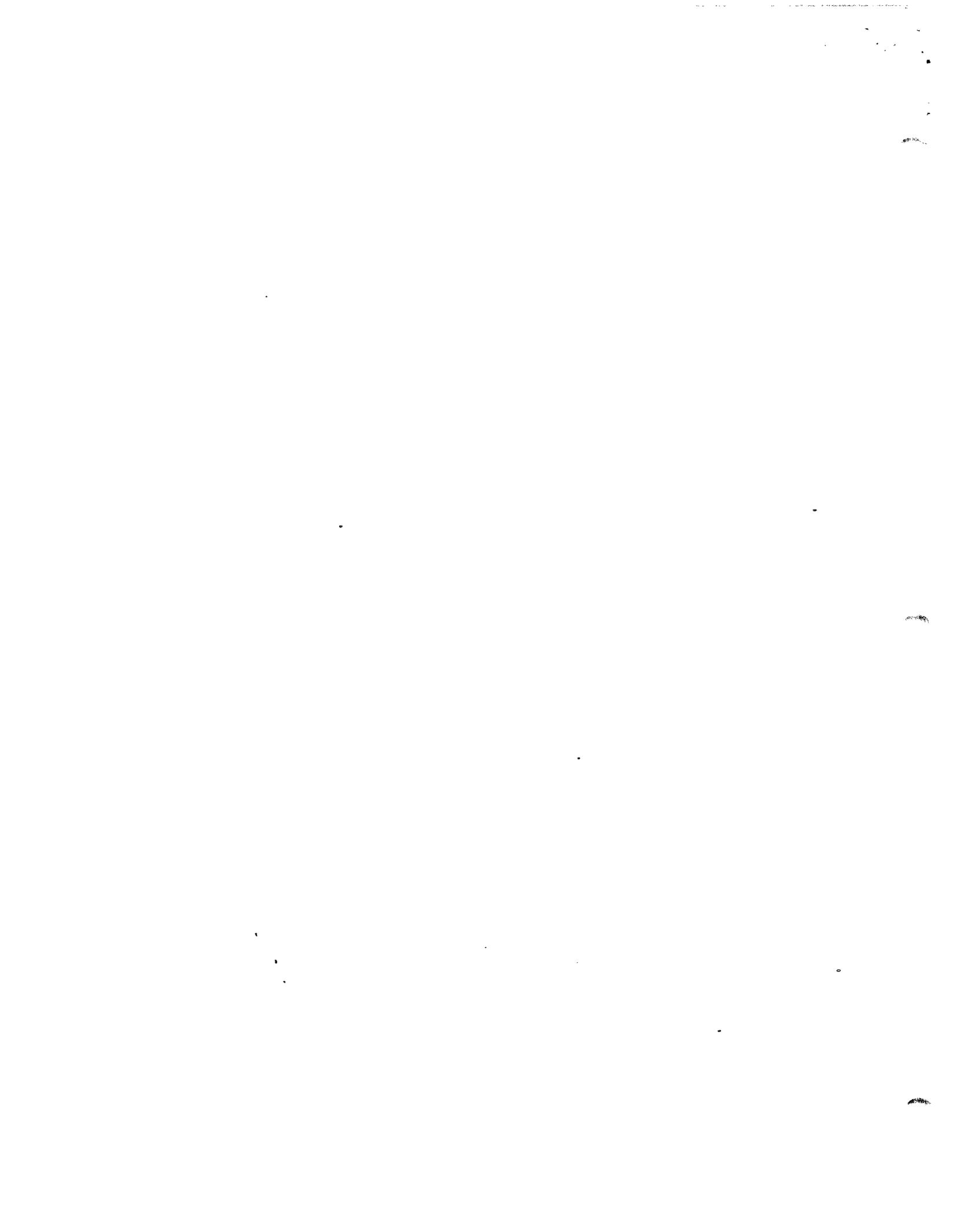
We may consider changes in our approach in light of IRS or Treasury Department rules or interpretations. In addition, we stand ready to consider individual exemptions from the prescribed procedures upon a showing of good cause.

Finally, affected utilities are free to consult with the Director of Accounting and Finance regarding specific questions that arise as these policies are implemented.



Respondents to Staff's Proposal
for Implementation of the
Tax Reform Act of 1986

Central Hudson Gas and Electric Corporation
Consolidated Edison Company of New York, Inc.
Long Island Lighting Company
New York State Electric and Gas Corporation
Niagara Mohawk Power Corporation
Orange and Rockland Utilities, Inc.
Rochester Gas and Electric Corporation
Pennsylvania Electric Company
The Brooklyn Union Gas Company
Pennsylvania and Southern Gas Company
AT&T Communications of New York, Inc.
ALLTEL New York, Inc.
Continental Telephone Company of New York, Inc.
Edwards Telephone Company, Inc.
New York Telephone Company
Rochester Telephone Corporation
Country Knolls Water Works, Inc.
Long Island Water Corporation
New York - American Water Company, Inc.
Shorewood Water Corporation
Wanakah Water Company
Attorney General - State of New York Department of Law
New York State Consumer Protection Board
New York State Builders Association, Inc.
The City of New York
Gold Bond Building Products



Tax Reform Act of 1986
Explanation of Other Changes
Affecting Public Utilities

Investment Tax Credit

1. Transition Rules - The Investment Tax Credit would be available for property constructed, reconstructed, or acquired under a binding commitment as of December 31, 1985. In addition, property under this transition rule must be finally placed in service by specific dates according to their ADR lives. These are: ADR life of at least five but less than seven years, January 1, 1987; ADR life of at least seven but less than twenty years, January 1, 1989; and ADR life of at least twenty years, January 1, 1991.

2. ITC Carryover Rules - Under prior law, unused credits for a taxable year could be carried back to each of the three preceding taxable years and then carried forward to each of the fifteen following taxable years. The Act reduces ITC carryovers by 35% for taxable years beginning on or after July 1, 1987. For tax years straddling that date, the decrease is prorated. For example, for a calendar year taxpayer, the 1987 reduction is 17 1/2%. The reductions apply to credits claimed under transitional rules provided by the bill and credits that are carried forward from years prior to January 1, 1986. The amount by which the credit is reduced will not be allowed as a credit for any other taxable year.

3. Qualified Progress Expenditures - Credits claimed with respect to Qualified Progress Expenditures (QPEs) incurred before January 1, 1986 are not affected by the ITC repeal or the phased-in 35% reduction. However, carryovers of credits attributable to QPEs are subject to the general rules providing for a reduction in carryovers. After December 31, 1985 credits for qualifying QPEs cannot be claimed unless it is reasonably expected that the property will meet the applicable in-service date requirement for transition property.

4. General Business Credit Limitation - Under prior law the general business credit (ITC, research credit, targeted jobs credit, and employee stock-ownership credit) could offset tax liability by up to \$25,000 plus 85% of tax liability over \$25,000. Under the Act, the 85% is reduced to 75%.

Tax Reform Act of 1986
Explanation of Other Changes
Affecting Public Utilities

Depreciation

1. Class Lives - The prior tax depreciation law provided classes of 3, 5, 10, and 15 years for tangible personal property and a 15 year class for real estate. TRA-86 provides class lives of 3, 5, 7, and 10 years (each 200% declining balance), 15 and 20 years (each 150% declining balance), for tangible personal property, and a 31.5 year straight-line class for non-residential real property. In each of the above classifications, with the exception of non-residential real property, the cost of the property is recovered using an accelerated method, which switches to straight-line at a time to maximize the deduction.

2. Transition Rules - Generally, the provisions that modify ACRS apply to all property placed in service after December 31, 1986. Exceptions to the applicability of this transition date are similar to those for ITC. In the case of ACRS, the new rules do not apply to property that is constructed, reconstructed, or acquired pursuant to a written contract that was binding as of March 1, 1986. Also, the rules do not apply to any property unless it has an ADR midpoint of seven years or more and is placed in service before the applicable date, determined according to the following: (1) for property with an ADR midpoint less than twenty years, January 1, 1989; and (2) for property with an ADR midpoint of twenty years or more, January 1, 1991.

Alternative Minimum Tax

The tax base for the corporate alternative minimum tax is the corporation's regular taxable income to which is added tax preferences. An exemption of \$40,000 would be available to those companies with alternative minimum taxable income (taxable income plus tax preferences) of \$150,000 or less. The exemption decreases, on a sliding scale, reaching zero for companies with alternative minimum taxable income of \$310,000. The net income remaining (taxable income plus tax preferences less an exemption amount) is subject to tax at a 20% rate. A corporation's tax liability for any given tax year would be the greater of (1) its regular income tax liability; or (2) the alternative minimum tax.

Tax Reform Act of 1986
Explanation of Other Changes
Affecting Public Utilities

Business Meals and Entertainment

Beginning in 1987, the deduction for business meals and entertainment (including meals away from home) is limited to 80% of those expenses.

Accrued Vacation Pay

Under prior law, an employer could make a special election to deduct currently vacation pay expected to be paid within twelve months after year-end. Under the Act, an employer's deduction for vacation pay under this elective method is limited to amounts paid during the tax year or paid within 8 1/2 months after the end of the year.

Research and Development Credit

The 25% credit for increases in research activities is reduced to 20% and is extended through 1988. The definition of qualified research has been narrowed to include only research in experimental expenditures which are technological in nature, useful in developing new or improved business components, and are elements of a process of experimentation relating to functional aspects of the business items.

Excess Deferred Taxes - Accelerated Depreciation

The Act requires an amortization of excess deferred taxes over the life of related property according to a formula called the "average rate assumption method." Under this approach the reversal of timing difference occurs at the average tax rate under which the deferred taxes were accumulated. The penalty for non-compliance is loss of accelerated depreciation deductions.

